IFRS 17 *Insurance Contracts*
Key issues

Objective

1 At the meeting of the EFRAG Board in May 2018, it was agreed that the EFRAG Board should discuss issues that should be considered in the IFRS 17 draft endorsement advice. This paper is designed to assist the EFRAG Board by providing a structured basis for discussion.

2 EFRAG Board members were requested to provide their three key issues. This paper lists the issues provided and includes a brief description on the specific concern(s) related to each issue. The list is not intended to be comprehensive.

Issues for consideration

3 Issues identified by EFRAG Board members (in no particular order) are:

(a) Effective date of IFRS 17;

(b) Level of aggregation and annual cohorts;

(c) Release of the contractual service margin (CSM);

(d) Scope of the variable fee approach;

(e) Reinsurance;

(f) Transition;

(g) Cost and complexity; and

(h) Lack of comparability.

Effective date of IFRS 17

4 Those who have raised a concern that the IFRS 17 effective date of annual periods beginning 1 January 2021 might be too early have provided the following information:

(a) Software solutions are still being developed;

(b) Insufficient technical expertise is available globally; and

(c) The ongoing work of the IASB's transition resource group may lead to clearer interpretations of IFRS 17.

Level of aggregation and annual cohorts

5 Unlike most IFRS Standards, IFRS 17's recognition and measurement requirements are based on groups of contracts rather than individual contracts. This recognises the special nature of the insurance business model.

6 IFRS 17 groups contracts through a three-step process:

(a) Collect contracts into portfolios that are subject to similar risks and are managed together.

(b) Subdivide each portfolio into groups: contracts that are onerous at initial recognition (if any), contracts that at initial recognition have no significant possibility of becoming onerous subsequently (if any), and remaining contracts (if any).

(c) Ensure that no group contains contracts that were issued more than one year apart.

7 The IASB's intentions in designing this approach include the following:

(a) to ensure that losses on onerous contracts at inception are recognised immediately;

(b) by requiring the separate grouping of contracts that have the possibility of becoming onerous, to limit the extent to which losses on contracts that become onerous after initial recognition are sheltered by profitable contracts;

(c) through the annual cohorts requirement, to ensure that the CSM is released over the period that the services are provided and that it is fully released when all the contracts in a group are completed. This is designed to provide information on profit trends over time as the economics of contracts change.

8 Concerns about the grouping requirements that have been raised include that they:

(a) are inconsistent with the insurance business model, especially the asymmetric recognition of losses on contracts that are onerous at inception, which may not reflect the level at which pricing decisions are taken;

(b) do not support the practice of mutualisation, especially the annual cohort requirement which is criticised as rule-based and artificial; and

(c) are costly and complex to apply.

Release of the CSM

9 IFRS 17 requires the CSM (unearned profit) to be released as the services under the contract are provided, over the insurance coverage period. This is designed to provide a pattern of profits that reflects the performance of the insurer.

10 Concerns about the pattern of release of the CSM include the following:

(a) It does not reflect the insurance business model, including preventing the intergenerational transfer of profits and mutualisation.

(b) The requirements of IFRS 17 are insufficiently flexible and may not therefore reflect the specificities of some types of contract. For example, in the case of contracts with discretionary participation features that do not fall within the scope of the variable fee approach, the required pattern of release of the CSM may not reflect the services provided in the optimum manner.

(c) There is a lack of clarity in how IFRS 17 should be applied.

Scope of the variable fee approach

11 The variable fee approach (VFA) was designed to reflect the interdependence of investments and the insurance contract liability for contracts in which the insurer can be regarded as providing an asset-management service in addition to insurance coverage. The VFA approach has the practical effect of spreading the effect of changes in the entity's share of gains and losses on the related assets.

12 IFRS 17 limits the scope of the VFA to contracts for which there is a contractually-specified relationship between identified assets/investments and the returns to the policyholder.

13 The major concern about the scope of the VFA is that some insurers issue insurance contracts that do not meet the eligibility conditions but the insurer considers that they are economically similar to contracts that do qualify. Some insurers refer to contracts in which the relationship between investments and the contract liability arises from a constructive rather than a contractual obligation.

Reinsurance

14 IFRS 17 treats a primary insurance contract and an associated reinsurance contract as separate contracts. In buying reinsurance, IFRS 17 considers that this is a service contract (as would be the case if a non-insurer purchased insurance). This leads to the following concerns:

(a) The primary insurer is not permitted to net the primary insurance contract and the reinsurance contract even if the provisions of the reinsurance contract exactly mirror the conditions of the primary insurance contract.

(b) Where the primary insurance contract is onerous at inception and the associated reinsurance contract is profitable, the losses on the primary insurance contract are recognised immediately while the profit on the reinsurance contract is spread over the reinsurance contract term.

(c) Where a reinsurance contract relates to existing and future primary insurance contracts, existing practice is to recognise the reinsurance contract only to the extent of issued primary insurance contracts. Under IFRS 17, the asset or liability recognised by the primary insurer for the reinsurance contract can reflect cash flows for primary insurance contracts not yet written.

(d) Reinsurance contracts are not eligible to apply the variable fee approach. For those who consider that the primary reinsurer should be allowed to apply the variable fee approach to a reinsurance contract held, it is not clear how this should be done.

Transition

15 The effect of the transition will have a pervasive effect for long-term business for a number of years. IFRS 17 requires full retrospective restatement at the start of the comparative period unless this is impracticable. Where full retrospective restatement is impracticable for a group of contracts, IFRS 17 offers two options: a modified retrospective approach or a fair value approach.

16 Concerns with these requirements of IFRS 17 include:

(a) The modified retrospective approach is too stringent and should be simplified;

(b) The fair value approach is forward looking, does not reflect past practices and will provide a pattern of performance that is inconsistent with past performance; and

(c) Any past hedging arrangements cannot be retained at transition.

Cost and complexity

17 The costs of implementing IFRS 17 will depend on entity-specific factors including range of products, and existing systems and processes. IFRS 4 *Insurance Contracts* grandfathered many insurance practices. EFRAG Secretariat is in the process of analysing the cost estimates received in the case study submissions.

Lack of comparability

18 Concerns have been raised that IFRS 17 requires the application of judgment and contains a number of options which may impair comparability.

19 Judgement is inherent in accounting for the insurance business. Although the nature of the judgements needed in applying IFRS 17 may change from current practice, it is not clear whether the need for judgement will increase.

20 Options were introduced into IFRS 17 as it developed in response to requests from the insurance industry. Although users have raised concerns about the options, it is not clear whether preparers share the same concerns.

Question for the EFRAG Board

21 Do you have any preliminary views on how the above issues should be reflected in the draft endorsement advice?