EFRAG Board: Educational Session 2

IFRS 17 *Insurance Contracts*

14 December 2017
Agenda paper 11.01

EFRAG
European Financial Reporting Advisory Group

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OVERVIEW

General Model (revisited)

Modifications to the General Model

- Variable Fee Approach
- Premium Allocation Approach
- Reinsurance contracts
- Investment contracts with discretionary participation features

Jargon used

GENERAL MODEL (REVISITED)

GENERAL MODEL – INSURANCE LIABILITY

INITIAL MEASUREMENT

Fulfilment cash flows	Probability weighted expected cash flows
	Discounted
	Risk adjustment
Contractual service margin	

Probability weighted expected cash flows: Includes consideration of a full range of possible outcomes and all cash flows within the contract boundary

Discounted: Consistent with current market and reflects characteristics of insurance liability

Risk adjustment: Compensation required for bearing uncertainty around timing and amount of claims

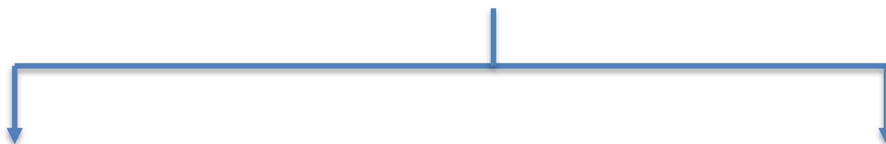
Contractual service margin: Represents unearned profit in the contract that will be recognised over time

Measurement of an insurance contract incorporates all available information in a way consistent with observable market data.

GENERAL MODEL – INSURANCE LIABILITY

INSURANCE ACQUISITION CASH FLOWS DEFINED AS:

Cash flows **arising from the costs of selling, underwriting and starting a group of insurance contracts** that are directly attributable to the portfolio of insurance contracts to which the group belongs.



Insurance liability (Balance Sheet)

CSM on initial recognition considers allocated insurance acquisition cash flows

IFRS 17, paragraphs 27, 38 (b), B125

Income Statement

Recognised in each reporting period over the coverage period as:

Insurance revenue

Portion of premium relating to recovery of acquisition costs in each period

Insurance service expense[1]

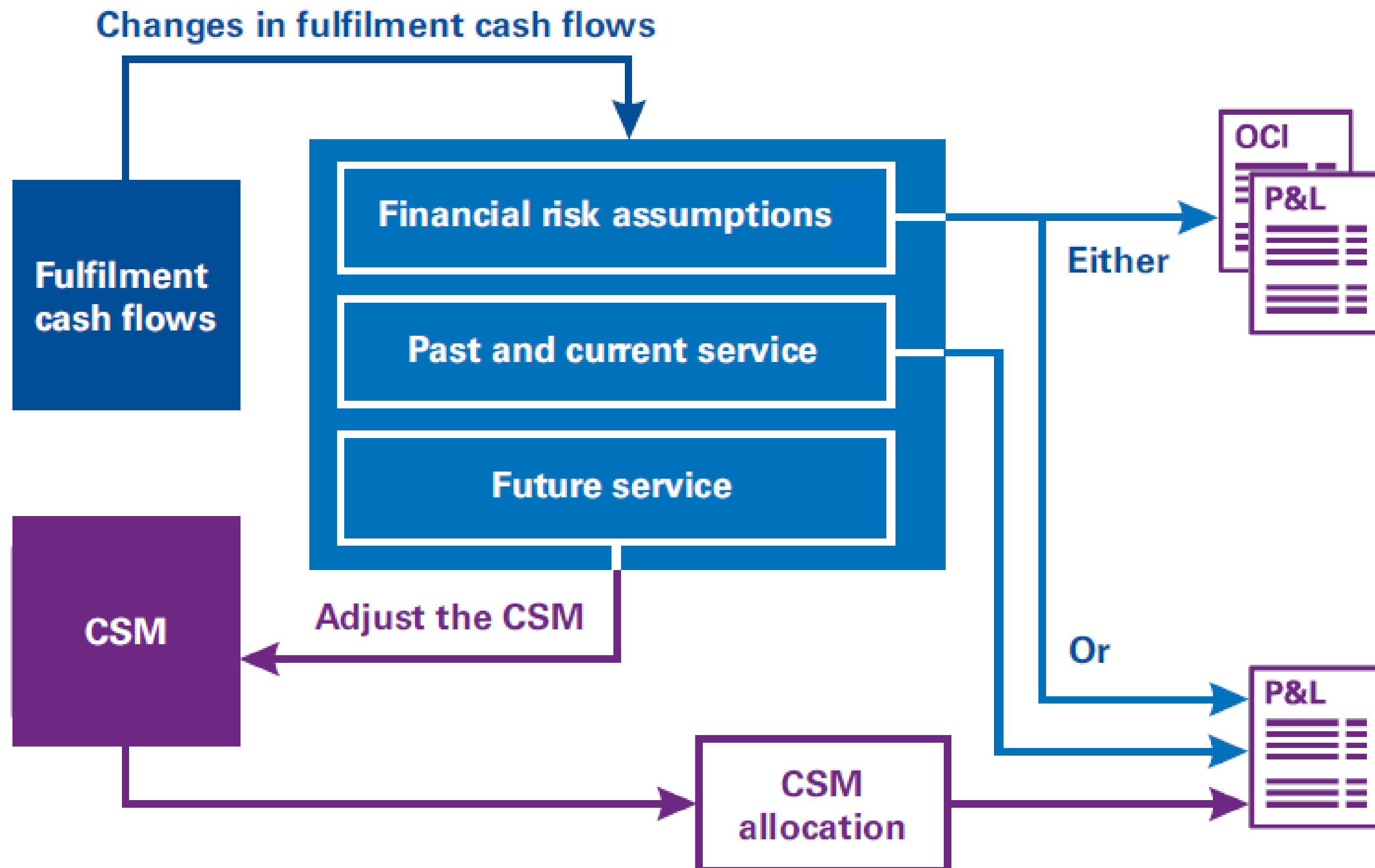
Same amount as insurance revenue above

Example 7, IE72- IE80

[1] Expenses relating to provision of coverage and other services, e.g., incurred claims

