EFRAG Board - Educational Session 3

IFRS 17 *Insurance Contracts*

06 February 2018

Agenda paper 09.01

EFRAG

European Financial Reporting Advisory Group

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OVERVIEW

Reinsurance contracts

Investment contracts with DPF

Presentation change from IFRS 4

Transition

Disclosures

Insurance business models

Risk mitigation

Jargon used

OVERVIEW

General model BBA

Modified/ changed for

Variable Fee Approach

For insurance contracts with direct participation features: i) participating in clearly defined pool of assets; ii) policyholder is paid a substantial part of fair value returns of underlying items and iii) a substantial proportion of amounts paid to policyholder varies with fair value returns of underlying items

Premium Allocation Approach

For insurance contracts where measurement of liability for remaining coverage is expected not to differ materially from measurement under the general model or where contract boundary is one year or less

Reinsurance contracts

An insurance contract issued by one entity to compensate another entity for claims arising from one or more insurance contracts issued by that other entity.

Investment contracts with DPF

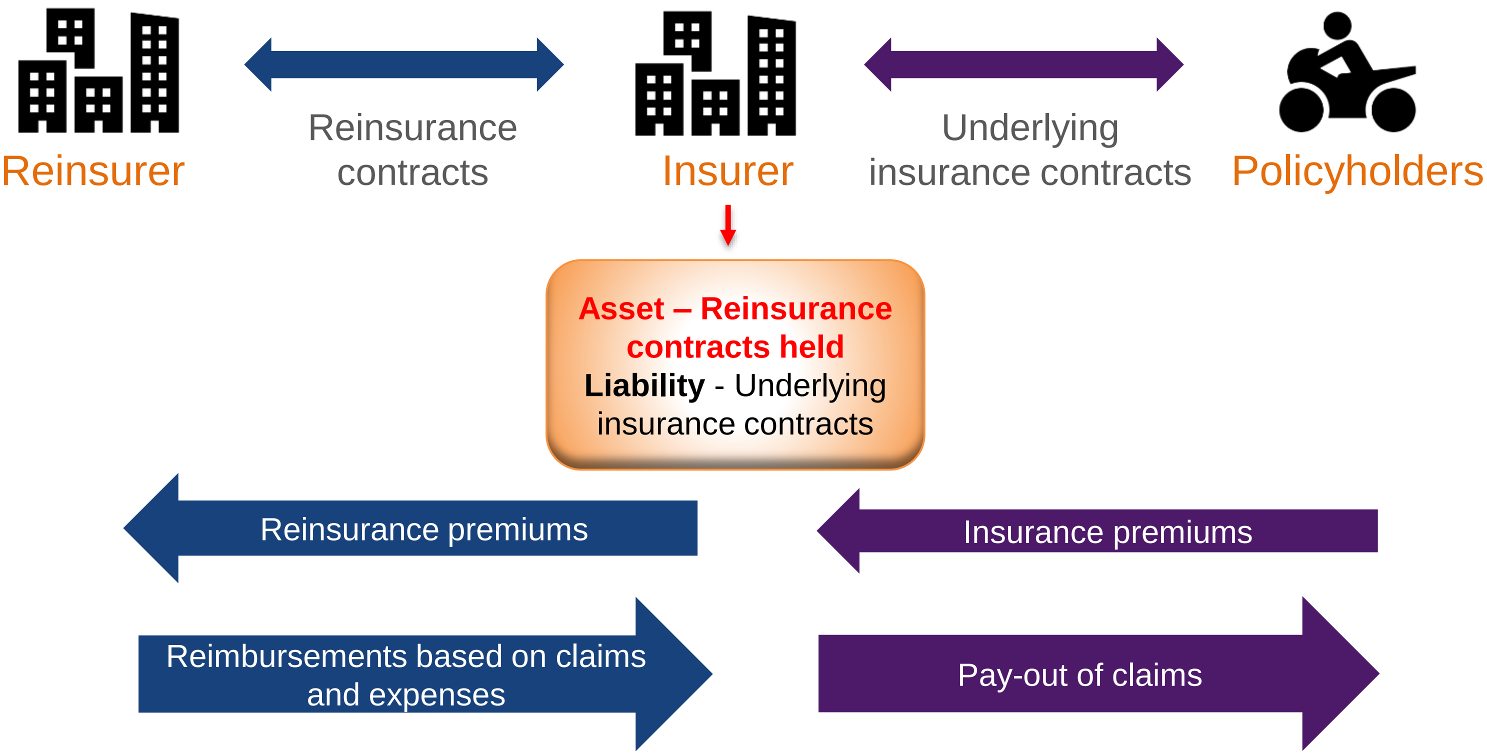
A financial instrument that provides the contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts

REINSURANCE CONTRACTS

REINSURANCE CONTRACTS HELD

What is a reinsurance contract held?

