IFRS 17 *Insurance Contracts*
Issues raised by the insurance industry – remaining issues

Objective

1 The objective of this paper is to seek the views of EFRAG TEG on the remaining issues raised by the insurance industry and include EFRAG TEG's view as to how these issues should be raised in the draft endorsement advice to be recommended by EFRAG TEG to the EFRAG Board.

Background

2 Insurers that provided responses to the full and simplified case studies provided a combination of evidence (quantitative and qualitative) and views on the effects of IFRS 17 *Insurance Contracts* and its acceptability in its current form. The CFO Forum presented its members' analysis of the key findings/concerns from the case study to the EFRAG Board on 3 July. This presentation was made available to EFRAG TEG as agenda paper 05-05 for the meeting on 5 July 2018[1].

3 The EFRAG Board requested an analysis of the issues for consideration at a future meeting. Accordingly, the EFRAG Secretariat has prepared analyses of the issues which are attached to this paper. The analyses summarise the relevant requirements of IFRS 17 and include evidence from the case studies.

4 EFRAG TEG discussed 7 of the 12 issues during the meeting on 25 July 2018, this paper deals with the remaining issues.

List of remaining issues

5 The list of remaining issues that were raised in the presentation to the EFRAG Board are:

(a) Measurement:

(i) Transition;

(b) Operational complexity:

(i) Business combinations;

(ii) Level of aggregation;

[1] The CFO Forum has since written to the President of the EFRAG Board and to the Chairman of the IASB calling for IFRS 17 (and IFRS 9) to be re-opened to address the CFO's Forum's concerns prior to endorsement.

(iii) Presentational issues;

(c) Other implementation challenges:

(i) Pressure on implementation timeline.

6 The CFO Forum also raised the issue of costs. This will be the subject of a separate paper.

Evidence from the case studies

7 The evidence from the case studies must be read in the light of the fact that case study participants made their best endeavours, but without fully developed systems to support their work. This required the use of shortcuts and approximations, given the time available. Further, the accounting policies used in the case studies and the IFRS 17 options selected may change as further analysis and information becomes available.

8 In the analysis, the evidence from the case study is derived from the full case study unless specifically mentioned that the evidence came from the simplified case study. The evidence from the case study included in this paper is necessarily summarised and therefore not comprehensive (but is intended to be representative).

Questions for EFRAG TEG

9 Does EFRAG TEG agree with the EFRAG Secretariat analysis, especially the aspects of the endorsement criteria that would be affected by the issues raised?

10 Does EFRAG TEG have other comments on the analysis before presentation to the EFRAG Board?

MEASUREMENT

8. Transition

CFO Forum Presentation

Description of issue and evidence

11 Applying the fully retrospective approach to transition is expected to be impossible in many cases due to the need for detailed historical data for long historic periods.

12 The modified retrospective approach is very restrictive and will not provide the simplifications that make retrospective application possible in practice.

13 The option to set OCI to nil under the fair value approach is not available to assets accounted at fair value through OCI.

Implications

14 If the modified retrospective method is not improved, insurers will be forced into the fair value approach for many portfolios. Whilst the fair value approach is a helpful practical expedient in some cases, it may not provide an appropriate profit recognition pattern in all cases. Depending on the final interpretation of the fair value, this could be the case for portfolios with significant in-force and significant new business.

15 Setting OCI on the liabilities to nil at transition, whilst maintaining the historical OCI on related assets will distort equity at transition and results going forward significantly.

IFRS 17 and IFRS 13

Requirements

IFRS 17, Appendix C

16 An entity shall apply IFRS 17 retrospectively unless impracticable.

17 If, and only if, it is impracticable for an entity to retrospectively apply IFRS 17 for a group of insurance contracts, an entity shall apply the following approaches:

(a) the modified retrospective approach; or

(b) the fair value approach.

<u>Modified retrospective approach</u>

18 The objective of the modified retrospective approach is to achieve the closest outcome to retrospective application possible using reasonable and supportable information available without undue cost or effort. In applying this approach, an entity shall:

(a) use reasonable and supportable information. If the entity cannot obtain necessary reasonable and supportable information, it shall apply the fair value approach.

(b) maximise the use of information that would have been used to apply a fully retrospective approach, that is available without undue cost or effort.

19 Permitted modifications are:

(a) assessments of insurance contracts or groups of insurance contracts that would have been made at the date of inception or initial recognition;

(b) amounts related to the contractual service margin or loss component for insurance contracts without direct participation features;

(c) amounts related to the contractual service margin or loss component for insurance contracts with direct participation features; and

(d) insurance finance income or expenses.

<u>Fair value approach</u>

20 To apply the fair value approach, an entity shall determine the CSM or loss component of the liability for remaining coverage at the transition date as the difference between the fair value of a group of insurance contracts at that date and the fulfilment cash flows measured at that date. Fair value is determined in accordance with IFRS 13 *Fair Value Measurement*.

IFRS 13, paragraphs 9, 41

21 Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

22 When applying a present value technique an entity might take into account either of the following:

(a) the future cash outflows that a market participant would expect to incur in fulfilling the obligation, including the compensation that a market participant would require for taking on the obligation.