GENERAL MODEL – INSURANCE LIABILITY

INSURANCE LIABILITY SUBSEQUENT MEASUREMENT

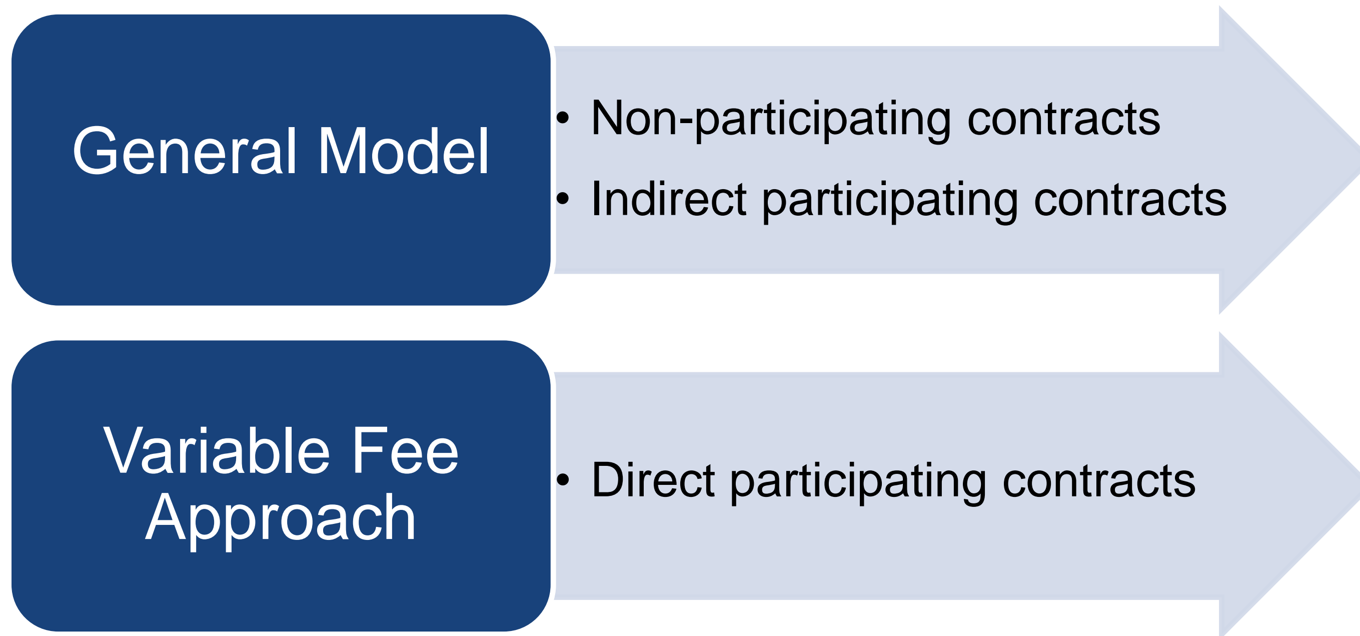


Source: KPMG – First Impressions IFRS 17

VARIABLE FEE APPROACH

VARIABLE FEE APPROACH

OVERVIEW – DEGREE OF PARTICIPATION



VARIABLE FEE APPROACH

ELIGIBILITY CONDITIONS

- Clearly identified pool of underlying items
- Entity pays policyholder a substantial share of the fair value returns on the underlying items
- A substantial proportion of any change in the payments to the policy holder will vary with the change in fair value of the underlying items

Direct participating contracts if all conditions are met

IFRS 17, paragraph B101

ISSUES RAISED BY EFRAG IAWG MEMBERS – VARIABLE FEE APPROACH

Scope of Variable Fee Approach	Issue 1: IFRS 17, paragraphs 2; B101, B104 and B105: the scope of the Variable Fee Approach means that similar contracts will be treated in different ways Issue 2: IFRS 17, paragraphs B101 and B102: To apply the VFA, 'a substantial proportion of any change in the amounts due to the policyholder vary with the change in fair value of the underlying items', but this may not apply to contracts that require payments in terms of local GAAP rather than change in fair value.

Points raised by the EFRAG IAWG members

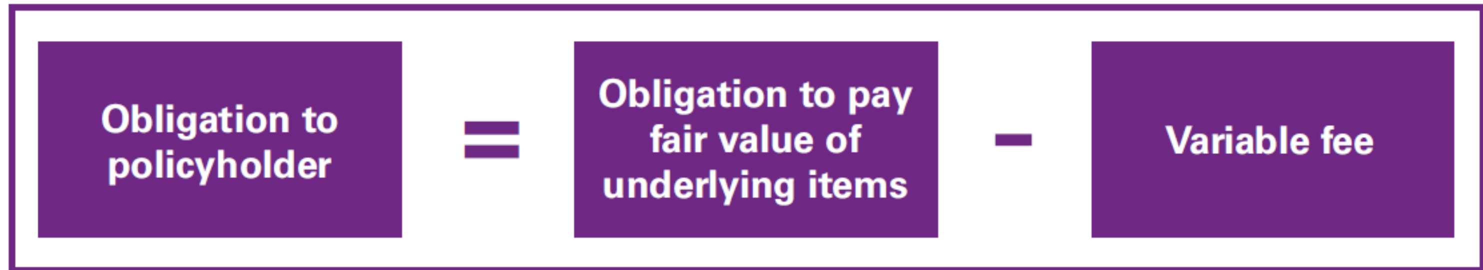
- The criteria for use of the VFA require that contractual rights and obligations are enforceable. The factors that determine enforceability may differ between jurisdictions, therefore limiting comparability.
- For contracts outside the scope, changes in financial risk cannot be deferred through CSM but affect the statement of comprehensive income. This may increase the volatility in equity.
- In some jurisdictions, contracts with constructive obligations are enforceable.

