Transition to IFRS 17 *Insurance Contracts*
Issues Paper

Objective

1 The objective of this session is to provide EFRAG TEG with an overview of the EFRAG's Secretariat understanding of the issues raised by EFRAG IAWG members in relation to transition.

2 The outcome of the discussion is to make relevant changes to Appendix II of the endorsement advice of IFRS 17 *Insurance Contracts*.

3 The EFRAG Secretariat will provide an oral update on the inputs received from EFRAG IAWG on the topic.

Background

4 Given the long-term nature of the business written by insurers, the impact of transition could last for a number of years. Furthermore, concerns have been raised that the impact of transition may not result in a fair presentation of the performance of entities with long duration contracts at transition.

5 In paragraph 373 of the Basis for Conclusions to IFRS 17, the IASB acknowledges that the optionality available on transition will result in less comparable financial statements for as long as the contracts written before the transition date continued to be recognised. However, the IASB concluded that the costs associated with the full retrospective approach or modified retrospective approach might exceed the benefits if there is little information available at the transition date. Thus, the fair value approach is permitted as one of the accounting policy choices available if, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, a full retrospective approach is impracticable.

Summary of the requirements

6 Apart from two exceptions, IFRS 17 paragraph C3 requires entities to apply IFRS 17 fully retrospectively (i.e. as if the standard has always been applied) unless impracticable. Where full retrospective transition is impracticable, an entity can apply either the modified retrospective approach or the fair value approach (IFRS 17 paragraph C5).

7 The modified retrospective approach aims to balance an outcome as close as possible to a full retrospective implementation of IFRS 17 using reasonable and supportable information available without undue cost or effort. Therefore, it allows simplification with regard to the assessment and the grouping of insurance contracts at inception or initial recognition (IFRS 17 paragraphs C9-C10), to the determination of the CSM (IFRS 17 paragraphs C11-17), and to insurance finance income or expense (IFRS 17 paragraphs C18-C19).

8 The fair value approach requires an entity to determine the CSM at transition date as the difference between the fair value of a group of insurance contracts and the fulfilment cash flows measured at that date (IFRS 17 paragraph C20). In addition, the fair value approach allows an entity to identify groups of insurance contracts, the assessment of significant insurance risk, and the way discretionary cash flows are determined either at the date of initial recognition or the transition date (IFRS 17 paragraphs C21-C22). Further simplifications relate to annual cohorts (IFRS 17 paragraph C23) and the determination of the cumulative amount of insurance finance income or expense recognised in OCI at transition date (IFRS 17 paragraph C24).

Concerns about transition requirements

9 The following concerns have been raised by members of the EFRAG IAWG:

(a) Size of contractual service margin under the fair value approach;

(b) Burden of the modified retrospective approach; and

(c) Prospective application of risk mitigation at transition

Size of contractual service margin under fair value approach

10 The main concern with respect to the fair value transition approach is that its implementation would result in a zero, or "too small", contractual service margin.

11 The reasoning for this is based on the reference in IFRS 17 to the fair value measurement in IFRS 13 *Fair Value Measurement*. Some argue that an exit price concept means that the CSM at transition would only reflect the margin an average market participant expects to earn for taking over a block of business.

12 In contrast, the CSM determined based on the (modified) retrospective approach reflects the future profits expected from existing business written in the retail market (i.e., updated entry price concept). As a result, the transition date compensation that a market participant would require under the fair value approach might in many cases be lower than the modified retrospective approach value of in-force business (in particular for insurance companies with an above average profitability). In such a situation, the fair value approach would result in lower future profits of a profitable insurance company, compared to a full or modified retrospective approach. In addition, it will result in similar future profits from business in-force at transition for all market participants, irrespective of their expected profitability. Consequently, it is argued that the fair value approach will not lead to meaningful "CSM" for the business in-force at transition.

EFRAG Secretariat analysis

13 The EFRAG Secretariat notes that on transition, it is generally expected that there will be a CSM when the fair value approach is applied, because IFRS 13 paragraph 41(a) indicates that the fair value of a liability would include the profit margin that a market participant would require for accepting obligations under insurance contracts.

