EFRAG IAWG Report to EFRAG TEG – March 2019

Objective and introduction

1 The objective of this session is for EFRAG TEG to receive the views of the EFRAG IAWG relating to:

(a) IBOR reform; and

(b) The February and certain March 2019 IASB's tentative decisions and how EFRAG IAWG's assessed their impact to draft comment letter on the forthcoming Exposure Draft proposing amendments to IFRS 17 *Insurance Contracts* and/or the future draft endorsement advice on a revised IFRS 17.

Agenda for the 28 March EFRAG IAWG meeting

2 EFRAG IAWG discussed the following:

(a) IBOR reform and its effects on financial reporting;

(b) The IASB Transition Resource Group issues for the meeting of 4 April 2019;

(i) Investment components within an insurance contract;

(ii) Reporting on other questions submitted;

(c) The IASB's tentative decisions on the following topics:

(i) Transition: optionality and comparative information;

(ii) Transition: loans that transfer significant insurance risk;

(iii) Transition: modified retrospective approach;

(iv) Transition: risk mitigation option and OCI; and

(v) Loans that transfer significant insurance risk.

IBOR reform and its effects on financial reporting

3 Not included for the purposes of this meeting.

TRG - Investment components within an insurance contract

4 While assessing that the overall IASB staff analysis was a step in the right direction, one EFRAG IAWG member disagreed with the argument that when components are highly interrelated, they cannot be measured independently. In part of their unit-linked business the investment component and the insurance component were highly interrelated, yet they were able to measure them separately. Notwithstanding the different revenue patterns that existed in both parts of their business, that member noted that separation of the investment component was not necessary (except for deposit amounts that were unbundled in accordance with IFRS 4 *Insurance Contracts*) as this was not how they looked at their business. Instead it was preferred to (i) to continue to use a Market Consistent Embedded Value (MCEV) measurement as was done for Solvency II; and (ii) be able to separate the

investment component even when it was highly interrelated with the insurance component (using unbundling as under IFRS 4). Other EFRAG IAWG members noted that the reintroduction of unbundling was not raised before and was also not on the agenda.

5 According to some EFRAG IAWG members, the measurement of the investment component should not be mandatory on a present value basis. This would not affect the objective of IFRS 17 not to inflate insurance revenue and service expenses. Also, it was noted that separation of the investment component was not adding value, was costly (5 mio euro for one insurer, but many insurers had not estimated the cost yet), and difficult to apply both at inception and continuously. For users, the result would be difficult to understand (e.g. the difference between a claim and an investment component in the reinsurance business) and would influence KPIs (e.g. combined ratio) result in the need to use non-GAAP measures.

6 As the issue was related to presentation it was considered less important by some. Hence, one EFRAG IAWG member suggested allowing voluntary unbundling and a liberal interpretation of the separation rules to solve the implementation problems. One EFRAG IAWG member noted that many in the industry did not support the IASB staff paper. In particular there was a fear that the examples might narrow the freedom to interpret the Standard on implementation.

7 In contrast, one EFRAG IAWG member noted that in any case a product classification already had to be done under IFRS 4 (applying amongst others the voluntary unbundling for investment components). Since that product classification is already available and the identification of the amount of an investment component is only necessary at the time a payment is made to a policyholder, the cost is not related to the implementation of IFRS 17. One EFRAG IAWG member clarified that, upon a death claim, the split between an investment component and an insurance claim was currently not identified in their systems; which raised further questions from a user perspective about how the surrender value was currently calculated upon death of a policyholder.

8 Some EFRAG IAWG members agreed with the IASB staff paper and the examples provided.

9 The example of deferred annuities was discussed in more detail. In contrast to the example provided in the IASB staff paper, some deferred annuities do not pay a surrender amount in case of death or termination of the contract before the annuity period commences. An annuity is only paid if the policyholder survives beyond a particular age. In the first case (i.e. the policyholder dies before a certain age), there is in accordance with IFRS 17 no investment component as no money flows back to the policyholder or his/her estate. However, the money collected through premiums (i.e. the accumulation period) is invested over time and at the moment of death of the policyholder the money falls to the insurer. The insurer has the choice whether to pay out some of these investments to surviving policyholders or to keep some or all of the money. The money that is paid to the surviving policyholders is variable as it depends on (i) the investments during the accumulation period and (ii) the “charges” added to the investment pot coming from policyholders that have died. At inception, the calculation of these charges is done in a prudent way, i.e. normally more money from dead policyholders falls to the insurance company than is distributed to surviving policyholders. One EFRAG IAWG member described this as a tontine approach.