(b) the amount that a market participant would receive to enter into or issue an identical liability or equity instrument, using the assumptions that market participants would use when pricing the identical item (eg having the same credit characteristics) in the principal (or most advantageous) market for issuing a liability or an equity instrument with the same contractual terms.

IFRS 17, paragraphs C18, C24

23 In applying the fair value approach, if an entity chooses to disaggregate insurance finance income or expenses between profit or loss and OCI, it is permitted to determine the cumulative amount of insurance finance income or expenses recognised in OCI at the transition date:

(a) retrospectively – but only if it has reasonable and supportable information to do so; or

(b) as nil – unless (c) applies; and

(c) for insurance contracts with direct participation features, as equal to the cumulative amount recognised in other comprehensive income from the underlying items.

24 A similar provision for setting OCI to zero is available for the modified retrospective approach.

Findings from the case study

25 Number of respondents addressing the issue: 3 (for the restrictive use of the modified retrospective approach) and 4 (for the option to set OCI to nil under the fair value approach).

26 Of the 40 portfolios where information on transition was provided:

(a) 9 used the full retrospective approach

(b) 13 used the modified retrospective approach

(c) 14 used the fair value approach

(d) 4 applied the PAA

27 For the remaining portfolios, the effects on transition were not quantified.

28 For the liabilities at transition:

(a) Full retrospective 5.5%

(b) Modified retrospective 63.2%

(c) Fair value 30.5%

(d) PAA 0.8%

29 One respondent adjusted the modified retrospective approach but gave no details about the adjustments.

30 The case study provides the following insights into the difficulties in applying the requirements of the modified retrospective approach:

(a) The requirements in IFRS 17 paragraphs C12, C17(c)(i) and C17(c)(ii) to make adjustments for amounts between initial recognition and transition (or earlier) date will prove to be very difficult (three respondents)

(b) The requirement in IFRS 17 paragraph C9(a) to split portfolios by profitability group (onerous, no significant possibility of becoming onerous, other) is likely to mean that they need to identify cash flows at a lower level than the portfolio level (i.e. individual contract or sub-groups within portfolios). This significantly increases the granularity of the data required (two respondents).

(c) The requirement in IFRS 17 paragraph C10 to produce transition figures by annual cohort is potentially significantly more onerous than if cohorts can be grouped together (two respondents).

(d) The simplifications in respect of loss components in IFRS 17 paragraphs C11-C17 should be consistent between the VFA and general model (one respondent).

One respondent provided suggested changes to address these concerns.

(e) One respondent noted that under IFRS 17 paragraph C6 the modified retrospective approach would require taking into account the past margins, therefore it would not reflect a simple prospective vision of the insurance contracts profitability. This respondent considered the valuation of such past margins to be extremely heavy to perform precisely, looking at the reduced time available to implement IFRS 17.

(f) Another respondent is still investigating whether this approach provides sufficient simplifications to make it operationally feasible.

31 The major reason for not using the full retrospective approach was the lack of available historical data, especially in older systems.

32 Of the 14 portfolios measured under the fair value approach, respondents indicated the following with regards to the option of setting OCI to nil:

(a) For 3 portfolios OCI will be equal to the cumulative amount recognised in OCI from the underlying items.

(b) For 2 portfolios the OCI will be set at nil as they are not restricted by IFRS 17 paragraph C24(c) from applying the option. Also, the selected portfolios were measured under the general model.

(c) For the remaining selected portfolios no information was provided on the treatment of OCI at transition.

EFRAG Secretariat analysis

33 The EFRAG Secretariat acknowledges that several case study participants have raised concerns about the operationality of the modified retrospective approach. However, it is difficult to identify the specific problem(s) and/or their severity and it is also unclear how this approach could be improved.

34 The EFRAG Secretariat also acknowledges the practical challenges of the fair value transition model, and that its outcome could differ materially from the full or modified retrospective approach. However, it is not clear to the EFRAG Secretariat why this approach should result in a systematically 'low' CSM.

35 In the circumstances the EFRAG Secretariat proposes that the concerns raised should be described in the DEA and a question to constituents should be added to seek further insights on the practical challenges of applying the modified retrospective approach.

36 The EFRAG Secretariat acknowledges that a major factor in the classification of financial assets in accordance with IFRS 9 is an entity's business model. The application of IFRS 17 would not of itself have been likely to have resulted in a change in an entity's business model in accordance with IFRS 9. However, the IASB acknowledged that there is a relationship between how entities manage their financial assets and their insurance contract liabilities. Therefore, to reduce the risk of accounting mismatches arising, the IASB decided to allow an entity to reassess its business models on the initial application of IFRS 17 if they have previously applied IFRS 9.

37 The EFRAG Secretariat is therefore of the view that the lack of an option to set OCI to nil at transition for assets classified at FVOCI is not an issue arising from IFRS 17 as entities are permitted to reassess their business models in order to reduce accounting mismatches. The transitional requirements for financial asset accounting are addressed in IFRS 9.

OPERATIONAL COMPLEXITY

9. Business combinations

CFO Forum Presentation

Description of issue and evidence

38 There are several elements in accounting for insurance business combinations that add significantly to complexity, including:

(a) the requirement to assess classification at the acquisition date instead of the original inception date

(b) the treatment of claims in payment at the acquisition date

Implications

39 This will result in a significantly different accounting treatment between the group and subsidiary financial statements. This adds significant unnecessary complexity and costs, particularly for GI business which may require GMM capability only if a future acquisition takes place.

