Amendments to IFRS 17 *Insurance Contracts*

Additional issues raised

Introduction

1 EFRAG has been informed about a number of topics that may potentially need to be addressed when finalising the Amendments to IFRS 17. These topics are listed below with the sole aim of informing the IASB and EFRAG has not developed a view as to whether standard setting is needed.

Topics part of the 25 issues discussed by IASB

2 Consistently with the decision taken by the Board in preparing the DCL to focus on the 6 issues in the letter sent to the IASB in September 2018, these topics have not been included in the FCL.

Exception to IAS 34 *Interim Financial Reporting*

3 It was noted the exception to IAS 34 that exists in IFRS 17 should be removed or made optional. Recalculating the carrying amount of the contractual service margin on a year to date basis will result in entities treating accounting estimates made in previous interim financial statements similarly and ensure comparability among entities whatever the frequency in the reporting.

Use of comparatives

4 It was noted that entities should be permitted to not present adjusted comparative information on initial application of IFRS 17, as it was authorized for the first application of IFRS 9. It is noted that revisiting the requirements on comparatives useful in order to safeguard the implementation deadline.

Scope of the standard – contracts that change in nature over time

5 It was noted there is an issue related to contracts that change in nature over time. The insurance industry issues products that change significantly in nature during their life due to the execution of an option by the policyholder (for example, products with a savings phase with profit sharing that may become an annuity). As the classification between general model and variable fee approach occurs at inception and is irrevocable, certain products may have to be accounted for under the variable fee approach, whereas, after the execution of the option, the variable fee approach model is not suitable and not comparable to similar products with a different 'history'. They propose a solution that treats a significant change in the nature of a contract due to the execution of an option by the policyholder as a contract modification. The 'new' contract post execution of the option by the policyholder could be reassessed and treated under the appropriate measurement model for its new features.

Setting OCI to nil at transition

6 It was noted that because assets will be discounted at the interest rate at the date of purchase of the asset while liabilities will be discounted at the interest rate fixed at the date of transition (much lower than the first rate), there will be a significant misallocation of the financial result.

7 In this sense, constituents understand that additional amendments to the fair value approach are necessary in order to homogenize the results achieved by applying the different methods.

8 One of the reliefs that constituents propose to eliminate the asymmetry described, resulting from the different requirements under IFRS 9 and IFRS 17 at the transition date, would be to consider that the interest rate applicable to the portfolio of the assigned assets is a good approximation of the interest rate to be applied to the portfolio of insurance contracts. In this way, the amounts allocated in OCI of assets and liabilities would be offset and the financial result would better reflect the reality of the operation.

Volatility of OCI introduced by IFRS 17 discount rates

9 There is concern about the variability in OCI introduced by IFRS 17 for Spanish long-term life-saving contracts that are not eligible to be measured under the variable fee approach. Under the general measurement model (both PL and FV-OCI option) changes in the IFRS 17 discount rate after initial recognition do not lead to a remeasurement of the CSM, given that the CSM is measured at inception with the locked-in rate and not remeasured to reflect changes in this rate. Even if the expected cash flows from an insurance contract are economically and perfectly matched with non-contractually disclosed financial assets that replicate those cash flows, including any long-term interest rate guarantee, an insurer will recognise in P&L/OCI amounts that go beyond the credit risk spread. This arises as a consequence of the CSM not being remeasured at each reporting date for changes in the discount rate. The fact that the CSM is not remeasured for changes in the IFRS 17 discount rate is equivalent to having a portion of the insurance liability not measured on a current basis, giving rise to amounts recognised in P&L/OCI that do not offset completely (assuming there is not a spread credit risk) with the remeasurement at fair value of the corresponding financial instruments. Some constituent believes such a difference in measurement leads to an accounting mismatch that does not portray the economic net financial situation of Spanish long-term life-saving products. Spanish insurers will mainly apply the OCI option for the presentation of the insurance finance result, as their related assets will be mainly classified in FV-OCI portfolios under IFRS 9. In this context, there is significant concern about the variability that will be recognised in OCI for these products under the general measurement model. It is important to highlight that Spanish users of insurers' financial statements place much emphasis on understanding the trend and evolution of the profit and loss and OCI statements, not expecting significant variability for the current business model under an economically matched balance sheet.

