Insurance contracts

Fair value at transition and Questionnaire on current insurance GAAP

Objective

1 The objective of this session is to inform EFRAG TEG members about:

(a) The EFRAG IAWG discussions held about determining fair value of insurance liabilities at transition to IFRS 17 *Insurance Contracts*; and

(b) The questionnaire to be sent to EFRAG IAWG members on the application of current insurance GAAP.

Calculating fair value of insurance portfolios at transition using the fair value approach

Background

2 The EFRAG Secretariat understands that IFRS 17 will offer the following possibilities in transitioning to the new Standard:

(a) Retrospective application;

(b) Modified retrospective application; and

(c) Fair value approach.

3 In case retrospective application is impracticable, the entity has a free choice on a group-by-group basis between the modified retrospective approach and the fair value approach.

4 In this paper, only the fair value approach is being discussed.

Information gathered from EFRAG IAWG members

5 In February 2017, the EFRAG Secretariat noted the following key messages from EFRAG IAWG members on the fair value approach:

(a) Most insurance entities – preparers - understood how to determine a fair value for insurance liabilities. One insurance entity did not fully understand IFRS 13 *Fair Value Measurement.* None of the insurance entities were looking for further rules based guidance to be incorporated in the Standard;

(b) Additional guidance could benefit users allowing for comparability between insurance entities. It was however unclear what additional guidance on top of IFRS 13 would be necessary to achieve that goal;

(c) At transition, when applying the fair value approach, insurance entities would have to include the compensation that a market participant would require for taking on the obligation (that is, a positive contractual service margin (CSM) representing future profits would be recognised on transition);

(d) When applying the fair value approach, insurers-preparers see themselves faced with a choice between i) presenting a relatively high CSM with relatively low equity, or ii) presenting a relatively high equity with a small CSM. Depending on the choice made financial markets could react differently, which was the concern of the preparers. The EFRAG Secretariat did not agree with this analysis, as described below; and

(e) It would take time for insurance entities to make the choice described in the above sub-paragraph (d).

6 In April 2017, the following additional messages were noted on the fair value measurement approach to transition:

(a) One EFRAG IAWG member had doubts whether the fair value used in acquisition accounting could be extrapolated in order to determine the fair value of insurance liabilities when transitioning to IFRS 17;

(b) It was noted that in determining fair value, subjective input would be used as it would be highly unlikely that Level 1 or even Level 2 fair value information would be available;

(c) EFRAG IAWG members generally understood that, at transition to IFRS 17, a positive margin required by a market participant would be part of the fair value. While it was straightforward for profitable business, this was also true for loss-making business. This is because IFRS 13 is clear on including the compensation that a market participant would expect in determining fair value. It was very unlikely that a third party would take on the risks of an insurance portfolio without the expectation of any profit; and

(d) However, in some actuarial discussions it was reasoned that the Solvency II concept of calculating fair value was more or less the same as the IFRS 13 fair value and therefore the CSM was considered to be zero. This was the view of industry representatives who presented the IASB's field-test results to EFRAG TEG in December 2016.

EFRAG Secretariat analysis

Introduction

7 The EFRAG Secretariat notes that, in estimating the CSM on transition, entities will have to calculate the difference between the fair value of a group of insurance contracts measured at that date in accordance with IFRS 13, and calculate the fulfilment cash flows measured at that date, in accordance with IFRS 17. In accordance with IFRS 13, the fair value of a group of insurance contracts shall include the compensation that a market participant would require for taking on the obligation.

8 While the application of this requirement is clear to almost all EFRAG IAWG members, the EFRAG Secretariat notes that EFRAG IAWG members, in their February 2017 meeting, put emphasis – independent of the IFRS requirements - on the interaction between:

(a) determination of the CSM; and

(b) determination of equity.

9 The EFRAG Secretariat understands that EFRAG IAWG members see the 'compensation that a market participant would require' as being equal to CSM[1]', which will only be the same by coincidence. The determination of the compensation

[1] Note that in this case, "CSM" is not necessarily equal to the CSM calculated under IFRS 17 – it may be the unearned profit that the entity has not recognised under its pre-IFRS 17 GAAP.

a market participant would require is a market-based measurement; the determination of the CSM is a company and product specific measurement. The difference does however provide useful information about the overall profitability of the entity's insurance liabilities compared to a market view, i.e. does the entity expect to be more or less profitable than the insurance market in future periods.