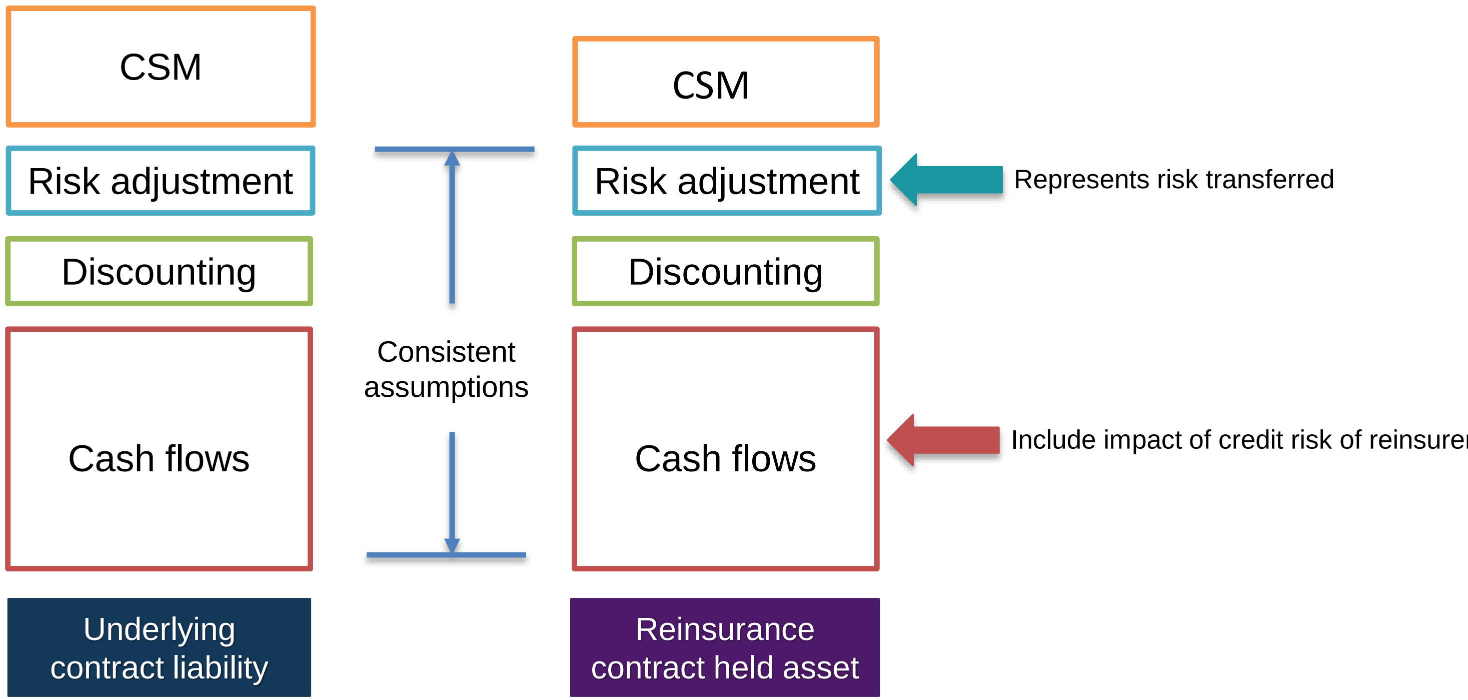
It is a contract held by the insurer whereby the reinsurer compensates the insurer for claims arising on underlying insurance contracts



REINSURANCE CONTRACTS HELD

MEASUREMENT OF REINSURANCE CONTRACTS HELD

In the insurer's books



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 (1/3)

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

- IFRS 17, paragraph 62 determines when to recognise reinsurance contracts held, depending on whether these provided proportionate coverage or not.