IFRS 17

Requirements

IFRS 17, paragraph B5, B93, B94

40 Some insurance contracts cover events that have already occurred but the financial effect of which is still uncertain. An example is an insurance contract that provides coverage against an adverse development of an event that has already occurred. In such contracts, the insured event is the determination of the ultimate cost of those claims.

41 When an entity acquires insurance contracts issued or reinsurance contracts held in a transfer of insurance contracts that do not form a business or in a business combination, the entity shall apply the level of aggregation requirements to identify the groups of contracts acquired, as if it had entered into the contracts on the date of the transaction.

42 An entity shall use the consideration received or paid for the contracts as a proxy for the premiums received. The consideration received or paid for the contracts excludes the consideration received or paid for any other assets and liabilities acquired in the same transaction. In a business combination, the consideration received or paid is the fair value of the contracts at that date.

Basis for Conclusions

IFRS 17, paragraph BC323, B326, B327

43 The entity determines the CSM in a way that reflects the consideration paid for the contracts.

44 The IASB considered how the amount of the fulfilment cash flows could differ from the amount of the consideration received, i.e. the fair value. For transfers of insurance contracts, the most likely cause of the difference is that the fair value would include the risk of non-performance by the entity. The IASB concluded that, for contracts in a liability position acquired in a transfer, the immediate recognition of a loss faithfully represents the entity's assumption of an obligation it expects to fulfil but for which it received a lower price because of the risk that it might not be able to fulfil the obligation.

45 For a business combination, the Board concluded that the most likely reason that fulfilment cash flows differ from the fair value is that the acquirer may have been willing to pay more for the contracts because of other synergies that might arise as the contracts are fulfilled. Consequently, the recognition of that difference as an adjustment to the gain on the business combination or goodwill is consistent with the accounting for similar effects in a business combination.

Findings from the case study

46 Number of respondents addressing the issue: 1 (from the simplified case study).

47 Regarding the issue in paragraph 38(a), there were qualitative comments from one respondent to the simplified case study. This respondent indicated that IFRS 17 has amended IFRS 3 paragraph 17 to remove an important exception that currently exists where insurance contracts are currently classified based on the factors at the inception date rather than acquisition date. The removal of this exception could result in a different contract classification (e.g. investment rather than insurance) between Group and solo entity accounts, where factors have changed since inception. In addition, due to the different dates of initial recognition between the Group and solo entity, this will result in a different CSM between these two.

48 Regarding the issue in paragraph 38(b), one respondent noted that the requirement reduced comparability and reduced understandability. No further explanation was provided.

EFRAG Secretariat analysis

Regarding the issue in paragraph 38(a):

49 The EFRAG Secretariat notes that the requirement to assess classification at the acquisition date and not at the inception date is consistent with the requirements in IFRS 3 *Business Combinations.*

50 There was an exception under IFRS 3 because at that time, the IFRS 3 guidance was developed in phase I of the IASB's project on insurance contracts and the IASB decided not to pre-empt phase II of the IASB's project on insurance contracts. Therefore, the EFRAG Secretariat considers that this exception was only a temporary one.

51 In addition, the requirement to assess classification at the acquisition date would increase comparability between insurance entities and non-insurance entities that have undertaken business combinations since there will be consistent accounting.

Regarding the issue in paragraph 38(b):

52 As detailed information was not provided in the case studies or in the presentation by the CFO Forum, the issue cannot be analysed without further information from the respondent who raised this.

53 At this stage, pending any further information, the EFRAG Secretariat assesses that the requirements in concern relate to well-established principles of business combination accounting and do not detract from IFRS 17's ability to meet the technical endorsement criteria.

10. Level of aggregation

CFO Forum Presentation

Description of issue and evidence

54 The prohibition to aggregate contracts that are issued more than one year apart is unduly complex. We believe that it should be replaced by a principle according to which the insurer determines based on its internal business and risk management the way it defines its cohorts. This determination should reflect mutualisation effects when they exist. In addition, the second profitability bucket (no significant possibility of becoming onerous) is highly subjective and adds to the complexity.

55 On the contrary, the requirement to - in principle – group contracts in their entirety prohibits the insurer to group components of an insurance contracts (e.g. the host contract and individual riders) in line with how the business and risks are managed in some cases.

Implications

56 The standard's requirements on level of aggregation, including the annual cohorts, are too prescriptive and detailed, leading to an excessive level of granularity, major implementation challenges, as well as undue costs.

57 The inability to group components of an insurance contract by relevant risks means contract aggregation will not reflect how the business and risks are managed.

58 The requirement to report on an underwriting year basis (including analysis of change) is not aligned with management of reserves which is on an accident year basis.

IFRS 17

Requirements

IFRS 17, paragraphs 14, 16, 18, 22

59 An entity shall identify portfolios of insurance contracts. A portfolio comprises contracts subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together. Contracts in different product lines (for example single premium fixed annuities compared with regular term life assurance) would not be expected to have similar risks and hence would be expected to be in different portfolios.

60 An entity shall divide a portfolio of insurance contracts issued into a minimum of:

(a) a group of contracts that are onerous at initial recognition, if any (for contracts issued to which an entity applies the PAA, the entity shall assume no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise);

(b) a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and

(c) a group of the remaining contracts in the portfolio, if any.