10 In these situations, some noted that the insurer should be able to recognise investment result during the accumulation period.

TRG - Reporting on other questions submitted

11 The IASB staff paper for the TRG meeting contained a list of issues that were not taken on to the agenda. The Appendix to this agenda paper contains the IASB staff summary of the issues referred to in this section.

12 An EFRAG IAWG member mentioned that paragraph B137 of IFRS 17 contradicts the basic principle in IAS 34 *Interim Financial Reporting* that the frequency of reporting should not impact the measurement of an entity's annual results without clear reasoning (issue S83). This impacts the endorsement criteria of relevance, comparability as well as cost (one member estimated the cost to be 10m euro for implementation only). Another indicated that given that there are various reasons why calculations need to be updated at year-end such as internal services allocations and acquisition costs.

13 One member commented on practical aspects (e.g. calculating the split between profit or loss and OCI on a computation) but agreed with the IASB staff's conclusion on Accumulated OCI (issue S102).

14 One member disagreed with the IASB staff's answer on the result of a modification of an insurance contract (and the analogy to paragraph B5 of IFRS 17 when this happens during the settlement period) (issue S82). Further questions to EFRAG IAWG members after the EFRAG IAWG meeting highlighted a concern that, whilst typically for an insurance contract the loss event is the insured event, the terminology is not consistently applied in the following cases:

(a) *Business combinations – acquisition of claims in the settlement period*: From the perspective of the acquirer, the remaining risk (if significant insurance risk remains) is the uncertainty around the ultimate cost of those claims. Some argue that since there is no contract, who is to be regarded as the policyholder, i.e. who is receiving this insurance coverage for adverse development?

(b) *Modifications resulting in a new contract during claims settlement period*: The coverage period is considered to start anew, ignoring past insured events that have occurred. It is then not clear who is the policyholder that is exposed to the risk of claims development.

(c) *Retroactive reinsurance*: net costs of purchasing reinsurance coverage that relate to events which have occurred before the purchase of the group of reinsurance contracts have to be recognised in profit or loss immediately at initial recognition. However, this ignores paragraph B5 of IFRS 17 that notes that for retroactive reinsurance the insured event may be the occurrence of an adverse loss development.

15 Clarifications considered as useful include that the risk adjustment may include the impact of reinsurance (issue S118) (this may alleviate the concern around non-proportionate reinsurance and onerous contracts) as well as the scope of VFA around unit linked business (issue S115).

Transition: optionality and comparative information

16 The discussion focused on two aspects around the transition to IFRS 17:

(a) Optionality included in the transition requirements has been highlighted by users as a concern; and

(b) Preparers are concerned about the requirement to provide comparatives under IFRS 17 but not for IFRS 9 as they do not provide comparison between old and new business.

17 The topic of transition was included in the EFRAG Board letter to the IASB of 2018 but referred to the extent of relief offered by the modified retrospective approach as well as challenges in applying the fair value approach.

18 Some EFRAG IAWG members assessed that the tentative decisions of the IASB to retain the requirements in IFRS 17 with regards to the allowed options and comparative information were a step in the right direction.

19 However, EFRAG IAWG members noted the following:

(a) A concern around comparability between legacy contracts (for which FV approach or modified retrospective approach would apply) and new insurance business (to which IFRS 17 would be applied in full).

(b) Most EFRAG IAWG members noted that they will apply IFRS 9 although some noted that pro forma information will be used as they do not provide comparison between old and new business.

(c) Some members noted the importance of the disclosure requirement for CSM on transition.

(d) Discrepancies that could arise between SEC reporters in the US with regards to comparative information, and this could be eased if the IASB allowed one year of comparatives for IFRS 17.