ISSUES RAISED BY EFRAG IAWG MEMBERS – REINSURANCE HELD (2/3)

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 (3/3)

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.

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

PRESENTATION CHANGE FROM IFRS 4

PRESENTATION CHANGE FROM IFRS 4

Reporting performance

IFRS 4*	IFRS 17	Key changes
Premiums	Insurance revenue	- Insurance revenue excludes deposits
Investment income	Incurred claims and expenses	
Incurred claims and expenses	**Insurance service result**	- Revenue and expense are recognised as earned or incurred
Change in insurance contract liabilities	Investment income	
Profit or loss	Insurance finance expense	- Insurance finance expense is excluded from insurance service result and is presented (i) fully in P/L or (ii) in P/L and OCI, depending on accounting policy
	Net financial result	
	Profit or loss	
	Discount rate changes on insurance liability *(optional)*	
	Total comprehensive income	- Written premiums disclosed in the notes

(*) Common presentation in the statement of comprehensive income in applying IFRS 4

Source: IASB Capital Markets Advisory Committee Meeting, March 2017 – Agenda paper 7

PRESENTATION CHANGE FROM IFRS 4

Balance sheet presentation

IFRS 4*	IFRS 17	Key changes
Assets		- Groups of insurance (or reinsurance) contracts that are in an asset position presented separately from groups of insurance (or reinsurance) contracts that are in a liability position - Other assets and other liabilities included in the measurement of insurance contracts issued and reinsurance contracts held resulting in an overall simplified presentation on the balance sheet
Reinsurance contract assets	Reinsurance contract assets	
Deferred acquisition costs	Insurance contract assets	
Value of business acquired		
Premiums receivable		
Policy loans		
Liabilities		
Insurance contracts liabilities	Insurance contracts liabilities	
Unearned premiums	Reinsurance contracts liabilities	
Claims payable		

(*) Common presentation in the balance sheet in applying IFRS 4

Source: IASB Capital Markets Advisory Committee Meeting, March 2017 – Agenda paper 7

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(*) Common presentation in the balance sheet in applying IFRS 4

Consists of

- Fulfilment cash flows
- Contractual service margin
- Liability for incurred claims

ISSUES RAISED BY EFRAG IAWG MEMBERS: PRESENTATION

Presentation of groups of insurance contracts	IFRS 17, paragraphs 40, 78-79: Requires entities to present groups of insurance contracts that are in an asset position separately from groups of insurance contracts that are in a liability position. As a result of the required presentation, IFRS 17 will amend IAS 1 paragraph 54

Points raised by EFRAG IAWG

Separate presentation of groups of assets and liabilities would cause operational difficulties as cash management systems are not aligned with the grouping required by IFRS 17

Further considerations

Offsetting of assets and liabilities reduces the usefulness of the information presented on the balance sheet. A change in timing of expected cash flows is useful information for users.

TRANSITION

TRANSITION

OVERVIEW

Is it impracticable to use a full retrospective approach?

No

Full retrospective approach

As if IFRS 17 had always been applied.

Yes

Either

Modified retrospective approach

Achieves closest outcome of full retrospective application possible using reasonable and supportable information without undue cost or effort.

Or

Fair value approach

CSM as the difference between the fair value of the group of insurance contracts based on IFRS 13 and the fulfilment cash flows of the group.

- Separate disclosures for each transition method
- Opportunity to reassess the classifications for financial assets under IFRS 9