61 An entity shall not include contracts issued more than one year apart in the same group.

62 There is no paragraph in IFRS 17 that addresses separating insurance components of an insurance contract. That is, the lowest level of the unit of account used in IFRS 17 is a contract, or a host insurance contract after separating non-insurance components (when relevant).

Basis for Conclusions

IFRS 17, paragraphs BC119 to BC139

63 BC119: The decisions about grouping in IFRS 17 were driven by considerations about reporting profits and losses in appropriate reporting periods.

64 BC120: The level of aggregation is also relevant to the recognition of the contractual service margin in profit or loss. … An entity should systematically recognise the remaining contractual service margin in profit or loss over the current and remaining coverage period to reflect the remaining transfer of services to be provided by the insurance contracts.

65 BC130: Some stakeholders nonetheless expressed the view that separating contracts that have no significant possibility of becoming onerous from other contracts that are not onerous was burdensome and unnecessary. The Board, however, concluded that in the absence of such a requirement, should the likelihood of losses increase, IFRS 17 would fail to require timely recognition of contracts that become onerous.

66 BC137: The IASB considered whether there were any alternatives to using a one-year issuing period to constrain the duration of groups. However, the IASB considered that any principle-based approach that satisfied the Board's objective would require the reintroduction of a test for similar profitability, which was rejected as being operationally burdensome. The IASB acknowledged that using a one-year issuing period was an operational simplification given for cost-benefit reasons.

67 BC136: The IASB noted that the decisions outlined in paragraph 60 above could lead to perpetual open portfolios. The Board was concerned that this could lead to a loss of information about the development of profitability over time, could result in the contractual service margin persisting beyond the duration of contacts in the group, and consequently could result in profits not being recognised in the correct periods. Consequently, in addition to dividing contracts into the groups, the Board decided to prohibit entities from including contracts issued more than one year apart in the same group. The IASB observed that such grouping was important to ensure that trends in the profitability of a portfolio of contracts were reflected in the financial statements on a timely basis.

68 BC138: The IASB considered whether prohibiting groups from including contracts issued more than one year apart would create an artificial divide for contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group. However, the IASB concluded that applying the requirements of IFRS 17 to determine the fulfilment cash flows for groups of such contracts provides an appropriate depiction of the results of such contracts. The Board acknowledged that, for contracts that fully share risks, the groups together will give the same results as a single combined risk-sharing portfolio … the Board noted that the requirements specify the amounts to be reported, not the methodology to be used to arrive at those amounts. Therefore, it may not be necessary for an entity to restrict groups in this way to achieve the same accounting outcome in some circumstances.

Findings from the case study

69 Number of respondents addressing one or more aspects of these issues: 9

Level of aggregation

70 Some of the respondents did not find material differences between the pattern of CSM release using annual cohorts and the equivalent pattern using only coverage units for specific portfolios (savings, unit-linked portfolios, fully or significantly mutualised contracts). One respondent applied the coverage units method to a fully mutualised portfolio in which the profit margin declined with 29% over a 4-year

period and found little difference between using coverage units and cohorts. These respondents argued that the annual cohort requirement adds cost and complexity and is unnecessary to provide a faithful representation.

71 However, other respondents demonstrated or acknowledged that the use of annual cohorts does or at least could change the pattern of CSM release. Of those respondents that used coverage units, one noted that their findings were based on a mature portfolio and acknowledged that bundling together all cohorts may not necessarily lead to the same outcome since, as cohorts are spread over time, more differences in the volume of business, its profitability as well as in the percentage of the CSM to be recognised in a given year are observed. Another respondent noted that, even in a mutualised portfolio, material differences were found between using cohorts or coverage units.

72 Finally, one respondent used assets under management, sums insured, expected profit/variable fee as coverage units and found significantly different outcomes between the methods used.

73 In all these cases no calculations (only the results of the calculation and/or graphic representations) were provided in the case study results.

74 Two respondents calculated the impact on their portfolios only for one year which did not illustrate the effect on reported trends.

Costs relating to the annual cohort requirement

75 Four respondents quantified the costs specifically associated with applying the subdivision of products into subgroups and annual cohorts:

	Millions euros	% costs over total IFRS 17 costs for respondents that quantified	# of respondents who quantified
One-off costs	19.3	between 4% and 23%	3
Ongoing costs	17.4	10% and 75%	2

Sharing of risks (also known as mutualisation)

76 Most respondents did not provide information about the quantification of risk sharing/intergenerational transfers or indicated they were not able to quantify that effect. Those that provided information showed very minor impacts in 2016 ranging from 0.2% till 1% of the liabilities in the portfolios measured, even when indicating that 100% of risks were being shared.

77 The following table provides an overview of the amount of the selected liabilities that were subject to risk sharing.

Fully sharing risks	**Partially sharing risks**	**Benefit from intergenerational transfers**
478,462	104,410	669,469

78 Two respondents provided a description for the term “intergenerational transfer”:

(a) One respondent defined intergenerational transfer as the transfer of wealth between contracts issued at different points in time.

(b) Another respondent noted that unrealised gains are used as an intergenerational transfer to support future generations of policyholders.