10 In order to solve this variability, a re-measurement of the CSM at each reporting date for changes in the discount rate should be permitted, including the effect in OCI, while keeping the other IFRS 17 current requirements unchanged. Such re-measurement would mitigate these accounting mismatches in OCI between IFRS 9 and IFRS 17. This proposal would apply to companies that apply the OCI option under the general measurement model, and some type of conditions or constraints could be set up to limit the remeasurement to certain types of insurance contracts (managed under matching adjustment techniques, for example). The above suggestion would not change other current IFRS 17 requirements (i) to use the locked-in rate to accrete interest on the CSM, and (ii) to use the same locked-in rate

to determine the adjustments to the CSM for changes in non-financial assumptions that affect future cash flows would remain unchanged under the new proposal. At the same time, some believe it would not affect any core principle of IFRS 17. In particular, the amounts recognised in OCI would naturally reverse over time and insurance service result would be shown separately from the insurance finance result.

Interaction between IFRS 17 and IFRS 9

11 It was noted there is a source of mismatch generated for some Spanish insurance products, backed by an important part of equities regarding the asset side. In these cases, under current accounting standards, the companies were selling part of their equity-portfolio (allocated to this product) getting realized gains from such equities which were accounted through P&L. The increase of the technical provision were also accounted through P&L. Therefore an adequate matching was reached. Under IFRS 9 realized gains from mentioned equity will be kept in OCI. However, under IFRS 17 the increase of the technical provision will be accounted through P&L. Here there is an evident source of mismatch. Constituents are aware that there is a fair value option (FVO), but it does not exist a “partial” FVO for the liability, thus this option will also affect all the fixed income assets portfolio (6 times bigger). Consequently, this option will transmit a huge volatility to P&L, namely, this will create a non-manageable P&L in the industry. It is recalled non realized gains amounted almost 20% of the market value. This type of market movements have been reflected historically in OCI in order to avoid distortions in P&L. Thus, this option is not suitable for this type of traditional retirement products. Therefore the most suitable solution for this mismatch would be to fix IFRS 9 allowing recycling for these type of equity investments.

General model – Locked-in interest rate for CSM

12 Some constituents continue to disagree with the use of a locked-in discount rate for measuring the CSM under the general model as it is inconsistent with the measurement of expected cash flows which are discounted using a current discount rate. This adds to the complexity of IFRS 17 and may distort the financial results in a given period.

Amendment to IFRS 3 Business Combinations (Appendix D of the ED, BC162)

13 Constituents did not agree with the requirement to re-assess the classification of acquired contracts on the business combination date, rather than retaining the classification made at inception.

14 Constituents did not concur with the requirement to re-assess the classification of acquired contracts on the business combination date, rather than retaining the classification made at inception for the following reasons:

(a) Due to further operational challenges, especially if the new subsidiary includes contracts that change in nature during their life. This would result in significantly different accounting treatments between the group and subsidiary financial statements. (two respondents)

(b) There was a concern with contracts that are acquired during the settlement period, it appeared counter-intuitive to ignore the substance upon execution of a business combination and to be required to treat that run-off contract as if it was a newly issued insurance contract. The insurer would have to artificially assign a CSM to a contract as if there was a period of remaining coverage where, in substance, no such coverage exists anymore. In addition, treating liabilities for incurred claims in the books of the acquiree as liabilities for remaining coverage in the books of the acquirer does not only give rise to completely different accounting but also does not positively contribute to the understanding of the business to an outside reader.