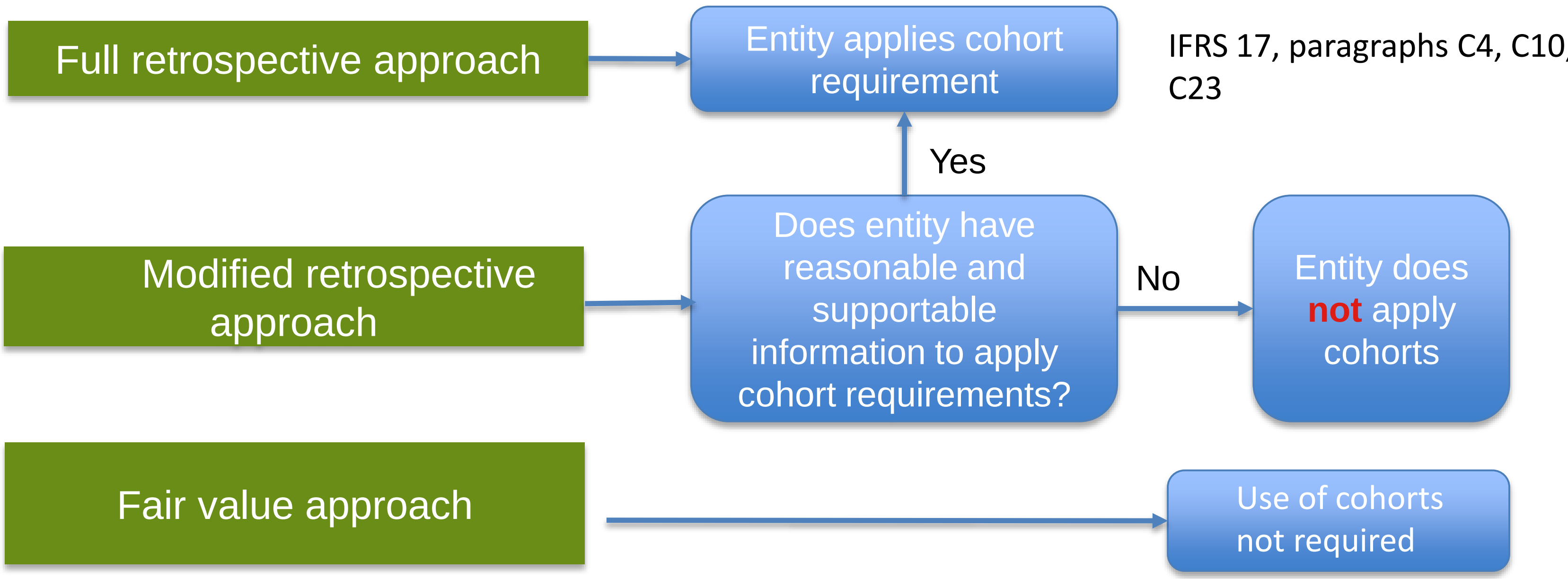
IFRS 17, paragraphs C3-C24

TRANSITION

LEVEL OF AGGREGATION

Entity applies portfolio level and group[1] level to each transition approach

Cohort[2] level is applied depending on transition approach used:



[1] Groups that are, if any, (i) Onerous (ii) Possibility of becoming onerous (“remaining contracts”) and (iii) No significant possibility of becoming onerous subsequently.
[2] Each cohort comprises of contracts issued within one year.

ISSUES RAISED BY EFRAG IAWG MEMBERS: TRANSITION (1/2)

Fair value approach	Issue 1: IFRS 17, paragraphs C5: At transition to IFRS 17, applying the fair value approach will lead to a zero[1], or very small contractual service margin Issue 2: IFRS 17, paragraphs C6 to C9: A fair value approach could result in a lower CSM on transition than if the fully retrospective approach is used which would influence the profitability of insurance entities with long-term business over a significant period. The concern is that the modified retrospective approach may be too onerous to be used.

Points raised by EFRAG IAWG	**Further considerations**
Issues 1 and 2	
The compensation that a market participant requires will almost always differ from the CSM calculated for internal purposes. Therefore the CSM on transition does not entirely represent the profit for future services.	The fair value approach recognises the transition effect over the remaining duration of the contract portfolio in line with the long-term busines model
Fair value measurement usually requires significant estimates which could increase the possibility for judgement	At transition, some entities may consider a trade-off between the CSM recognised on the one hand and the equity recognised on the other. Using a fair value approach provides an alternative for when historical information is not available to apply retrospective application.