Separating components within insurance contracts

79 Only one respondent encountered the issue from their selected portfolios in the case study. This respondent noted that certain participating contracts (written in a ring-fenced fund) have attaching insurance riders (written in a separate non-profit fund) that are funded by additional premiums. While there is significant uncertainty in the treatment of such riders under IFRS 17, particularly in light of recent discussion at the IASB TRG, their initial assessment is that because a rider lapses if its host contract lapses the riders are sufficiently closely related to the host contract to prevent them being separated. However, the riders do not form part of the underlying items of the participating contract (shareholders receive 100% of the profits on the riders). It would therefore not be meaningful to include rider cash flows within the fulfilment cash flows of the host participating contract for which profits are shared between policyholders and shareholders on a 90:10 basis. As such, the separation requirements of IFRS 17 result in an outcome that does not reflect the economics of the business.

80 Four other respondents also raised the concern that some contracts issued by them include multiple types of insurance risk. For these respondents, the issue did not arise from their selected portfolios. These respondents were also of the view that an individual contract is not the lowest level of account as it is not in all circumstances consistent with how insurance risk is managed. They considered that the necessary flexibility needs to be achieved in order to also reflect the way insurance risks are managed and reported to the management for financial reporting purposes.

Other feedback regarding the level of aggregation

81 Although current practice does not include the level of aggregation requirements of IFRS 17, it is noteworthy that portfolios under current practice may be more granular than required by IFRS 17. Of the 40 portfolios where information was provided,

(a) 12 portfolios were smaller than required by IFRS 17;

(b) 19 portfolios were of a similar size to that required by IFRS 17;

(c) 9 were larger than the portfolios required by IFRS 17; and

(d) 11 portfolios were not specified.

82 To the extent that grouping is undertaken under current practice, 45 groups were reported, whereas under IFRS 17 this would increase to 343.

(a) Five respondents provided grouping details for one year resulting in 26 groups under current accounting and 56 groups under IFRS 17; and

(b) Four respondents provided grouping details for five years, i.e. over the testing period, resulting in 19 groups under current accounting and 287 groups under IFRS 17.

83 The type of contracts where onerous groups could arise were:

(a) VFA – unit linked;

(b) General model – long-term contracts;

(c) General model – other; and

(d) PAA motor and other.

84 One respondent stated that an onerous contract provision on the personal motor book would need to be recognised on day one representing 17% of profit on that book.

EFRAG Secretariat analysis

Level of aggregation

Annual cohort requirement

85 The EFRAG Secretariat refers to the EFRAG Background Papers on *Level of Aggregation* and *Release of the CSM*.

86 The EFRAG Secretariat acknowledges that the level of aggregation requirements may not reflect the level at which pricing (as doing so was noted to be too onerous) and risk management of insurance contracts is undertaken. The EFRAG Secretariat also acknowledges that the annual cohort requirement is widely considered to increase the cost and complexity of implementation. However, the EFRAG Secretariat equally notes that the IFRS 17 approach is at a significantly higher level of aggregation than in other areas of IFRS (e.g. IFRS 9 and IFRS 15, which are based on individual contracts). The EFRAG Secretariat considers that the IFRS 17 requirements represent a reasonable compromise between different perspectives.

87 The EFRAG Secretariat considers that providing trend information relating to profitability from one year to the next is a valid objective that contributes to relevance. The EFRAG Secretariat considers that achieving this objective requires some mechanism to ensure closed groups. Without the annual cohort or some alternative mechanism groups would remain open indefinitely, resulting in a continuous re-averaging of the CSM and a loss or obscuring of trend information.

88 Some have argued that the trend information can be provided via disclosures. However, EFRAG has consistently taken the view that disclosures are not a substitute for recognition and measurement.

89 The EFRAG Secretariat acknowledges that the annual cohort requirement is to some extent arbitrary due to the allocation needed for fulfilment cash flows if done at a level higher than group level (but entities can choose to align with the financial reporting year). Further, the annual cohort requirement achieves the objective of providing trend information and enabling comparability across entities and product lines. It should also be noted that the financial statements are not presented on a cohort level but are aggregated in order to provide an overall view of the entity’s financial performance and position. Further, limiting the size of the group of insurance contracts (which the annual cohort requirement does) limits the extent to which contracts that become onerous subsequent to initial recognition are shielded by profitable contracts.

90 Furthermore, based on the case study results, in some cases, the annual cohorts requirement makes a significant difference in the amounts released to CSM compared to not applying cohorts while in other cases, there may not be a significant difference. Therefore, the EFRAG Secretariat considers that the annual cohort requirement results in relevant information.

91 Also, the EFRAG Secretariat considers that IFRS 17 does not prevent the impact of cash flows relating to sharing of risks being included in the fulfilment cash flows. The EFRAG Secretariat acknowledges that an allocation would need to be made to the cohort level if the sharing of risks is determined at a higher level. However, this allocation is again a mechanism to achieve the objective of providing trend information.

92 For the above reasons, the EFRAG Secretariat considers that the annual cohort requirement provides relevant information while also acknowledging the trade-offs referred to above.

93 While the EFRAG Secretariat acknowledges the concerns expressed about the impact of the annual cohort requirement on complexity and cost, most respondents did not quantify the costs associated with this requirement.