14 IFRS 13 paragraph B31 indicates that the present value calculations should reflect the future cash outflows that market participants would expect to incur in fulfilling the obligation. This would include market participants' expectations about the costs of fulfilling the obligation and the compensation that a market participant would require. This includes a return for undertaking the activity and assuming the risk associated with the obligation (i.e. that actual cash flows may vary from the expected ones).

15 The EFRAG Secretariat considers that the fair value approach will restate the contractual terms of the insurance contracts to the prevailing market conditions at date of transition. This means that contracts being transitioned to IFRS 17 that are

more profitable than identical contracts written at transition date will have a higher compensation as that is what a market participant would require. However, that compensation will differ from a compensation calculated at the inception of the contract which would reflect the market conditions at that time.

16 The EFRAG Secretariat also notes that the fair value estimate will be conducted from the perspective of an average market participant and has to exclude entity-specific considerations such as synergies. However, as the objective is the measurement of a specific asset (such as a book of insurance business), the measurement will take into account the specific characteristics of that asset where relevant per IFRS 13 paragraph 11. Therefore, the profitability of a book of insurance business is one of the factors that would be considered in the fair value estimation. Similarly, the underwriting standards of a reputable insurer may contribute to the recognition of a lower risk margin than for business written by an insurer with less robust underwriting standards. This would result in a higher CSM where the fair value of the book of business by these two insurers are equal.

17 Lastly, the EFRAG Secretariat notes that the adjustment to retained earnings on transition would depend on the profitability pattern of the group of contracts, how much of that profit has been already recognised and how much profit is still left at the moment of transition.

Question for EFRAG TEG

18 What comments do EFRAG TEG members have on the EFRAG Secretariat analysis above?

Burden of modified retrospective approach

19 It is not yet clear whether the simplifications described in IFRS 17 paragraphs C6-C19 will be sufficient to allow for the calculation of a meaningful CSM.

20 This issue can be illustrated for a block of business with direct participation features. The Standard states the CSM for such a group of contracts would be determined based on the steps described in IFRS 17 paragraph C17. First, one would determine the 'value of in-force' by deducting the fulfilment cash flows as of the date of transition from the fair value of the underlying items. As this is a fully prospective calculation, it should not present a challenge for insurance entities. However, this amount needs to be further adjusted for actual charges to policyholder, payments that have not been varying with changes in underlying items and release of the risk adjustment that have occurred before the date of transition. The result of these adjustments to the 'value of in-force' would be the CSM at contract inception. To get from there to the CSM at transition date, the entity then needs to deduct the amount of the CSM that relates to past services, i.e. one needs to determine past CSM releases. It may also result in the use of hindsight.

21 The critical issue is that the amounts charged to policyholders as well as the amounts paid that would not have varied based on the underlying items are in many cases only available since the 2000s. Hence, an entity needs to make simplifying assumptions regarding the adjustments before this point in time, such as that the adjustment is equal to the CSM release of the period and in effect lock-in the CSM in this period.

EFRAG Secretariat analysis

22 In the Basis for Conclusions, the IASB notes that the modified retrospective approach was incorporated based on information received that in many cases entities face only a small number of limitations on retrospective application. The IASB concluded that more comparable information could result if a modified retrospective approach was allowed when needed, if an entity lacked information to apply a fully retrospective approach.

23 The EFRAG Secretariat notes that the problems described may be a question of materiality in the sense of whether the answer provided is materially in line with the specific requirements of the standard.

Questions for EFRAG TEG

24 What comments do EFRAG TEG members have on the EFRAG Secretariat analysis above?

Prospective application of risk mitigation on transition

25 Some argue that restricting the application of risk mitigation only from the date of initial application will lead to a misstatement of shareholders' equity at this point and, consequently, misstated future profits.

26 Entities should be allowed to retrospectively apply risk mitigation if they can demonstrate that their hedging strategy has been well defined with the financial impact audited.

EFRAG Secretariat analysis

27 The EFRAG Secretariat notes that similar to the hedging requirements in both IAS 39 Financial *Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*, the risk mitigation parts of IFRS 17 can only be applied prospectively from date of initial application. The IASB was of the view that allowing retrospective application of the risk mitigation treatment could result in the use of hindsight. The particular concern was that documentation after the event could enable entities to choose the risk mitigation relationships to which it would apply the risk mitigation treatment given that it is optional.

Questions for EFRAG TEG

28 What comments do EFRAG TEG members have on the EFRAG Secretariat analysis above?