[1] Note from the EFRAG Secretariat: the compensation that a market participant would require to be included in the fair value of the insurance liabilities will not be zero as no market participant will be willing to accept insurance and financial risk for free

ISSUES RAISED BY EFRAG IAWG MEMBERS: TRANSITION (2/2)

Risk mitigation and changes to modified retrospective approach	Issue 3: IFRS 17, paragraphs B115-B116: Risk mitigation for contracts that apply the VFA is to be applied prospectively at transition Issue 4: IFRS 17, paragraphs C6-C19: the modified retrospective approach should be further changed to allow for the calculation of a meaningful CSM

Points raised by EFRAG IAWG	Further considerations
Issue 3	
The prospective application of risk mitigation reduces the entity's possibilities in "optimising" their opening equity position at transition	The prospective use of risk mitigation at transition avoids the use of hindsight
Prospective application decreases the comparability of information over time.	Retrospective application could be burdensome and costly to apply due to the information needed that is not readily available
Issue 4	
Instead of the fair value approach, entities should be able to rely on a « further » modified retrospective approach. I.e. allowing that the value in force can be adapted for past CSM releases, noting that data for the latter are available only for a limited number of years.	Depending on the availability of historical information, entities can elect on transition the approach which is most relevant to reflect their business.

DISCLOSURES

DISCLOSURES

General disclosure objective is to disclose information that gives a basis for users to assess the effects that insurance contracts have on the entity's financial position, financial performance and cash flows.

Entities consider the level of detail that is necessary to satisfy the general disclosure objective.

Examples of aggregation bases that may be appropriate for information disclosed:

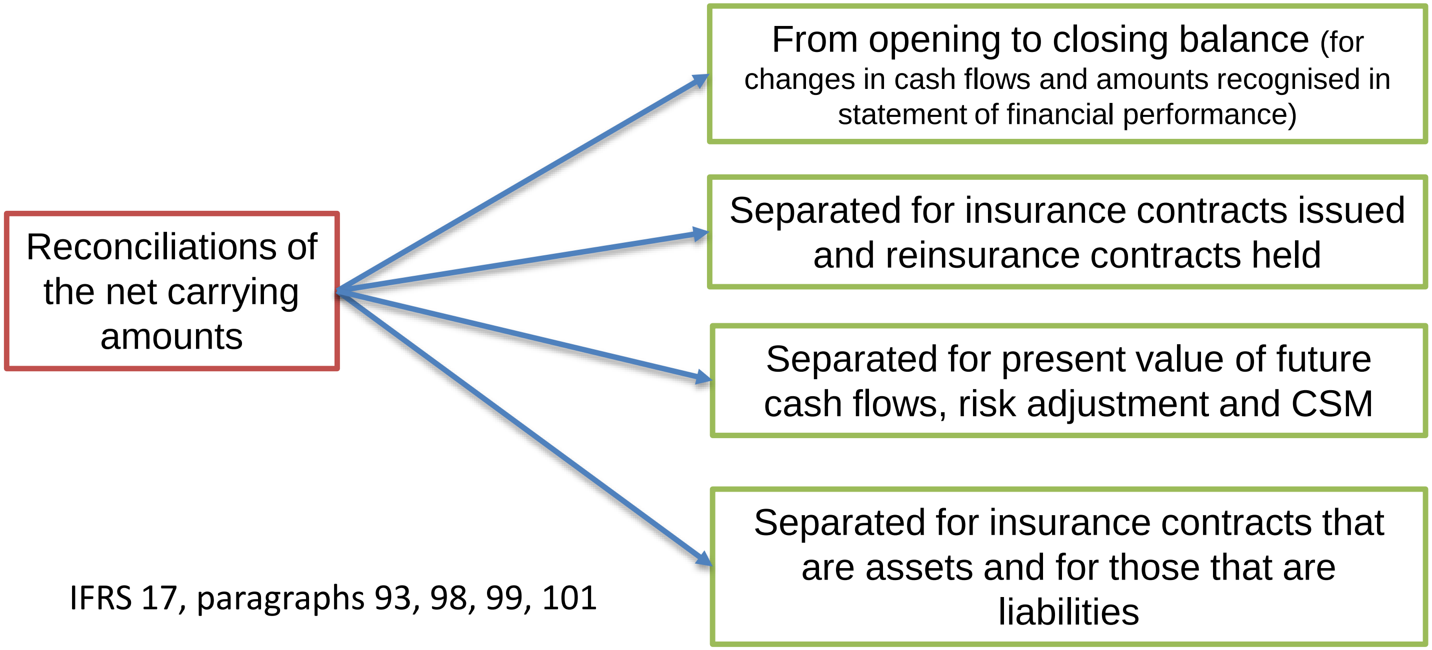
- type of contract (e.g. major product lines);
- geographic areas (e.g. country or region); and
- reportable segments (as defined in IFRS 8 *Operating Segments*) .