The second profitability bucket (no significant possibility of becoming onerous)

94 Insurance contracts that are profitable at inception are subdivided into two categories: (i) contracts that have no significant possibility of becoming onerous and (ii) remaining contracts. The EFRAG Secretariat considers that these separate buckets of profitable insurance contracts enable a timely recognition of groups of contracts that become onerous after inception thus reflecting trend information and ensuring early recognition of losses. The determination of the appropriate contractual service margin is a balance between the avoidance of the need to track individual contracts and cross-subsidisation between different levels of profitability of contracts with similar risks (if these buckets were not required). The EFRAG Secretariat further assesses that grouping plays an essential role in the determination of unearned profit and its subsequent allocation to insurance revenue.

Separating components within insurance contracts

95 This topic was discussed at a meeting of the IASB's TRG and the TRG members observed that the lowest unit of account that is used in IFRS 17 is the contract that includes all insurance components. At the TRG meeting, the TRG members also observed that considerations that might be relevant in the assessment of whether the legal form of a single contract reflects the substance of its contractual rights and contractual obligations include (a) interdependency between the different risks covered; (b) whether components lapse together; and (c) whether components can be priced and sold separately.

96 The EFRAG Secretariat notes that an entity first needs to separate out distinct components in an insurance contract and measure those applying the relevant IFRS Standard. However, based on the case study responses, the EFRAG Secretariat understands that a further separation of remaining components of the host insurance contract is desired. The EFRAG Secretariat notes that the one-year cohort level is considered to be unduly complex, however, separating components is desired which is, in contrast, at an even lower level of granularity than the one-year cohort level.

97 The EFRAG Secretariat considers that entities would usually design contracts in a way that reflects their substance. However, there may be cases where this is not so. In that case, since the remaining host insurance contract components is considered to be inter-related, the EFRAG Secretariat considers that the three aspects stated in paragraph 95 above need to be considered together to make an assessment of whether components within an insurance contract can be separated. If the components are not interdependent, do not lapse together and can be priced and sold separately, the EFRAG Secretariat considers that separating these components would provide relevant information because these components are managed separately by the entity.

98 As a result, the EFRAG Secretariat considers that IFRS 17 should permit the separation of different insurance risks contained in a single insurance contract, for example, in cases where two or more insurance contracts are combined for administrative convenience. That is, the premium charged to the policyholder is the total of the premiums that would have been separately charged for each insurance cover.

99 Other than the suggestion above, the EFRAG Secretariat expects that the separation of a single insurance contract into its components may be costly and increase complexity.

11. Presentational issues

CFO Forum Presentation

Description of issue and evidence

100 The standard requires that groups of contracts be presented as asset or liability based on its entirety. In reality, different components, such as claims liabilities to be settled, unearned premiums, receivables/payables, etc are managed separately and administered in different systems. Groups of contracts may frequently switch from an asset to liability position.

101 The standard requires premiums and claims to be included in the insurance provision on a cash paid/received basis. In reality, these are reflected on an accrual basis and payments/receipts are managed and administered separately.

102 The standard requires, for presentation of revenue only, segregation of non-distinct investment components, even for contracts that do not have a specified account balance or component.

103 In several reinsurance contracts, the cedant is obligated to provide funds withheld as collateral. IFRS 17 requires a presentation of reinsurance funds withheld on a net basis, i.e. the insurance contract liability is offset by the funds withheld.

Implications

104 These requirements, that impact only presentation, would require major system changes compared to the current approach, which is a well-established industry practice.

105 These changes will also lead to insurance receivables, policy loans and reinsurance collateral (funds withheld) no longer being separately visible in the balance sheet, which is a deterioration in relevance of the financial statements.

106 Companies have considered the implications for implementation and maintenance of systems for these requirements and found that the complexity and costs will very significant.

IFRS 17

Requirements

Separate presentation of assets and liabilities

107 Premiums and claims (IFRS 17, paragraph 78) are included in the fulfilment cash flows of the insurance contract liability or the liability for incurred claims. Under IFRS 17, paragraph 33, fulfilment cash flows include all the future cash flows within the boundary of each contract in the group. This includes premiums due but not yet received.

108 Definition: The liability for incurred claims is the 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.

Segregation of investment components for presentation

109 Paragraph 83: Insurance revenue depicts the provision of coverage and other services arising from the group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services.

110 Paragraph 85: Insurance revenue and insurance service expenses presented in profit or loss shall exclude any investment components.

Insurance funds withheld

111 Paragraph 63: Estimates of the present value of the future cash flows for the group of reinsurance contracts held shall include the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

Basis for Conclusions

Separate presentation of assets and liabilities

112 BC328: Consistent with the requirement in IAS 1 that an entity not offset assets and liabilities, IFRS 17 prohibits entities from offsetting groups of insurance contracts in an asset position with groups of insurance contracts in a liability position.

Segregation of investment components for presentation

113 BC108: An investment component is the amount an insurance contract requires the entity to repay to the policyholder even if an insured event does not occur. Many insurance contracts have an implicit or explicit investment component that would, if it were a separate financial instrument, be within the scope of IFRS 9.