Further considerations

- For contracts outside the scope of VFA, there is no direct link between the insurance contract and the assets held by the insurer. Any changes in financial risk may identify economic mismatches.
- The VFA reduces volatility in shareholders' equity as it eliminates accounting mismatches with the underlying items
- The VFA-scope requires that contractual rights and obligations should be enforceable and that 'economic compulsion' should be ignored which is consistent with other IFRS standards

VARIABLE FEE APPROACH – INSURANCE LIABILITY

VARIABLE FEE: INITIAL MEASUREMENT



Source: KPMG - First Impressions IFRS 17

IFRS 17, paragraph B104

VARIABLE FEE APPROACH – INSURANCE LIABILITY

INITIAL MEASUREMENT

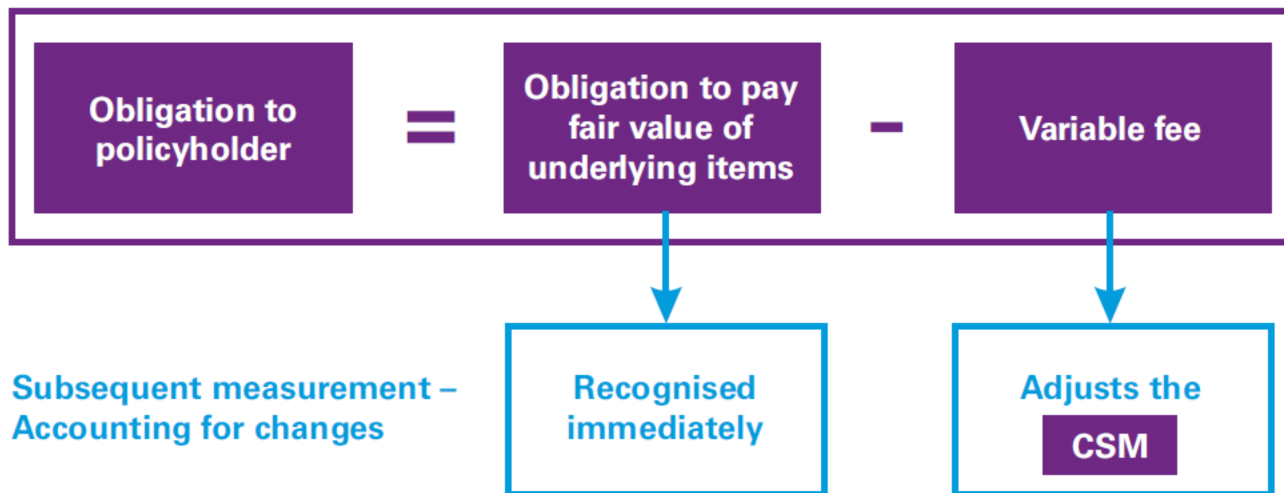
Fulfilment cash flows	Probability weighted expected cash flows
	Discounted
	Risk adjustment
Contractual service margin	

Similar approach as for general model, except (subsequently) treatment of CSM which reflects the variable fee to be received by insurer.

IFRS 17, paragraph 32

VARIABLE FEE APPROACH – INSURANCE LIABILITY

VARIABLE FEE: SUBSEQUENT MEASUREMENT



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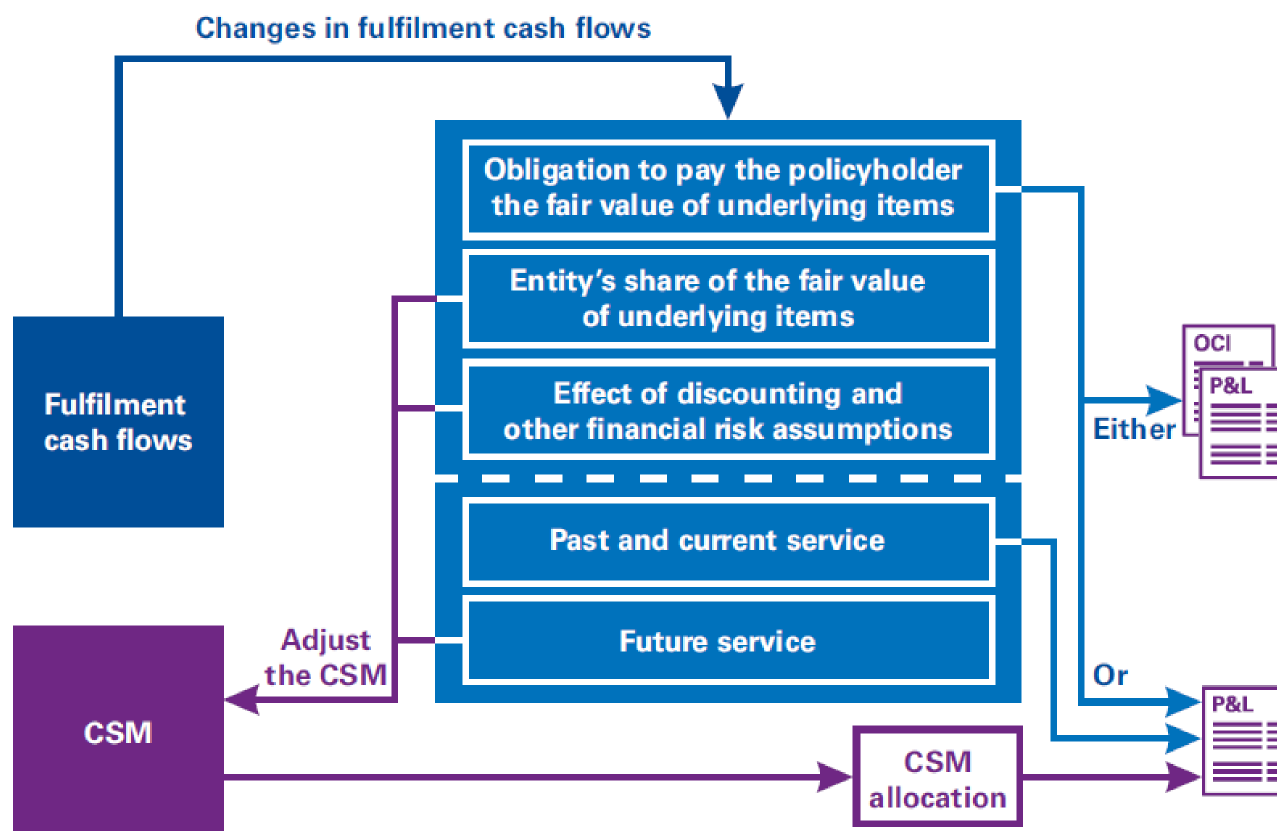
IFRS 17, paragraph 45

