EFRAG
European Financial Reporting Advisory Group

EFRAG SECRETARIAT PAPER FOR PUBLIC EFRAG BOARD MEETING

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of the EFRAG Board. The paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Insurance Contracts
Issues Paper

Objective

1 The objective of this paper is to:

(a) update the EFRAG Board on how the IASB intends to amend the forthcoming IFRS 17 *Insurance Contracts* in response to the results of the July-September 2016 field test ("the field test"). The topics covered by the field test relate to:

(i) Aggregation of contracts;

(ii) Scope of the variable fee approach;

(iii) Derivatives used to mitigate financial market risk;

(iv) Finance income and expense;

(v) Changes in estimates; and

(vi) Transition.

(b) Seek the preliminary views of the EFRAG Board on the proposed approach to preparing EFRAG for a request for endorsement advice from the European Commission.

2 For each of the issues referred to under paragraph 1(a), this paper summarises:

(a) The IASB's proposals prior to the field test;

(b) The results of the field test as reported by the European companies involved in the field test; and

(c) The IASB's response to the comments from the field test.

The insurance business model

3 As a very broad generalisation, the insurance business is about collecting premiums from insured parties in return for making payments on the occurrence of specified events. The insurance business relies on the pooling of risks between insured parties. For example, assume a life insurance policy is sold to a 30-year old male. The premium charged will depend on a range of actuarial assumptions. If only one policy was sold, it is very unlikely that the estimates of risks included in the actuarial assumptions would occur exactly as expected. However, over a large group of 30-year old males, it is likely that *on average* events will occur as expected (this is known as the law of large numbers).

4 It is this business model that creates misunderstanding about the term "mutualisation". Broadly, the term is used in two ways:

(a) By some in the insurance industry, to denote the economic pooling of risk among a large class of policyholders with premiums based on actuarial estimates of the average level of risk. The class of policyholders may be limited to 30-year old males, extended to all those with similar life insurance policies or extended to policies with other contractual features. The law of large numbers leads to actual outcomes being close to actuarial estimates. It is important to note that in this use of the term, each insurance policy is between the insurer and the insured party (although it can be argued that economic cross-subsidisation between policyholders of specific products is inherent to the business model).

(b) By the IASB, where mutualisation was used in some IASB staff papers to denote the contractual sharing of risks between policyholders. That is, any claim from an insured party would be met from (i) other policyholders and, if necessary, (ii) the insurance company. To avoid confusion, the IASB is no longer using the term mutualisation.

Aggregation of contracts

The IASB's proposals prior to the field test

5 On initial recognition of an insurance contract, the insurer would calculate the fulfilment cash flows as the net present value of the cash inflows and outflows (including a risk adjustment) for each contract:

(a) Where the fulfilment cash flows are positive, a contractual service margin (CSM) would be established equal to the fulfilment cash flows. The CSM represents the unearned future profits and leads to a zero liability at the inception of the contract.

(b) Where the fulfilment cash flows are negative, the contract is onerous and the loss is recognised in profit or loss.

6 Contracts are aggregated into groups to measure the CSM after initial recognition. Groups consist of insurance contracts with:

(a) Future cash flows that are expected to respond similarly in terms of amount and timing to changes in actuarial assumptions; and

(b) Similar expected profitability.

Results of the field test

7 The companies involved in the field testing reported:

(a) The criteria described in paragraph 6 above lead to an excessive level of granularity, resulting in a very large number of portfolios; and

(b) The relationship of the level of aggregation with mutualisation (as understood by some in the insurance industry – paragraph 4(a)) is unclear.

IASB's response to the field test

8 The IASB responded to the comments received by:

(a) Removing the need for a group of contracts to have similar expected profitability, so that contracts that are subject to similar risks and managed together as a single pool are grouped together;

(b) Groups cannot include contracts that are issued more than one year apart (i.e. contracts are divided into "annual cohorts");

(c) Groups are divided into:

(i) Contracts that are onerous at inception;

(ii) Contracts that have no significant risk of becoming onerous; and

(iii) Other profitable contracts.

