IFRS 17 *Insurance Contracts* – Towards a DEA
Appendix I

Background to IFRS 17

1 This paper presents a summary of IFRS 17 *Insurance Contracts* as prepared by the EFRAG Secretariat.

2 The previous IFRS Standard on insurance contracts, IFRS 4, was an interim standard that allowed entities to use a wide variety of accounting practices for insurance contracts, reflecting national accounting requirements and variations of those requirements. The differences in accounting treatment across jurisdictions and products made it difficult for investors and analysts to understand and compare insurers' results. Also in Europe a significant divergence in accounting treatment exists. Most stakeholders, including insurers, agreed on the need for a common global insurance accounting standard even though opinions varied as to what it should be.

3 Long-term and complex insurance risks are difficult to reflect in the measurement of insurance contracts. In addition, insurance contracts are not typically traded in markets and may include a significant investment component, posing further measurement challenges. Some previous insurance accounting practices permitted under IFRS 4 did not adequately reflect the true underlying financial positions or the financial performance of these insurance contracts. To address these issues, the IASB undertook a project to make insurers' financial statements more useful and insurance accounting practices consistent across jurisdictions.

How the issues have been addressed

4 The IASB issued IFRS 17 in order to make the insurer's financial statements more useful and consistent. The objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents insurance contracts.

5 Under IFRS 17, entities will apply a consistent accounting framework for all insurance contracts. Comparability will be increased among insurers as many insurance accounting differences will be removed, among insurance contracts as entities will measure insurance contracts consistently within the group and also among industries as the deposit component is excluded from revenue, like other industries.

What has changed?

6 Because the current standard, IFRS 4 *Insurance Contracts*, permits a range of practices this section addresses the following major areas of change to current practices:

(a) Level of aggregation;

(b) Measurement of insurance liabilities (technical provisions);

(c) Accounting policy options on discounting;

(d) Risk mitigation;

(e) Reinsurance contracts held;

(f) Sharing of risks;

(g) Presentation and disclosure; and

(h) Transition.

Level of aggregation

Grouping of insurance contracts

7 Most insurers do not manage their contracts on an individual basis. IFRS 17 requires insurers to identify portfolios of contracts that are subject to similar risks and that are managed together. Further division of the portfolios into groups of (i) onerous contracts, if any, (ii) contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any and (iii) remaining contracts in the portfolio, is aimed at identification of losses. A group of contracts cannot include contracts issued more than one year apart. This is to ensure that the contractual service margin representing unearned profits relating to a group of contracts is entirely taken to profit or loss when the last contract in the group is derecognised.

8 Existing insurance practices on aggregation vary depending on jurisdiction and type of contracts and range from individual contract level to groupings that are broader than the grouping required by IFRS 17.

Onerous contracts

9 IFRS 17 requires an insurer to identify onerous contracts (if any) at initial recognition as part of grouping contracts to achieve timely recognition of losses. The insurer is required to recognise losses on those contracts immediately in profit or loss. Subsequently, the insurer is required to regularly update the fulfilment cash flows to:

(a) recognise in profit or loss additional losses for groups of onerous contracts, if any; and

(b) adjust the contractual service margin for other groups of contracts. If the contractual service margin for those groups of contracts is reduced to zero, changes for additional expected outflows are recognised in profit or loss.

Impact of regulation

10 Situations occur when law or regulation constrains the entity's practical ability to set a different price or level of benefits for contracts or policyholders with different characteristics. IFRS 17 permits an exception to the overall grouping requirements, in that, in situations when law or regulation constrains the entity's practical ability to set a different price or level of benefits for contracts or policyholders with different characteristics, insurance entities are allowed to include such contracts in the same group.