Transition: loans that transfer significant insurance risk

20 The IASB allowed that transfer significant insurance risk to fall in the scope of either IFRS 9 and IFRS 17 in its February and March meetings. This decision deals with the resulting impact on transition that then required consideration. This was not one of the items in the EFRAG letter.

21 EFRAG IAWG members assessed that the tentative decisions of the IASB was a step in the right direction as it is a practicable solution of the transition aspects of the new concern around scope of IFRS 17. That is, to retain IFRS 17 transition requirements if an entity elects to apply IFRS 17 and to retain IFRS 9 transition requirements if the entity elects to apply IFRS 9 and it applies IFRS 17 and IFRS 9 at the same time. The IASB also tentatively decided to amend IFRS 9 transition requirements if an entity elects to apply IFRS 9 and has applied IFRS 9 before IFRS 17.

22 EFRAG IAWG members also assessed that the IASB staff reasoning supporting these tentative decisions was appropriate.

Transition: modified retrospective approach

23 The concern relates to the difficulties in applying the modified retrospective approach in practice and further exemptions or short-cuts were requested by preparers.

24 This was one of the items highlighted in the 2018 EFRAG Board letter to the IASB.

25 The IASB decided to tentatively retain the transition requirements in the modified retrospective approach, except to amend IFRS 17 for liabilities that relate to the settlement of claims incurred before an insurance contract was acquired. An entity is permitted to classify these contracts as liability for incurred claims under the modified retrospective approach and the fair value approach.

26 EFRAG IAWG members noted that the full retrospective approach would be ideal to appropriately reflect financial performance at transition and subsequently. Furthermore, considering the impracticability in many cases of the full retrospective approach, either the FV approach or the modified retrospective approach may be frequently applied in practice.

27 With reference to the modified retrospective approach, they expressed their concern that it is difficult to apply in practice.

28 Members also noted the complexities in trying to find reasonable and supportable information in order to utilise the different modifications. Members specifically noted the barriers to applying the modified retrospective approach, including example data gaps which means that they must in practice use the fair value approach.

29 EFRAG IAWG members also noted that IFRS 17 proposed a prescriptive model of deducing cash flows using strict criteria. They also noted the different modifications under the general model and the VFA. They noted that the application of all the modifications are costly to apply and did not necessarily produce the required result.

30 There was agreement that one should not move too far away from the principle of a full retrospective approach, however increased flexibility would allow for greater use of the modified retrospective approach.

31 Some members indicated that MCEV could be used instead of a fair value approach which will be far away from the full retrospective approach. Some members were concerned that the fair value approach will result in a lower CSM than a retrospective approach but did not explain why. The references available in the extensive case studies did not provide an explanation but only made a statement or provided an outcome without explaining how the numbers were obtained.

32 EFRAG IAWG also discussed the use of estimates in applying the modifications under the modified retrospective approach.

33 In conclusion, although EFRAG IAWG members had expressed concerns around the practicality of the modified retrospective approach which may lead to using fair value on transition. The latter transition method was considered to provide financial information at transition and in subsequent periods different from the full retrospective application. They thought the proposed amendment that liabilities that relate to the settlement of claims incurred before an insurance contract was acquired could be classified as liabilities for incurred claims on transition was a step in the right direction.

Transition: risk mitigation option and OCI

34 The concerns related to the prospective application of the risk mitigation option and that the resetting of OCI to zero for insurance liabilities is not available for the related assets.

35 This was not highlighted in the EFRAG letter. The EFRAG Secretariat will address risk mitigation in its upcoming questionnaire on hedge accounting for insurance liabilities. The hedge accounting questionnaire will assess in detail the reasons why IFRS 9 hedge accounting, in the view of some, cannot be used in relation to insurance liabilities. The draft questionnaire will be discussed with EFRAG IAWG in May 2019.

36 With regards to the risk mitigation option, although members agreed that the IASB tentative decision to allow retrospective application of the risk mitigation option as from transition date is a step in the right direction, they had mixed views about the benefit of this decision. Members considered that the risk mitigation option should be applied fully retrospectively in all cases where risk documentation is available. Members noted that the outcome will work but that it does not conceptually solve the problem.