15 One of these constituents proposed to limit the relief provided by IFRS 3.64(N) to legacy contracts only.

New topics

Current and prospective measurement model inadequate in some cases

16 It was noted that under specific economic conditions, a current and prospective measurement model may not appropriately portray the mechanism of some long-term contracts. For valuation purposed, IFRS 17 requires using stochastic methods that capture a large number of scenarios, in order to measure the associated time value of financial options and guarantees (TVOG). Because the changes in the TVOG are recorded against the contractual service margin (CSM) it can represent a significant part of the variation of the CSM, all the more because the sensitivity of the TVOG is closely linked to the exposure to investments in equities.

17 In stressed market conditions (for instance, durable low interest rates), the VFA model may not correctly reflect in the IFRS financial statements the annual performance of these contracts because the change in the value of the options and guarantees may drastically reduce (and even offset) the CSM although it is very unlikely that these options and guarantees may be paid to the policyholders, due to these stressed market conditions. As a result, companies may consider changing their investment policy to reduce their equities exposures, in order to limit the induced volatility and thus secure their IFRS financial performance to the detriment of their statutory results, which nevertheless remain the basis of policyholders' participation benefits and dividends payable to the shareholders.

Presentation of collateral deposits

18 It was noted that collateral deposits related to reinsurance issued and held, these amounts are usually presented for separately under IFRS 4. Under IFRS 17, when a reinsurer provides funds withheld as a collateral with the ceded insurer, these funds will be included in the measurement of the liabilities. This offset will not fairly portray the economics of these deposits, because from a contractual point of view, these amounts correspond to funds transferred as guarantees to cover a risk of default by the reinsurer, and not to an advance payment. Offsetting the deposits with the reinsurance liability (for the reinsurer) or the asset (for the ceding company) will incorrectly reflect a compensation which may never exists if no default occurs.

VFA – Unlocking of CSM for changes in non-underlying cash flows

19 It was noted that some contracts are classified under the VFA but that contain also certain non-participating features. The cash flows arising from these features are not covered by underlying items.

20 These products qualify for the VFA based on an assessment against the criteria in IFRS 17.B101 at inception, even though there is a non-trivial part of future cash flows which may not vary based on changes in the underlying item. For example, at the time of eligibility assessment the non-variable annuity pay-out phase of the variable annuity may have had less weight compared to the variable cash flows in the participating accumulation phase.

21 Applying the current requirements to these contracts containing cash flows not arising from underlying items would result in significant accounting mismatches in profit or loss. Because according to IFRS 17.B113(b), the changes in the time value of money (TVoM) and financial risk not arising from underlying items shall adjust the

CSM, while the investment result from the general account investments backing the non-participating future cash flows is directly recognized in profit or loss in the current period. Consequently, the CSM might be eaten up rapidly, giving rise to a loss component, although economically the contract is not onerous.

22 Constituents understand and acknowledge that any solution to this issue might be difficult to develop. However, they consider a solution to this issue an absolute necessity in order to obtain a consistent, reasonable accounting framework for such insurance contracts that have been described in the fact pattern. Otherwise, applying the current requirements to these contracts containing cash flows not arising from underlying items would result in significant accounting mismatches in profit and loss.

23 The accounting issue presented above is not just a theoretical issue, but it is a "real-world" problem affecting a multitude of common insurance contracts in different jurisdictions.

Accounting for time value of money in VFA

24 It was noted that IFRS 17.B113(b) requires changes in the effect of the time value of money and financial risks not arising from the underlying items to adjust the CSM for contracts with direct participation features. The scope of this paragraph extends to all changes in the effect of the time value of money and financial risks. Some have interpreted this as including the effect of unwinding of the discounting of relevant fulfilment cash flows. Constituents are concerned that this interpretation will cause distortions in the financial statements, particularly as a result of the unwinding of the discounting of the insurance contract liabilities being included in the CSM. They believe this interpretation is conceptually incorrect, as the time value of money effect arising purely as a result of the passage of time (i.e., unwinding of the discounting of the liability) relates to current service and should be included in insurance finance expense for the period. They suggest the IASB to amend B113(b) to require the unwinding of the discounting of the liabilities to be recognised in insurance finance income or expense.