Determination of fair value at transition: no free choice

10 Determination of fair value is done from a market participant's perspective. There is *no free choice* for the entity in determining it.

11 The EFRAG Secretariat considers that including a compensation from a market participant perspective is likely to result in a change to the 'in-house'[2] calculation of the CSM. That change could be positive or negative. When the compensation from a market participant is higher than the 'in-house' CSM, it means a market participant would require more profit to assume the risks incorporated in the portfolio than the entity is currently expecting to recognise in future periods under its previous GAAP. Alternatively, when the compensation from a market participant is lower than the 'in-house' CSM, it means a market participant would require less profit than the entity is currently expecting, to assume the risks incorporated in the portfolio.

The relation between CSM and equity

12 The relation between CSM and equity is understood by the EFRAG Secretariat - for the existing business - as an optimisation exercise. The intention of it being that, the higher the CSM is set at transition, the lower the resulting IFRS retained earnings and vice-versa.

13 The EFRAG Secretariat assesses that the optimisation exercise is a balancing act between (i) showing sufficient capital in order to withstand solvency issues and (ii) showing sufficient profitability over the coverage period. The EFRAG Secretariat acknowledges that the capacity to pay future dividends is determined by the statutory accounts.

14 The EFRAG Secretariat does not agree that such an optimisation exercise is available within the determination of the fair value of insurance liabilities. As explained above, in determining fair value there is no free choice available. However, the EFRAG Secretariat can see that a choice between using (i) the fair value approach and (ii) the modified retrospective approach provides the entity with some control over the split between equity and CSM at transition. That is, the entity can apply – to some extent - an optimisation exercise *between* transition methods.

Question to EFRAG TEG members

15 Do EFRAG TEG members have questions about the calculation of fair value of insurance liabilities at transition?

Questionnaire for EFRAG IAWG members

Introduction

16 The EFRAG Secretariat wishes to build a more detailed understanding of current insurance accounting practices by issuing a questionnaire to EFRAG IAWG members. The results of this questionnaire are meant to help the EFRAG Secretariat in:

[2] The words 'in-house' are used to provide contrast to the market perspective and refer to the CSM calculation prior to application of IFRS 17.

(a) Describing insurance accounting as applied by European insurers today considering necessary nuances and different insurance business (based upon materiality); and

(b) Preparing a case study approach – as part of the future endorsement process of IFRS 17 - identifying the challenges relating to the implementation of IFRS 17.

17 The current insurance accounting landscape is a diversified environment affected by many variables and spread across different types of insurance business. The EFRAG Secretariat seeks help from the EFRAG IAWG members in obtaining a sufficiently detailed picture on the current accounting for insurance contracts within Europe, i.e. granular enough to picture and differentiate between each situation that is of material size in Europe.

18 The results of the questionnaire are also expected to help in drafting the case studies by (i) identifying the areas of considerable differences with the upcoming insurance standard; (ii) identifying the extent to which areas are already documented in the financial statements; and (iii) providing an understanding of the business reasons for current practices.

Fields addressed in the questionnaire

19 The questionnaire touches upon the following topics:

(a) Understanding current accounting of insurance contracts;

(i) How national GAAP is used for measuring types of insurance products;

(ii) Grouping of insurance contracts (i.e. the unit of account);

(iii) Measurement of the insurance liability;

(iv) How insurance contracts are managed;

(v) Definition of revenue;

(b) Treatment of accounting mismatches;

(c) Specific elements of the insurance business, e.g., key performance indicators and trends in product offerings;

(d) Mutual insurers;

(e) Re-insurance;

(f) Use of Solvency II; and

(g) Asset-liability management.

Timing

20 The questionnaire will be issued mid-May 2017, with answers expected by end September 2017. The results will be, to the extent possible, aggregated and discussed with EFRAG IAWG and EFRAG TEG. Where confidential information is provided, the EFRAG Secretariat will ensure necessary confidentiality.

Question to EFRAG TEG members

21 Do EFRAG TEG members have questions about the questionnaire for EFRAG IAWG members relating to current insurance accounting practices?