37 Some members also raised their concern that IFRS 9 *Financial Instruments* was not an appropriate solution for hedge accounting.

38 With regards to the determination of the cumulative amount of insurance finance income or expenses recognised in OCI on transition, EFRAG IAWG members noted

that this is a conceptual issue in both the fair value approach and the modified retrospective approach. However, members noted that the use of OCI is an option.

39 Members noted that in future, this provided the positive effects of the OCI option on the asset side, without offsetting adjustments on the liabilities side. They also pointed out that the OCI did not fully belong to the policyholder. Instead, there should be an assessment of what would be paid to the shareholders. This could, for example, be based on the credited rate provided to the policyholder.

40 EFRAG IAWG members also noted that the general rule was to put OCI to zero when the liabilities were measured at transition. If there was a different discount rate for the assets and the liability, then a new OCI would be created, and it would never reach zero, leading to a permanent mismatch in OCI.

41 EFRAG IAWG members were divided on whether the fair value approach resulted in a lower CSM at transition in all cases. One EFRAG IAWG member stated that this systemically lower CSM was demonstrated in the case study, while another member one thought the CSM could be close to the CSM under the modified retrospective approach.

42 When questioned why market participants would be prepared to accept lower profitability in all cases compared to an insurer, one EFRAG IAWG member noted that when defining fair value:

(a) It was determined based on the assumption that the buyer would not be willing to pay for the profit of the insurer;

(b) In most cases, insurance liabilities were not bought in isolation, rather a business which was expected to deliver synergies and expectations of future business to be developed.

Loans that transfer significant insurance risk

43 Constituents were concerned that the terms of certain instruments may contain significant insurance risk although the objective was to provide credit, e.g. equity release mortgages and credit cards in the UK.

44 This was not mentioned in the 2018 EFRAG letter.

45 EFRAG IAWG members agreed with the tentative decisions of the IASB that entities issuing such contracts would account for those contracts applying either IFRS 17 or IFRS 9 at portfolio level. EFRAG IAWG members also agreed with the IASB staff reasoning supporting these tentative decisions.

Appendix: IASB TRG - reporting on other issues

Introduction

1 For those issues referred to, this appendix replicates the details provided by the IASB staff on issues not taken to the TRG agenda[1]. These were all issues that the IASB staff considered could be answered by the words of the standard.

S82 Modification of an insurance contract

Question

2 The submission notes discussions at the February 2018 and May 2018 TRG meetings on applying paragraph B5 of IFRS 17 to contracts acquired in their settlement period. The submission asks whether a new contract recognised as a result of a modification is accounted for similarly to contracts acquired in their settlement period applying paragraph B5 of IFRS 17 (i.e. if the new contract is in its settlement period on recognition, is the insured event the determination of the ultimate cost of the claims). The submission describes two specific examples and additionally asks how to identify the coverage units.

Response

3 If the terms of an insurance contract are modified an entity shall derecognise the original contract and recognise the modified contract as a new contract, applying IFRS 17 or other applicable Standards if, and only if, any of the conditions in paragraph 72(a)−(c) of IFRS 17 are satisfied. Applying paragraph B5 of IFRS 17, when an entity recognises new contracts that are in their settlement period, and therefore cover events that have already occurred but the financial effect of which is still uncertain, the insured event is the determination of the ultimate cost of the claims. The topic of identifying coverage units has been discussed at the February 2018 and May 2018 TRG meetings.

S83 Disclosures and reporting frequency

Question

4 The submission asks how the reconciliation of estimates of the present value of future cash flows applying paragraphs 101 and 104 of IFRS 17 for the annual reporting period should be disclosed, considering the requirements in paragraph B137 of IFRS 17 relating to interim financial statements. For example, the submission asks whether changes disclosed as relating to past service in an interim reporting period should be disclosed as changes relating to current service in the annual reporting.

Response

5 Paragraph B137 of IFRS 17 states an entity shall not change the treatment of accounting estimates made in previous interim financial statements when applying IFRS 17 in subsequent interim reporting periods or in the annual reporting period. The amounts disclosed in the reconciliations set out in paragraphs 101 and 104 of IFRS 17 reflect amounts included in the measurement of insurance contracts. The staff observe that in the example in the submission the description of the amount as relating to past or current service does not affect the measurement.