IFRS 17, paragraphs 93, 96

DISCLOSURES

IFRS 17 contains specific disclosure requirements that focus on information about:

- amounts recognised in the financial statements by means of reconciliations;
- significant judgements and changes to those judgements; and
- the nature and extent of risks that arise from insurance contracts.



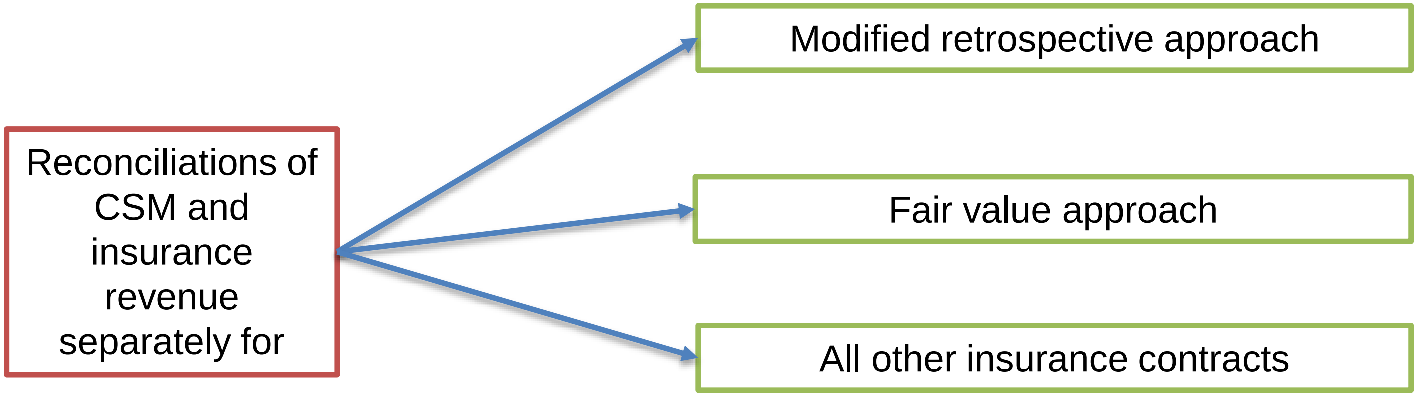
IFRS 17, paragraphs 93, 98, 99, 101

DISCLOSURES

TRANSITION AMOUNTS

On transition, an entity should provide disclosures to:

- identify the effect of groups of insurance contracts measured at the transition date
- explain how it determined the measurement of insurance contracts at the transition date.