VARIABLE FEE APPROACH – INSURANCE LIABILITY

SUBSEQUENT MEASUREMENT



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GENERAL MODEL VS VARIABLE FEE APPROACH

PRIMARY MEASUREMENT DIFFERENCES

	General measurement model	Variable fee approach
Changes in the fulfilment cash flows arising from time value of money and financial risks	Recognised immediately in the statement(s) of financial performance as insurance finance income or expense	Regarded as part of the variability of the fee for future service and recognised in the CSM*
Interest rate accreted to the CSM	Interest rate determined on initial recognition	No explicit interest accretion is required since the CSM is effectively remeasured when it is adjusted for changes in financial risks

* Note: Unless either the changes exceed the amount of the CSM, or the entity applies the risk mitigation option for not adjusting the CSM

Source: KPMG – First Impressions IFRS 17

ISSUES RAISED BY EFRAG IAWG MEMBERS - COHORTS

Annual cohorts requirement	IFRS 17, paragraph 22: This does not reflect the nature of insurance business and is costly.

Points raised by EFRAG IAWG members	**Further considerations**
All contracts	
• Will require significant changes to systems and increase costs • Average results reflect how the pricing is set at portfolio level • There is no need for using annual cohorts, the use of coverage units is sufficient	• Appropriate amount of CSM in P&L and CSM amortised to zero at maturity • Application results in useful trend information regarding the CSM over time • Cross-generation risk-sharing can be considered
Direct participation contracts	
• Change current practice based upon open portfolios where profit increases over time as assets increase due to changes in fair value as well as new contracts written	• Using annual cohorts avoids showing averaged profits over time thereby blurring the trend information of CSM

ISSUES RAISED BY EFRAG IAWG MEMBERS – VARIABLE FEE APPROACH

CSM and coverage units	IFRS 17, paragraph B119: CSM allocation is mechanical (rather than principle-based).

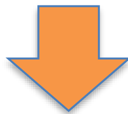
Points raised by EFRAG IAWG members	**Further considerations**
All contracts	
• A linear allocation pattern of the CSM does not reflect how the business earns profit on its contracts	• As not all contracts in a group have an identical duration, a systematic allocation of CSM will lead to the earnings pattern corresponding to the contracts still in force. The alternative could lead to building of hidden reserves
Direct participation contracts	
• The revenue would not reflect the economics of asset management services included within the contracts as these normally increase with the volume of the assets over the life of the contracts	• The insurance and investment-related services are highly interrelated and are provided over the coverage period in return for an expected fee. Therefore, the release of the CSM would reflect the provision of these services throughout the coverage period

PREMIUM ALLOCATION APPROACH

PREMIUM ALLOCATION APPROACH

PREMIUM ALLOCATION APPROACH PERMITTED IF

- Coverage period is 12 months or less or
- Reasonable approximation to the General Model



REASONABLE APPROXIMATION IF:

- no significant variability expected in fulfilment cash flows
- at inception, no significant changes in estimates of fulfilment cash flows likely to occur before the claims are incurred

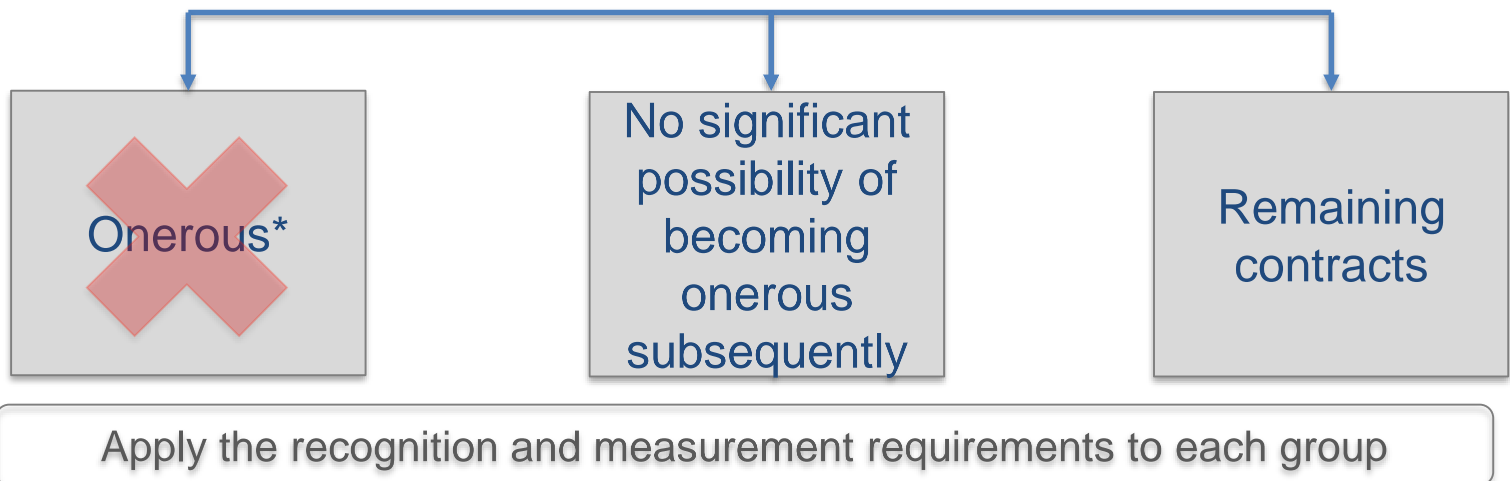
IFRS 17, paragraphs 53-54

PREMIUM ALLOCATION APPROACH

Step 1 — Identification of *portfolios* of insurance contracts issued at inception