9 Subsequent to the IASB meeting, industry representatives raised concerns that the final wording was needed before the effect of the change could be fully assessed. However, they were concerned about the introduction of annual cohorts and that the separation into three categories did not align with business practice.

Scope of the variable fee approach (contracts with direct participation features)

The IASB's proposals prior to the field test

10 Contracts are within the scope of the variable fee approach if:

(a) The contract specifies that the policyholder participates in a share of a clearly identified pool of underlying items;

(b) The insurer expects to pay the policyholder an amount equal to a substantial share of the returns from the underlying items; and

(c) This "substantial share" of the cash flows is expected to vary with the cash flows from the underlying items.

Results of the field test

11 Contracts with constructive, but not contractual, obligations are outside the scope of the variable fee approach.

IASB's response to the field test

12 The IASB made no change to the scope of the variable fee approach.

Derivatives used to mitigate financial market risk

The IASB's proposals prior to the field test

13 A specific form of hedge accounting is available for derivatives used to mitigate financial market risk in relation to contracts within the scope of the variable fee approach. This was considered necessary because application of the variable fee approach created a potential mismatch:

(a) IFRS 9 *Financial Instruments* requires entities to measure derivatives at fair value with changes recognised in profit or loss; and

(b) Draft IFRS 17 would require entities that apply the variable fee approach to recognise changes in the fulfilment cash flows resulting from financial risk against the CSM.

14 The IASB decided to enable this mismatch to be avoided by allowing entities to recognise specific changes in the fulfilment cash flows in profit or loss instead of in the CSM, when particular criteria are met.

Results of the field test

15 The companies involved in the field test raised concerns about:

(a) The limitation of this form of hedge accounting to the variable fee approach;

(b) The potential for residual accounting mismatches; and

(c) No provision for macro hedging.

IASB's response to the field test

16 The IASB made minor changes to hedging adjustments within the scope of the variable fee approach but did not extend this to contracts outside the variable fee approach.

17 No changes were made for macro hedging, so insurers have the same options as all other entities.

Finance income and expense

The IASB's proposals prior to the field test

18 IFRS 17 will permit two approaches for disaggregating changes in financial assumptions between profit or loss and OCI for participating contracts that are not within the scope of the variable fee approach:

(a) Use a level systematic allocation over the life of the contract; or

(b) Use a systematic allocation based on the amounts expected to be credited to policyholders.

Results of the field test

19 The companies involved in the field test deem the approach to be complex and, potentially, to create to inconsistencies in earnings patterns and accounting mismatches.

IASB's response to the field test

20 The IASB agreed that an entity should be permitted to recognise part of the finance income or expense relating to the change in the risk adjustment in profit or loss and OCI consistently with the way that the finance income or expense for that group of contracts as a whole is presented.

Changes in estimates

The IASB's proposals prior to the field test

21 The underlying principle is that changes relating to future service are taken to the CSM and changes relating to the past or the present are taken to the statement(s) of profit or loss or other comprehensive income.

22 Changes to expected future cash flows, in particular the amounts paid to policyholders, can result from changes in financial market assumptions or the exercise of discretion by the insurer:

(a) Under the variable fee approach, both types of change are taken to the CSM because they reflect the variable nature of the fee.

(b) For contracts outside the variable fee approach, the impact of the exercise of discretion is taken to the CSM (as relating to future cash flows) and the impact of changes in financial market assumptions is taken to profit or loss or OCI (because these do not relate to future service).

Results of the field test

23 Companies were concerned about:

(a) The lack of clarity as to the meaning of 'discretion'; and

(b) Whether users are provided with relevant information.

IASB's response to the field test

24 The IASB decided that:

(a) Under the variable fee approach, the following should be recognised in profit or loss, rather than adjusting the CSM:

(i) experience adjustments arising from non-financial risk that do not affect the underlying items; and

(ii) any directly-caused changes in the estimates of the present value of future cash flows.