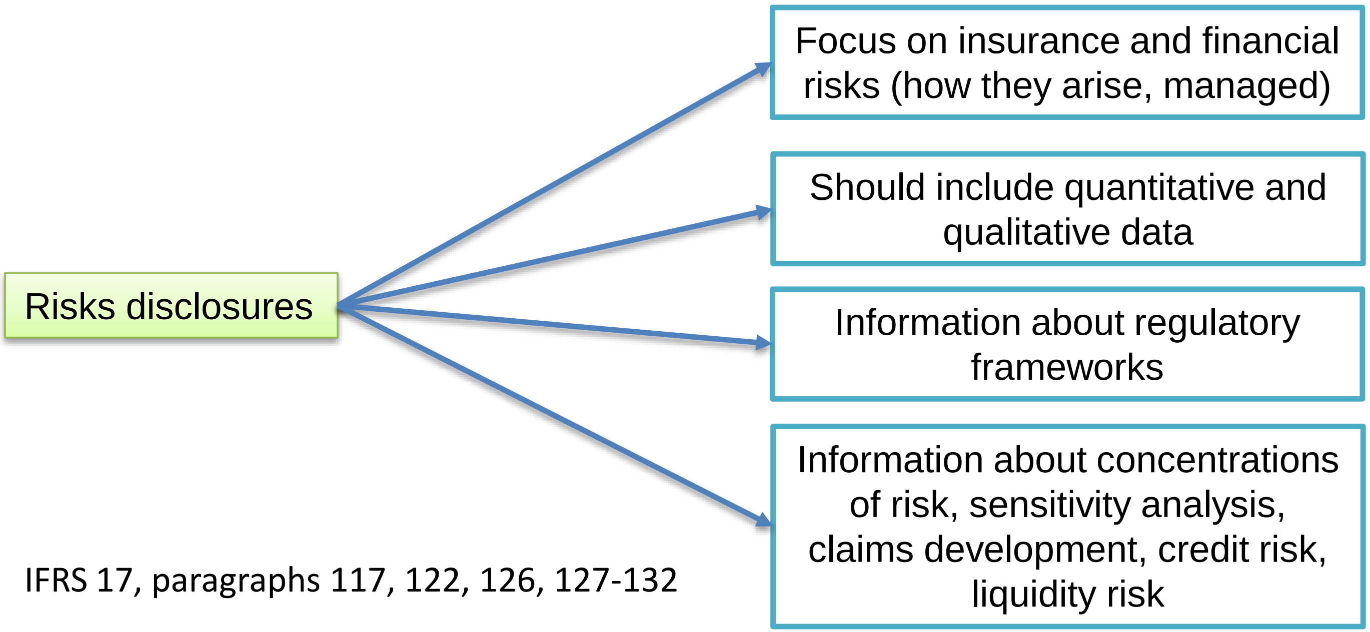


IFRS 17, paragraphs 114, 115

DISCLOSURES

Entities discloses information about the *significant judgements*, these include:

- the methods used to measure insurance contracts and the processes for estimating the inputs into those methods (includes quantitative information, unless impracticable); and
- any changes in estimating inputs used, the reason for change and the type of contracts affected.



IFRS 17, paragraphs 117, 122, 126, 127-132

ISSUES RAISED BY EFRAG IAWG MEMBERS – DISCLOSURES

Disclosures	IFRS 17, paragraphs 93-132: The disclosure requirements are not aligned with Solvency II which affects their relevance.

Points raised by EFRAG IAWG	**Other considerations**
The non-alignment between the two reporting frameworks increases the cost for entities.	The non-alignment with Solvency II enhances comparability between European and non-European insurers.
Although Solvency II and IFRS 17 requirements have different objectives, there are some similarities regarding the measurement of insurance contract liabilities (estimates of future cash flows, current discount rates, adjustments for risk) which can be leveraged from in order to reduce duplication of disclosure.	Solvency II and IFRS 17 have different objectives. Solvency II is not designed as a performance reporting metric. It focuses on capital required. Consequently, any comparison between Solvency II and IFRS 17 is meaningful for balance sheet information only.
One of the key stakeholders for insurance entities is the regulator, therefore consideration should be given to information that is relevant for them.	Under IFRS 17, insurance entities are not prevented from disclosing information on their capital requirements. In fact, IAS 1 requires such disclosure.

INSURANCE BUSINESS MODELS

INSURANCE BUSINESS MODELS

NO UNIFORMITY: Some general identifiers

Multiple identifiers can be combined into one activity
• Long duration, eg life insurance
• Short(er) duration, eg non-life insurance (tail risk may occur, i.e. claims may occur after the contract period has ended)
• Insurance coverage only
• Savings coverage provided in addition to insurance coverage
• Operational reinsurance vs financial reinsurance
• Assets managed in a dedicated fund or general fund
• Degree of risk sharing: shareholders absorb all risks, act only as risk-taker of last resort or anything in between
• …

INSURANCE BUSINESS MODELS

SOME INSURANCE BUSINESS PRACTICES

Pooling of risks

from individual policyholders and spreading it across a portfolio.*

Risk diversification

Ensures that an insurer's aggregate risk is less concentrated in one single risk

* For example, the claim as a result of a fire destroying a house, is financed not only by the premiums of the policyholder affected, but by the premiums of a large number of policyholders.

INSURANCE BUSINESS MODELS

TYPES OF CONTRACTS

Different ways of managing insurance business depending on type of contract:

- Participating contracts[1] whereby, in addition to insurance cover, the policyholder receives a return based on assets
- Non-participating contracts, eg, car insurance
- Reinsurance contracts issued and held

[1] These can be indirect participating (which apply the General Model) or direct participating contracts (which apply the Variable Fee Approach)

JARGON USED

JARGON USED

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.

Financial risk: The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable.

Liability for incurred claims: An entity’s obligation to investigate and pay valid claims for insured events that have already occurred, including events
that have occurred but for which claims have not been reported, and other incurred insurance expenses.

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