Step 2 — Divide portfolios of contracts into annual time buckets (cohorts)

Step 3 — Divide annual cohorts into *groups* of contracts, at inception (if any):



* Assume no contracts are onerous unless facts and circumstances indicate otherwise, IFRS 17, paragraph 18

PREMIUM ALLOCATION APPROACH

INITIAL MEASUREMENT

Future cash flows	Premium(s) received
	- Acquisition cash flows[1]
	+/- derecognition asset or liability for Acquisition cash flows[1]

Revenue recognised for a period based on expected premium receipts[2]

[1] Unless entity chooses to expense as incurred
[2] Excluding investment component
[3] No need to identify components otherwise identified in IFRS 17, but initial measurement is considered to reflect these components implicitly, including CSM (if any)

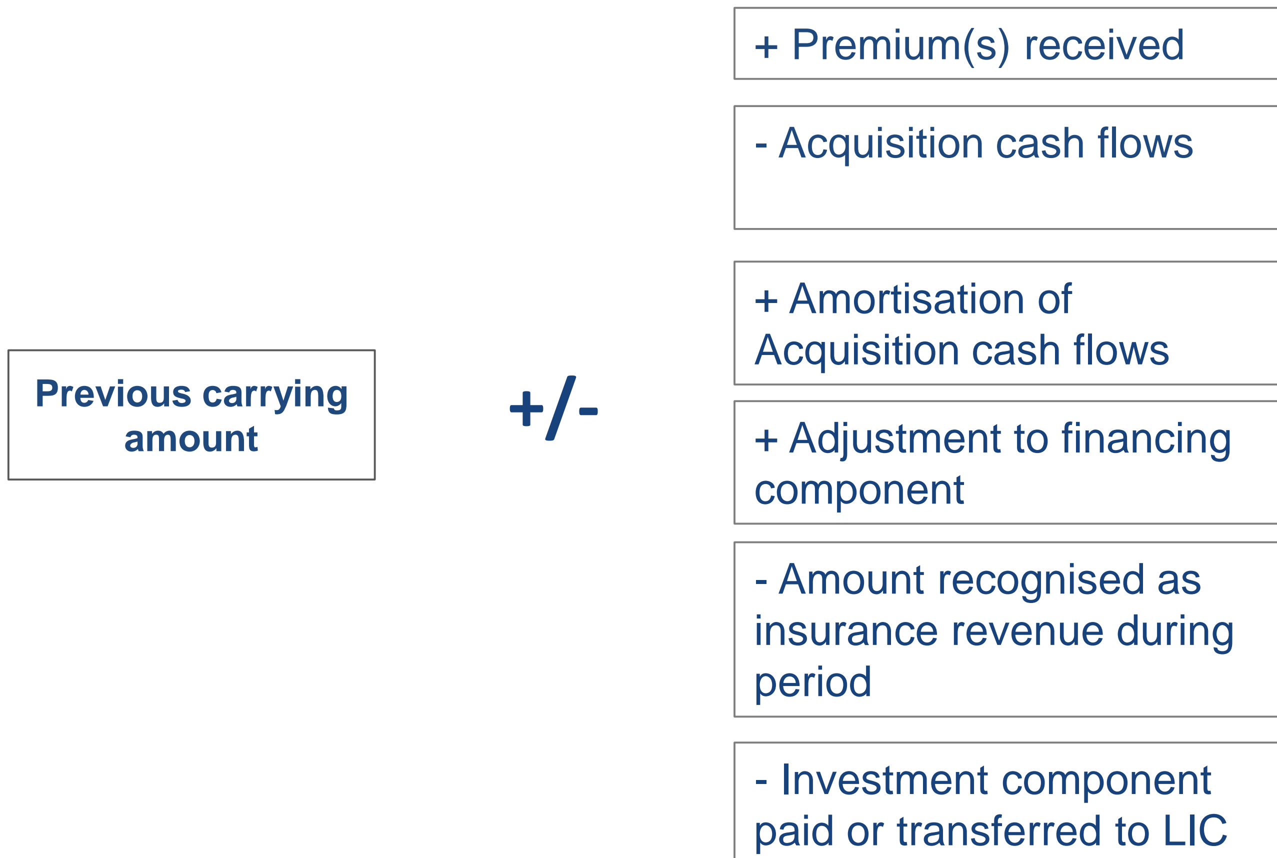
IFRS 17, paragraphs 55(a), BC289

PREMIUM ALLOCATION APPROACH

SUBSEQUENT MEASUREMENT

IFRS 17, paragraph 55(b)

Liability for remaining coverage



PREMIUM ALLOCATION APPROACH

SUBSEQUENT MEASUREMENT

IFRS 17, paragraph 55(b)

Liability for remaining coverage

New carrying amount

+

Liability for incurred claims[2]

Fulfilment cash flows	Probability weighted expected cash flows
	Discounted[3]
	Risk adjustment

IFRS 17, paragraph 57 a loss component is determined when facts and circumstances indicate a group of insurance contracts is onerous

[1]Unless entity chooses to expense as incurred
[2]Zero at inception
[3]Unless cash flows are expected to be paid within one year from the incurred claim

ISSUES RAISED BY EFRAG IAWG MEMBERS – PAA - INCURRED CLAIMS

PAA – discounting incurred claims	IFRS 17, paragraphs 88(b), B133 and B72(e)(iii): To determine the insurance finance income or expenses to be included in profit or loss, the requirement to discount the liability for incurred claims is not practical as entities do not know when claims have been incurred (e.g. IBNR) and thus which discount rate is to be used.