114 BC109: IFRS 17 requires the cash flows allocated to a separated investment component to be measured on a stand-alone basis as if the entity had issued that investment contract separately. This requirement is consistent with the objective of separation, which is to account for a separated component the way stand-alone contracts with similar characteristics are accounted for. The Board concluded that, in all cases, entities would be able to measure the stand-alone value for an investment component by applying IFRS 9.

Findings from the case study

Separate presentation of assets and liabilities

115 Several respondents raised this issue.

116 Two respondents quantified estimates of the cost implications of this. One of these respondents stated that an investment in a three-digit million Euro range would be needed in order to link payment information with cash management systems or to change the mechanics of policy administration systems (i.e., change to cash basis). The other respondent indicated that cost of compliance with this requirement was estimated to be between 21 and 27 million Euros, representing between 9 and 12% of this respondent's one-off costs.

117 Comments/explanations from the other respondents provided were:

(a) One respondent confirmed the concerns on tracking groups of insurance contracts if they are in an asset or a liability position, via modelling of their testing.

(b) Another respondent indicated that this was an issue.

(c) Four respondents provided qualitative comments summarised as follows:

(i) This requirement will imply to connect and integrate – at insurance contract group level – administration, technical accounting, actuarial, claims and cash management systems. All these systems are running at different granularity levels and reconciliation of information is granted only at a higher level than the group.

(ii) The requirement to present groups of insurance contracts distinguishing those that are assets and those that are liabilities induces the need to duplicate all accounts related to the Insurance contracts liabilities in the Chart of Accounts and to duplicate all posting schemes between the feeder systems and the accounting systems to capture all possible scenarios.

Separate presentation of receivables and payables

118 Comments/explanations provided were:

(a) One respondent indicated, supported by one of the portfolios, that there would be a lack of transparency and undue cost;

(b) Four respondents indicated that this was an issue and provided qualitative comments explaining the issue summarised as follows:

(i) Under IFRS 17, liabilities have to calculated at the level of group of contracts and have to be netted from receivables due by policyholders from this same group of contracts. The netting has to be done on a cash basis, which is not possible in the timeframe of an accounting closing.

(ii) Insurance accounting systems are equipped to know what is due by each client on a given date whilst cash is not managed on a client but on a global basis. In practice, this is because, based on contracts term, it is possible to know in advance when a client has the obligation to pay what it owes to the insurance company but it is not possible to know with certainty in advance when he or she will do so (at least when considering the short timeline of an accounting closing). As a consequence, measuring liabilities on a cash basis is not manageable without drastic IT changes.

(iii) Actuarial systems today are not set-up to model data stemming from the cash management systems. Modelling is based on data from the technical feeder systems with no granular link to the cash management systems. Balancing of receivables and payables and reconciliation with the cash management system is dealt with in the general accounting systems. Nevertheless, during the stretched timeline of the closing process of our IFRS consolidated financial statements, this reconciliation is performed at a much less granular level than the group of contracts level.

(iv) One of these respondents used for each portfolio an allocation key for receivables and payables, as the IASB staff proposed in the its paper preceding the May 2018 TRG meeting. While that might be considered a feasible simplification, they had encountered many short-comings. For example, the change in the weight of a group of contracts measured based on its insurance liabilities changes over the coverage period. As such does the allocation change over time. This respondent stated that this is not reflecting the actual receivables and payables of the group of contracts and would lead to a systematic underestimation of the related receivables and payables for new annual cohorts.

Separation of the non-distinct investment component of revenue

119 Two respondents quantified the costs with regards to non-distinct investment components, management of double set of discount rates, etc:

Millions euros	% costs over total IFRS 17 one-off costs	# of respondents who quantified
2.6	0.2% and 40%	2

120 Comments/explanations provided are as follows:

(a) One respondent indicated, supported by one of the portfolios, that the split of non-distinct investment components is very detailed and does not reflect the way they look at the business.

(b) Two respondents indicated that this was an issue. One of these provided comments regarding the complexity and associated costs. That respondent stated that these amounts (in particular the investment component on death or relating to a guaranteed annuity) are not currently available from existing systems and processes and, consequently, new processes will need to be developed.

Insurance funds withheld

121 One respondent from the simplified case study and one from the full case study mentioned the lack of clarity whether funds withheld should be included in the fulfilment cash flows. It is unclear from the responses whether these comments relate to reinsurance.

EFRAG Secretariat analysis

Separate presentation of assets and liabilities

122 The EFRAG Secretariat understands that this issue touches upon the following situations:

(a) *Liability for remaining coverage*: depending on the pattern of expected cash flows, the ‘best estimate liability’ may move over time from a liability position towards an asset position and vice-versa.

(i) *Short-term insurance contracts*: the moving between an asset or liability position may be caused by the delay in expected premium payments. On a group of insurance contracts, this may be rare as it would require that a large number of policyholders are overdue in paying their premiums to move the entire group of insurance contracts. An exception here is the reinsurance business which uses small groups of policyholders (sometimes one policyholder represents one group of insurance contracts);

(ii) *Long-term insurance contracts*: the moving between an asset or liability position may follow from the pattern of expected cash flows over the duration of the contract, e.g. pension savings with a death benefit with the option to turn into an annuity as from a certain age.

The EFRAG Secretariat understands that the switch between an asset and liability position is not necessarily related to the profitability of the insurance contract, which is assessed over the entire duration of the group of insurance contracts (except that an onerous group of contracts cannot be presented as an asset position).