Measurement of insurance liabilities (technical provisions)

Introduction

11 IFRS 17 describes principles for the measurement requirements for groups of insurance contracts. To accommodate specific types of contracts, changes to these principles are made for:

(a) insurance contracts with direct participation features where *some* of these general requirements are changed. Insurance contracts with direct participation features are insurance contracts for which, at inception (i) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items; (ii) the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns from the underlying items; and (iii) the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items;

(b) reinsurance contracts held, reflecting that these represent a service that has been purchased;

(c) investment contracts with discretionary participation features as these contracts do not transfer significant insurance risk; and

(d) short term contracts or contracts where the measurement of the insurance liability would not materially differ from application of the general requirements (referred to as the Premium Allocation Approach).

12 One of the key principles of IFRS 17 is that an insurer recognises and measures groups of insurance liabilities (under current accounting requirements often referred to as technical provisions) at:

(a) a risk-adjusted probability weighted estimate of the present value of the future cash flows that incorporates all of the available information about those cash flows in a way that is consistent with observable market information; plus (if this value is a liability) or minus (if this value is an asset);

(b) an amount representing the unearned profit in the group of contracts (the contractual service margin). For reinsurance contracts held, there is no unearned profit but instead a net cost or a net gain on purchasing the insurance.

13 Consequently, the measurement required by IFRS 17 results in:

(a) the liability for a group of insurance contracts relating to performance obligations for remaining service being measured broadly consistent with IFRS 15 *Revenue from Contracts with Customers* except that:

  (i) the measurement is updated for changes in financial assumptions; and

  (ii) the liability often includes an investment component typically not found in contracts within the scope of IFRS 15.

(b) the liability for a group of insurance contracts relating to incurred claims being measured broadly consistently with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, except that the liability often includes an investment component that is typically not in contracts within the scope of IAS 37.

Use of current estimates

14 IFRS 17 requires the use of current estimates based on the most up-to-date information available and disclosure of the relevant assumptions. That current measurement is not a fair value as it is an entity specific measurement, e.g. the client portfolios of one insurer are not the same as another insurer, for instance, the expected mortality rate of clients of insurer A will differ from the expected mortality rate of clients of insurer B. The current measurement is referred to as the fulfilment value (representing the value of the insurance liability as the insurer fulfils the contract).

15 Under the current situation, insurers are allowed to use estimates that are not updated at all or are not fully updated after contract inception.

Time value of money

16 IFRS 17 requires an insurer to discount the cash flows from insurance contracts using discount rates that reflect the characteristics of the cash flows arising from the insurance contract liability.

17 Currently, some insurers discount the future cash flows from insurance contracts using discount rates that are based on the expected return on assets backing the insurance contract liability. Some insurers use a discount rate specified by law or a regulator. A few use a risk-free discount rate whilst others do not discount at all.

Explicit risk-adjustment

18 IFRS 17 requires an insurer to always include an explicit, current risk adjustment in the measurement of insurance contracts and to provide relevant disclosures.

19 Currently, insurers show different approaches in relation to reflect risk: risk margins can be implicit or explicit; can be applied to some and not to all insurance contracts or are used for regulatory purposes only.

Current value of financial options and guarantees

20 IFRS 17 requires an insurer to include all financial options and guarantees embedded in insurance contracts in the measurement of the fulfilment cash flows, in a way that is consistent with observable market prices for such options and guarantees.

21 Current accounting for financial options and guarantees embedded in insurance contracts differs between entities. In some cases, embedded financial options and guarantees are not recognised until current rates fall below the guaranteed minimum. In other cases, embedded financial options and guarantees are recognised and their measurement reflects the possibility that they might become worthy of exercising (i.e. reflects intrinsic value and time value). However, in some cases, their measurement is inconsistent with relevant market prices.

Consistent treatment of acquisition costs

22 IFRS 17 requires an insurer to include in the measurement of insurance contracts all fulfilment cash flows, including directly attributable acquisition cash flows. Therefore, a separate asset associated with the acquisition of insurance contracts is not recognised for a recognised group of contracts. When applying IFRS 17, at inception, any lack of recoverability of the acquisition cash flows will be reflected in the measurement of the CSM, eliminating complex mechanisms to deal with deferral, amortisation and impairment of the separate asset.

23 Currently, most insurers recognise deferred acquisition cost as assets for costs associated with writing new insurance contracts.