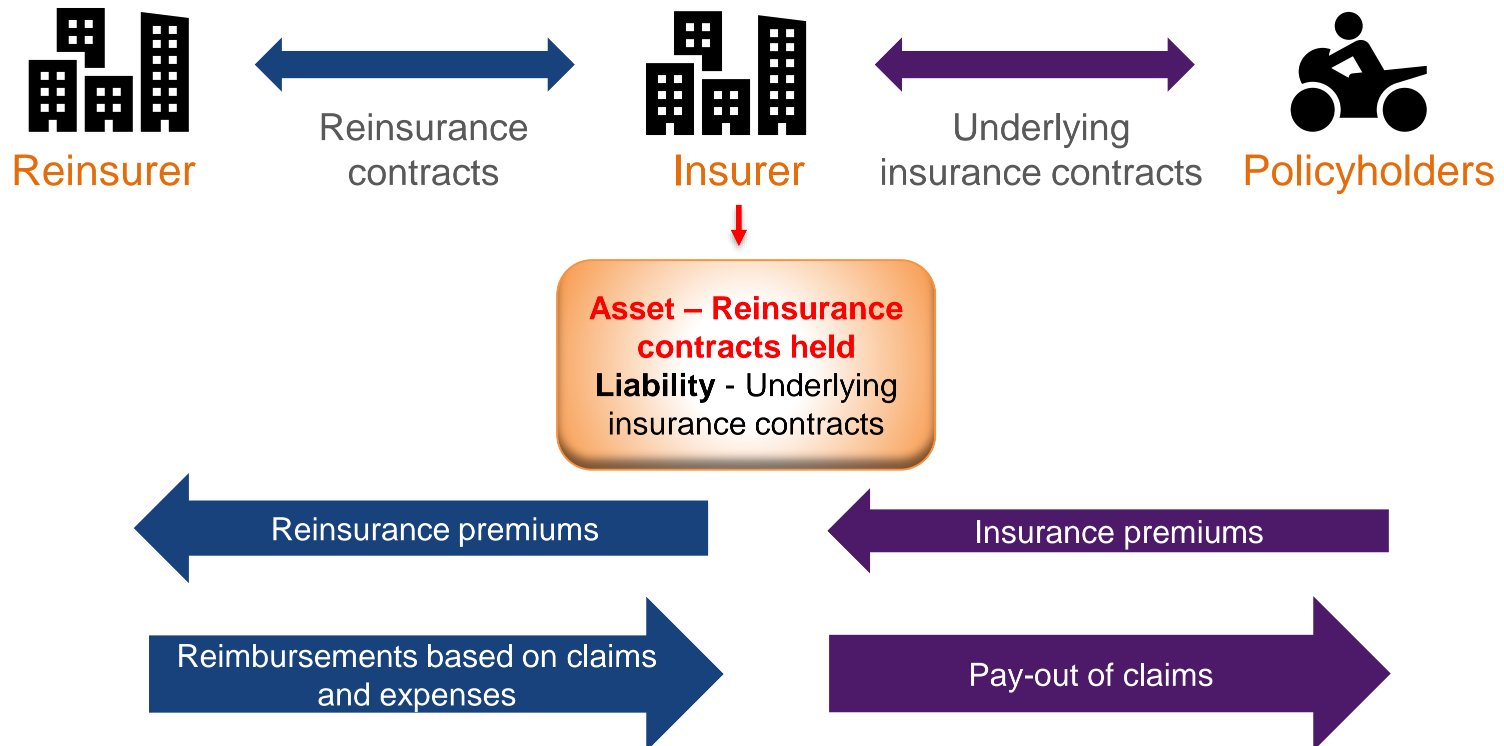
Points raised by EFRAG IAWG members	Further considerations
The entity will have to estimate the exact dates when claims have been incurred.	When there is a significant financing component, aligning the measurement between the liability for remaining coverage and the liability for incurred claims results in reliable information.
Apart from estimating the exact dates on which claims have been incurred entities, uncertainties may arise on which discount rates to apply which increase the amount of judgement used.	Applying judgement and estimates is inherent to the application of IFRS Standards.
Entities would have to keep track and calculate the different incurred claims liabilities which could lead to overly complex calculations.	Considering the time value of money when payment terms are deferred will align the PAA with other IFRS Standards.