[1] https://www.ifrs.org/-/media/feature/meetings/2019/april/trg-for-ifrs-17/ap2-reporting-on-other-questions-submitted.pdf

S102 Accumulated OCI

Question

6 The submission is about contracts measured applying the general model when an entity makes an accounting policy choice to disaggregate insurance finance income or expenses between profit or loss and OCI. The submission asks whether accumulated OCI on insurance contracts should be reclassified to profit or loss when experience does not unfold as expected, and if so, how.

Response

7 Applying paragraph B130 of IFRS 17, if paragraph 88(b) of IFRS 17 applies, the amount of insurance finance income or expenses allocated to profit or loss is determined by a systematic allocation of the expected total finance income or expenses over the duration of the group. This results in the amounts recognised in OCI over the duration of the group of contracts totalling zero. The cumulative amount recognised in OCI at any date is the difference between the carrying amount of the group of contracts and the amount that the group would be measured at when applying the systematic allocation.

S115 Definition of insurance contracts with direct participation features

Question

8 The submission describes a unit linked insurance contract for which the entity charges an asset management fee determined as a percentage of the fair value of the underlying items at the end of each period plus a premium for mortality cover by reducing the underlying items at the beginning of each period. The submission questions the application of paragraph B101(b) of IFRS 17 in determining whether a contract meets the definition of an insurance contract with direct participation features. First the submission asks how to determine the share of the fair value returns on the underlying items ignoring the mortality cover. It proposes:

(a) a calculation that compares the share of each party in the fair value returns on the underlying items;

(b) a calculation that results in 100% share to the policyholders in all circumstances; and

(c) a calculation that compares the incremental share of each party in the fair value returns (incremental to a scenario in which the fair value returns are nil).

9 Then the submission considers whether and how the premium for mortality cover deducted from the underlying items impacts the above calculation.

Response

10 Paragraph B101(b) of IFRS 17 requires that the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items as a condition for meeting the definition of an insurance contract with direct participation features. Therefore, a determination based on any calculation other than a calculation of the policyholder's share in the fair value returns on the underlying items would be inconsistent with the requirements of IFRS 17.

11 The deduction of a premium for mortality cover from the underlying items is, in effect, an amount paid out of the policyholder's share. In other words, the policyholder's share includes that charge. However, an entity needs to also consider paragraph B101(c) of IFRS 17 in determining whether the definition of an insurance contract with direct participation features is met. Paragraph B101(c) of IFRS 17 requires that the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items. For

the purposes of this condition an entity considers changes in any amounts to be paid to the policyholder regardless of whether they have been paid from the underlying items or not. See example 2 in Appendix A to the IASB paper.

S118 Disclosures and reporting frequency

Question

12 The submission questions whether the effect of reinsurance should be considered in calculating the risk adjustment for non-financial risk for contracts that have been reinsured.

13 The submission further provides an example illustrating two alternative approaches in determining such effect.

Response

14 Paragraph B88 of IFRS 17 requires that the risk adjustment for non-financial risk reflects the compensation the entity would require for bearing the nonfinancial risk arising from the uncertain amount and timing of the cash flows. The risk adjustment for non-financial risk reflects the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk. Therefore, if an entity considers reinsurance when determining the compensation it requires for bearing non-financial risk related to underlying insurance contracts, the effect of the reinsurance (both cost and benefit) would be reflected in the risk adjustment for non-financial risk of the underlying insurance contracts. IFRS 17 does not specify the estimation techniques to be used to determine the risk adjustment for non-financial risk. Paragraph 64 of IFRS 17 requires that the risk adjustment for non-financial risk for reinsurance contracts held represents the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts. Therefore, the risk adjustment for non-financial risk of the reinsurance contract held could not be nil, unless:

(a) the entity considers reinsurance when determining the compensation it requires for bearing non-financial risk related to underlying insurance contracts; and

(b) the cost of acquiring the reinsurance is equal or less than the expected recoveries. See example 1 in Appendix A to the IASB paper.