Accounting policy options on discounting

24 Both for contracts with and without participating features, IFRS 17 offers an accounting policy choice for dealing with insurance finance income or expenses. This accounting policy choice allows entities to recognise insurance finance income or expenses either in profit or loss or disaggregating it between other comprehensive income and profit or loss.

Risk mitigation

25 Subject to meeting particular conditions, an entity may choose not to recognise a change in the contractual service margin to reflect some or all of the changes in the effect of financial risk on the entity's share of underlying items. The documentation requirement for this option is analogous to the documentation requirements for hedge accounting in IFRS 9 *Financial Instruments*.

Reinsurance contracts held

26 Reinsurance contracts issued are recognised and measured as with any other insurance contract issued, IFRS 17 also applies to reinsurance contracts held by an entity (i.e. in which the entity is the policyholder). Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purposes of IFRS 17.

27 IFRS 17 requires a reinsurance contract held to be accounted for separately from the underlying insurance contracts to which it relates. This because an entity that holds a reinsurance contract does not normally have a right to reduce the amounts it owes to the underlying policyholder by amounts it expects to receive from the reinsurer.

Sharing of risks

28 Some insurance contracts affect the cash flows to policyholders of other contracts by requiring the policyholder to share with policyholders of other contracts the returns on the same specified pool of underlying items. As a consequence, either of the policyholder groups may bear a reduction in their share of the returns because of payments to the other policyholder groups. IFRS 17 therefore requires the cash flows of each group to reflect the extent to which such group is affected.

29 This is not normally the case under current practice.

Presentation and disclosure

Presentation on the statement of financial position

30 Insurance contracts are presented on the statement of financial position as insurance contract liabilities (or as insurance contract assets).

Insurance revenue and insurance finance expenses or income

31 IFRS 17 requires an insurer to recognise profit (i.e. insurance revenue) according to source:

(a) *the contractual service margin* - recognised as profit as the insurer provides services over the coverage period; and

(b) *the risk adjustment* - recognised in profit or loss as the insurer is released from risk over the coverage period plus the settlement period.

32 IFRS 17 requires a consistent approach for the recognition and measurement of the contractual service margin, and for the determination of the explicit risk adjustment.

33 Consequently, as IFRS 17 requires an insurer to report as insurance revenue the consideration for services on an earned basis, insurance revenue will exclude deposit components which represent policyholders' investments, not consideration for services. Under current practice, some insurers recognise all premiums (including any deposit component) as revenue.

34 Further, IFRS 17 also requires an insurer to report separately the insurance finance income or expenses in the statement of comprehensive income. This comprises the investment return on assets, the effect of the time value of money on the investments and the effect of changes in financial assumptions for example changes in discount rates.

Disclosures

35 To enable users of financial statements to assess the effect that contracts within the scope of IFRS 17 have on the financial position, financial performance and cash flows of an insurer. IFRS 17 requires disclosure of qualitative and quantitative information about:

(a) the amounts recognised in its financial statements from insurance contracts;

(b) the significant judgements, and changes in those judgements, made when applying IFRS 17;

(c) detailed reconciliations of opening and closing balances; and

(d) the nature and extent of the risks from contracts within the scope of IFRS 17.

Transition

36 An insurer is required to account for its insurance and reinsurance contracts as if IFRS 17 had always been applied unless this is impracticable (for example, if, after making every reasonable effort, the insurer is unable to gather historical data for contracts issued many years before). However, when this is impracticable, an insurer can measure existing insurance contracts when it first applies IFRS 17 using either:

(a) a modified retrospective approach - which can be used only if reasonable and supportable information is available; or

(b) a fair value approach.

37 For the purpose of the transition requirements, the date of initial application is the start of the annual reporting period in which an insurer first applies IFRS 17, and the transition date is the beginning of the period immediately preceding the date of initial application.

When does IFRS 17 become effective?

38 An insurer shall apply IFRS 17 for annual periods beginning on or after 1 January 2021. An insurer can choose to apply IFRS 17 before that date, but only if it also applies IFRS 9 and IFRS 15.