REINSURANCE CONTRACTS

REINSURANCE CONTRACTS HELD

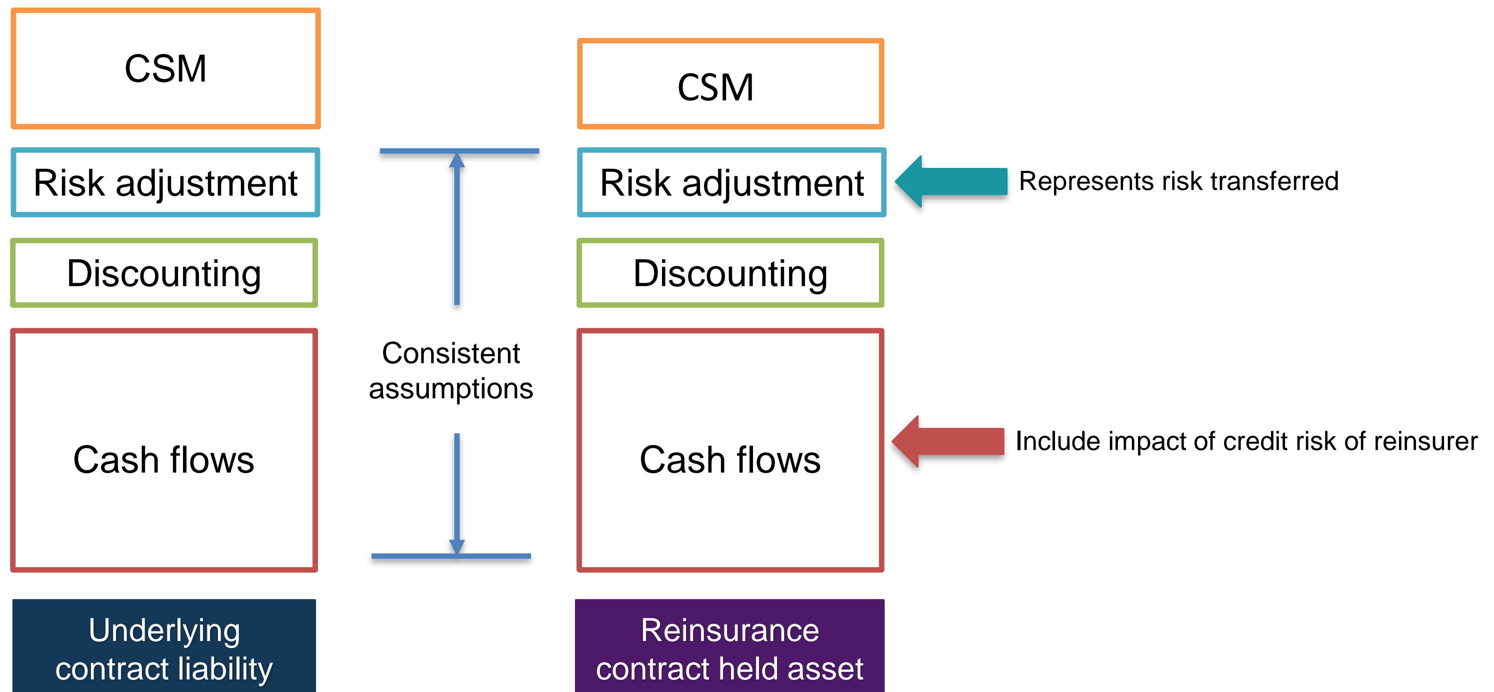
What is a reinsurance contract held?

It is a contract held by the insurer whereby the reinsurer compensates the insurer for claims arising on underlying insurance contracts



REINSURANCE CONTRACTS HELD

MEASUREMENT OF REINSURANCE CONTRACTS HELD

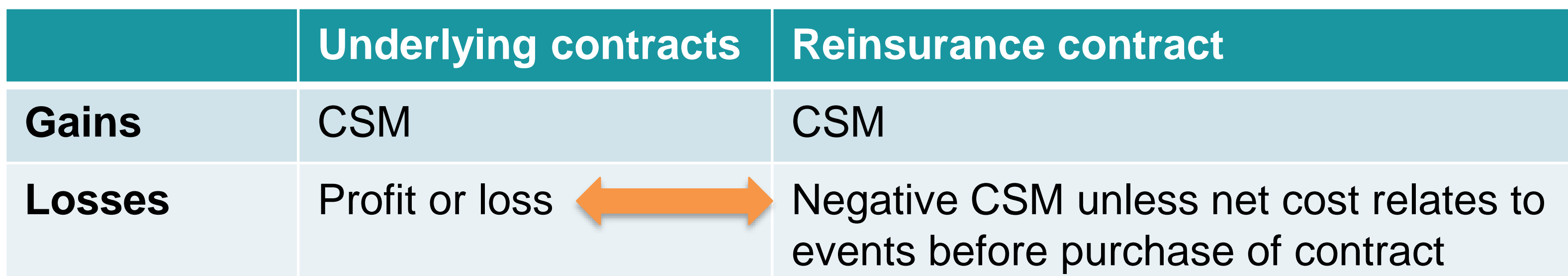


Source: KPMG – First Impressions IFRS 17

IFRS 17, paragraphs 63-64

REINSURANCE CONTRACTS HELD

CSM: Treatment of gains and losses at initial recognition



	Underlying contracts	Reinsurance contract
Gains	CSM	CSM
Losses	Profit or loss ⟷	Negative CSM unless net cost relates to events before purchase of contract

Clarifications:

- Buying service (resulting in an asset) instead of providing service
- Premiums will mostly differ

CSM: Treatment of subsequent changes to estimates

Treatment of changes in fulfilment cash flows for the reinsurance contract directly mirrors the treatment of the underlying insurance contracts.

IFRS 17, paragraph 65-67

REINSURANCE CONTRACTS HELD

Presentation

- Similar to IFRS 4, an insurer presents reinsurance contracts held *separately* from the underlying insurance contracts on the Balance Sheet

Measurement

- Consistent assumptions used between reinsurance held and underlying insurance contracts. (IFRS 17, paragraph 63)
- Effect of non-performance by reinsurer included in measurement reinsurance contracts. (IFRS 17, paragraph 63)
- Risk adjustment represents risk transferred between holder of reinsurance contracts and issuer of those contracts (IFRS 17, paragraph 64)
- Requirements for CSM modified (IFRS 17, paragraph 65)
- Reinsurance contracts (both held and issued) are not eligible for the Variable Fee Approach (IFRS 17, B109)

- Reinsurance contracts held may use Premium Allocation Approach (if eligibility criteria are met) (IFRS 17, paragraph 69)

ISSUES RAISED BY EFRAG IAWG MEMBERS – REINSURANCE HELD (1/4)

Proportional reinsurance	IFRS 17, paragraph 34 indicates that for proportional reinsurance held, the treaty is considered as a single contract, even when it relates to underlying contracts not yet written by the cedant.

Points raised by EFRAG IAWG members

- The reinsurance treaty may partly relate to risks of insurance contracts that have not been written yet (i.e. future contracts). This may affect the reliability of the measurement.