(b) For contracts outside the variable fee approach, when an experience adjustment directly causes a change in the estimate of the present value of future cash flows, the combined effect of the experience adjustment and the change in the estimate of the present value of the future cash flows should be recognised in profit or loss rather than adjusting the CSM.

Transition

The IASB's proposals prior to the field test

25 The proposed approach to transition was:

(a) The full retrospective approach, as if IFRS 17 had always been applied;

(b) If it is impracticable to apply the full retrospective approach, an insurer would apply either:

(i) A modified retrospective approach; or

(ii) A fair value approach.

Results of the field test

26 None of the approaches were considered practical.

IASB's response to the field test

27 The IASB tentatively decided that:

(a) The full retrospective approach should be applied unless impracticable.

(b) For insurance contracts for which the entity cannot identify a group retrospectively, and for groups of insurance contracts for which retrospective application is impracticable, the entity may choose either a modified retrospective approach or the fair value approach. If a modified retrospective approach is impracticable, the entity must use the fair value approach.

(c) In applying the fair value approach, an entity should be permitted a choice on when to make the following assessments:

(i) whether a contract is eligible for the variable fee approach;

(ii) how to group contracts; and

(iii) how to determine the effect of discretion on estimated cash flows for contracts outside the scope of the variable fee approach.

Question for EFRAG Board

28 What further background information would be useful for the EFRAG Board in preparing for the forthcoming IFRS 17 *Insurance Contracts*?

Proposed approach to preparing for the draft endorsement advice

29 Unlike most of the work EFRAG conducts on endorsement, the accounting impact of IFRS 17 cannot be assessed on a Europe-wide basis because of the flexibility provided by IFRS 4 *Insurance Contracts*. In the view of EFRAG Secretariat, a different approach will be needed to assess the potential impact of the new Standard.

30 EFRAG Secretariat proposes a case study approach whereby about 12 companies from a range of jurisdictions will be contacted and asked to assist EFRAG Secretariat by modelling the effect of IFRS 17 on their financial statements. EFRAG Secretariat's tentative view is that the selection should:

(a) represent a range of practices under IFRS 4;

(b) include those companies involved in the IASB's field test; and

(c) include both pure insurers and insurers that are part of a group.

31 Prior to contacting the selected companies, EFRAG Secretariat will review their financial statements to understand their existing practices as a basis for specific requests for information. EFRAG Secretariat would then seek to meet with the relevant operational units within each company in order to explore key issues in depth.

32 As well as understanding the likely impact on the financial statements of the selected companies, EFRAG Secretariat would be seeking information from them that would be relevant for the assessment of the impact of IFRS 17 on the European public good (including the specific elements, i.e. risk of negative consequences on European competiveness, financial stability and economic development). This would include seeking information on:

(a) costs of implementing IFRS 17, by type of cost, separated as far as possible from costs associated with other system upgrades (input to the cost-benefit analysis);

(b) trends in product offerings, to enable a view of the impact on the selected companies beyond the impact at transition (input to the economic development element);

(c) the basis for key assumptions in order to undertake sensitivity analyses/stress testing of the impact on the financial statements (input to the financial stability element); and

(d) comparing the estimated impact on the financial statements with the information provided under Solvency II to understand the size of the differences between IFRS 17 and Solvency II and any ability for the companies to benefit from the work undertaken in reporting under Solvency II (input to various elements).

33 Work that can be started because it does not depend on the case studies with companies includes:

(a) comparison of IFRS 17 with US GAAP, including the proposed changes to US GAAP (input to the competitiveness element);

(b) preparing a survey of users to understand the benefits they expect from IFRS 17 (input to the cost-benefit analysis); and

(c) considering how to identify changes in the behaviour of insurers, policyholders and other parties (especially in their capacity as long-term investors) and the associated effects on the European economy as a whole and the specific

impacts on SMEs if applicable. This is likely to require some element of outsourcing some of the analysis to an economic consultancy (input to financial stability and European economic development elements).

Question for EFRAG Board

34 Do you agree with EFRAG Secretariat's proposed approach to preparing for the endorsement advice to be provided on IFRS 17 *Insurance Contracts*?