(b) *Liability for incurred claims*: IFRS 17 requires presenting the liability for incurred claims in the financial statements on a group level. Today, insurers make use of claim triangles[2] that are based on the accident year or the underwriting year to gather information to estimate claims that are being paid out. As the actuarial estimates are done on a broader population than the groups of insurance contracts as defined in IFRS 17 some argue there is no

[2] A claims triangle is a way of reporting claims as they develop over a period of time. This is the primary method in which actuaries organise claim data that will be used in an actuarial analysis, e.g., to estimate claims and to manage the claims process.

linkage possible between the actuarial outcomes and the groups of insurance contracts as defined in IFRS 17.

123 At this stage, the EFRAG Secretariat does not have information regarding the materiality of groups of contracts in an asset position. However, the EFRAG Secretariat considers that, since the unit of account under IFRS 17 is a group of contracts and therefore there will frequently be a netting of contracts in an asset or liability position within the group, the usual arguments about the relevance and other endorsement criteria of separate presentation of assets and liabilities may not apply to the same extent. Therefore, the EFRAG Secretariat has sympathy regarding the concerns about the cost of this requirement.

124 In addition, the EFRAG Secretariat acknowledges the comment that users cannot necessarily derive information on profitability of the underlying insurance contracts depending on whether the group of long-term insurance contracts is an asset or liability position. As a result, the EFRAG Secretariat is of the view that, in these situations, separate presentation of asset and liability positions at the level of groups of insurance contracts may not add relevant information.

125 The EFRAG Secretariat assesses that gathering information on actual cash inflows (e.g. premiums) or actual cash outflows (e.g. claims being paid) is essential for any accounting system. Nevertheless, the EFRAG Secretariat doubts whether separately presenting asset and liability positions for groups of long-term insurance contracts conveys any material information to users of financial statements regarding credit risk (of policyholders who have paid their premiums late). As a result, the EFRAG Secretariat is of the view that, in these situations, separate presentation of asset and liability positions at the level of groups of insurance contracts may not add relevant information.

126 The EFRAG Secretariat further assesses that the liability for incurred claims, in combination with the annual cohorts, may achieve a similar outcome to claim triangles used today and provide useful information for the users of financial statements. In case claim triangles are determined based upon underwriting year, the statistical population would be largely identical to the one of the onerous group of insurance contracts as determined in accordance with IFRS 17. As a result, the EFRAG Secretariat disagrees with the argument that the statistical estimation would be distorted by relying on groups of insurance contracts.

127 Overall, the EFRAG Secretariat assesses that separate presentation of asset and liability positions at the level of groups of insurance contracts may not add relevant information.

Separate presentation of receivables and payables

128 Regarding cost/benefit, based on the responses, since IFRS 17 does not require separate presentation of receivables and payables, the question will be whether the benefits of not presenting separating receivables and payables outweigh the costs or not.

129 The EFRAG Secretariat proposes to ask a question to constituents in the IFRS 17 draft endorsement advice whether presenting receivables and payables separately would have a positive effect for users.

Segregation of investment components for presentation

130 The EFRAG Secretariat considers that, since the insurance revenue and insurance service expenses relate to insurance services, excluding the investment component separately provides relevant information.

131 In addition, determining insurance revenue in this way makes the financial statements more comparable not only between insurance entities but also across industries.

Insurance funds withheld

132 Based on the responses from the case study, this issue seems to be resulting from a lack of clarity with IFRS 17. Therefore, the EFRAG Secretariat proposes that the affected entities raise the issue at the TRG.

133 At this stage, the EFRAG Secretariat is not clear how significant the issue is.

OTHER IMPLEMENTATION CHALLENGES

12. Pressure on implementation timeline

CFO Forum Presentation

Description of issue and evidence

134 A number of issues have been identified that put pressure on the implementation timetable, including:

(a) Industry and auditor consensus on technical interpretation issues will take time to emerge, for example on interim reporting, application of judgement on discount rates, transitional approaches, etc.

(b) The discussions in the TRG may lead to further clarifications and amendments; the TRG discussions are not planned to end before the end of 2018.

(c) In general, there are insufficient resources within the insurance market, for actuaries, accountants and IT specialists.

(d) IT solutions, including those for the calculation of the CSM, are not yet available for purchase.

(e) Stakeholder engagement, including with investors and analysts, will only be possible if real accounting impacts with sufficient accuracy are available well in advance of the “go live” date. To achieve that it will be necessary for systems, interpretations, dry runs etc. to have all been completed. Given the complexity of the requirements and the resulting financial information, stakeholder education will be key.

Implications

135 Given our findings we believe the implementation timelines are very challenging

Findings from the case study

136 Seven respondents addressed this issue.

(a) The following were suggestions of timeframes to delay IFRS 17 implementation:

(i) One year (one respondent);

(ii) Two years (two respondents); and

(iii) Three years (one respondent).

(b) Two respondents recommended a delay in implementing IFRS 17 without suggesting a timeframe.

(c) One respondent indicated that first-time application of IFRS 17 in 2021 was realistic, even with some targeted improvements that were listed.

EFRAG Secretariat analysis

137 The relevance of this issue to the DEA will depend on the overall direction of the DEA. The EFRAG Secretariat proposes that this is discussed at a later date.