Further considerations

- The reinsurance treaty is a contractual commitment to insure future volumes of direct insurance contracts

ISSUES RAISED BY EFRAG IAWG MEMBERS – REINSURANCE HELD (2/4)

Proportional reinsurance	IFRS 17, paragraphs 65 and B109. The treatment of reinsurance contracts held leads to accounting mismatches due to differing treatment of CSM and the fact that the reinsurance asset does not necessarily equal the liability of the underlying contracts.

Points raised by EFRAG IAWG members

- The treatment of the CSM on initial recognition may result in an accounting mismatch and is inconsistent with subsequent measurement of the CSM
- The accounting ignores the economic reality of the reinsurance contract in the financial statements of the insurer.
- Divergent treatment of internal reinsurance contracts may impact profit and the capacity to pay dividends at individual controlled entity level.

Further considerations

- A gain at initial recognition of a reinsurance contract is a cost reduction and not an unearned profit as with underlying contracts.
- The accounting reflects the economics of the contract with the reinsurer. Differences may require updates to estimates for underlying contracts.
- The two contracts have different counterparties and different economic drivers. Disclosures can explain the extent of risk reduction.

ISSUES RAISED BY EFRAG IAWG MEMBERS – REINSURANCE HELD (3/4)

Proportional reinsurance	IFRS 17, paragraphs 65 and B109. Reinsurance contracts held are not eligible for the Variable Fee Approach

Points raised by EFRAG IAWG members

- Different accounting for reinsurance contracts held compared to the underlying insurance contracts could reduce comparability – assuming both meet the eligibility criteria for the VFA.
- The accounting does not reflect the economics of the reinsurance transaction.
- Reinsurer insures investment and insurance risk. Pricing reflects the relevant risks with no distinction between insurance and investment risk.

Further considerations

- The insurer is unlikely to share in returns of the underlying items under the reinsurance contract. In cases where it does, the returns from underlying items would not reflect compensation for management services provided by the reinsurer. The reinsurer will share in unitised portfolio or replicate the insurer’s portfolio, not providing any management services.

ISSUES RAISED BY EFRAG IAWG MEMBERS – REINSURANCE ISSUED(4/4)

Proportional reinsurance	IFRS 17, paragraph 34 indicates that for proportional reinsurance issued, the treaty is considered as a single contract, even when it relates to underlying contracts not yet written by the cedant.

Points raised by EFRAG IAWG members

- Less transparency in the reinsurer's financial statements as the liability will not change as more underlying contracts are written (ignoring estimate changes).
- Similarly, where these new contracts are onerous, the reinsurer will not recognise these in profit or loss but merely adjust the CSM.

Further considerations

- The reinsurance contract is a single contract and separate from the underlying insurance contracts.

INVESTMENT CONTRACTS WITH DPF

INVESTMENT CONTRACTS WITH DISCRETIONARY PARTICIPATION FEATURES (DPF)

Definition*

A financial instrument that provides the contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts:

a) that are expected to be a significant portion of the total contractual benefit
b) the timing or amount of which are contractually at the discretion of the issuer
c) that are contractually based on:
   i. the returns on a specified pool of contracts or a specified type of contract;
   ii. realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
   iii. the profit or loss of the entity or fund that issues the contract.

*Investment contracts without DPFs and investment contracts with DPFs not issued by an entity that also issues insurance contracts, are within the scope of IFRS 9 *Financial Instruments* and not IFRS 17.

IFRS 17, Appendix A

INVESTMENT CONTRACTS WITH DPF

Investment contracts with DPF

- Do not transfer significant insurance risk
- Within the scope of IFRS 17 *only* if issued by an entity that also issues insurance contracts

Changes to general measurement model

- Date of initial recognition
- Contract boundary
- CSM recognition

IFRS 17, paragraph 71

JARGON USED

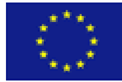
JARGON USED

Insured event: An uncertain future event covered by an insurance contract that creates insurance risk.

Investment component: Amounts that an entity contractually repays to a policyholder even if an insured event does not occur.

Investment contracts with discretionary participation features (DPFs): A financial instrument that provides a particular investor with the contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts:

a) that are expected to be a significant portion of the total contractual benefits;
b) the timing or amount of which are contractually at the discretion of the issuer; and
c) that are contractually based on:
    i. the returns on a specified pool of contracts or a specified type of contract;
    ii. realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
    iii. the profit or loss of the entity or fund that issues the contract.



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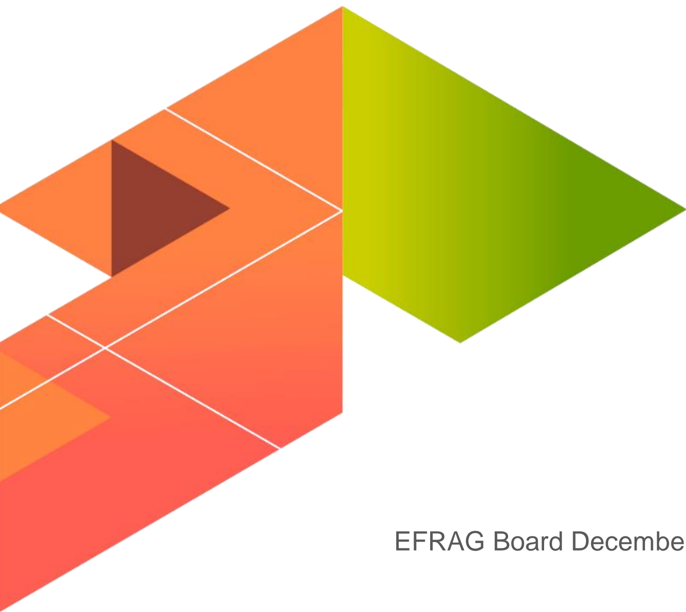

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