Re-classification of OCI

25 A potential accounting mismatch in equity for contracts accounted for under the variable fee approach was identified resulting from investments in equities accounted for under FVOCI.

26 The accounting policy choice in paragraph 89(b) is chosen; therefore the insurance finance income or expense in the period is disaggregated to include in profit and loss an amount that eliminates accounting mismatches with income or expenses included in profit or loss on the underlying items held.

Non-distinct investment components

27 It was noted that the current prevalence of non-distinct investment components (with often small non-distinct investment components being identified in everything from funeral plans to reinsurance treaties) is operationally extremely onerous for preparers. Constituents consider that in certain cases (funeral plans being a good example), the measurement of non-distinct investment components is arbitrary and likely to lead to a lack of comparability between entities, and consequently non-useful information for users.

28 They consider increasing the comparability of the income statement to other industries such as banking and fund management where products have deposit features, can be achieved by revising the definition of an investment component to include only contracts where the policyholder has the right to make withdrawals. They consider the defining features of a deposit is the right of the policyholder to

withdraw their deposit (adjusted as appropriate by investment return added and fees deducted from the deposited amount), and in the absence of this right to withdraw a deposit does not exist. They believe such a change would better meet the needs of users.

29 They believe the original intention of the IASB was that non-distinct investment components only need to be identified and measured when a claim occurs. They note changes to the definition of an investment component, have created uncertainty around when a non-distinct investment component is identified and measured. They ask the IASB to resolve the uncertainty around identification by clarifying that non-distinct investment components are identified based on facts and circumstances at initial recognition of the contract.

30 The accounting policy choice in paragraph B5.7.1. in IFRS 9 for respective FVOCI underlying items is chosen; therefore the amounts presented in OCI will not be subsequently transferred to profit and loss, but the cumulative gain or loss will be transferred within equity.

31 Implication:

32 As referred in IFRS 9 B5.7.1 (Gains and losses, regarding investments FVOCI) …" Amounts presented in other comprehensive income shall not be subsequently transferred to profit or loss. However, the entity may transfer the cumulative gain or loss within equity." They believe reclassifying the cumulative gain or loss at disposal from accumulated OCI to retained earnings provides better information because it ensures that ultimately all gains or losses from the investment are presented in retained earnings and no amounts remain in accumulated OCI after the investment has been derecognized.

33 Where such FVOCI investments are underlying items, the fair value changes in the investments (underlying items) are reflected in the insurance liability OCI. Paragraph B134 of IFRS 17 provides clear guidance for direct participating contracts which amounts to include in profit or loss. In particular the insurance liability OCI reflecting the cumulative gain or loss shall not be reclassified or reflected in to profit or loss at any time. Furthermore, paragraph 91(b) explicit prohibit recycling of liability OCI to P/L for certain cases of contract derecognition.

34 If the respective reclassification option from accumulated OCI to retained earnings within equity for IFRS 9 investments accounted for at FVOCI is chosen, they would like to apply a similar reclassification option to the respective liability OCI: reclassification of any remaining liability OCI from other comprehensive income to retained earnings within equity. This reclassification would mirror the corresponding reclassification in IFRS 9 and ensure that ultimately all gains or losses from the investment are presented in retained earnings and no amounts remain in accumulated OCI after the insurance contract has been derecognized.

35 However, the Standard does not explicitly state whether or not such a reclassification from accumulated OCI to retained earnings is permitted for IFRS 17. A reclassification is supported by the basis for conclusion for IFRS 9 on the implementation of the FVOCI accounting policy choice for investments which emphasizes the conceptual consistency in presentation between IFRS 9 investments and IFRS 17 insurance contract liabilities: BC4.148 of IFRS 9 details the initial decision of the IASB to implement the FVOCI accounting model which is partly due to concerns of accounting mismatches with insurance contracts liability accounting. A similar reasoning is brought forward in BC 44 of the Basis of Conclusion of IFRS 17.

36 However, constituents recommend to clarify in IFRS 17 that a similar reclassification option for insurance contract liabilities exists as in IFRS 9 B5.7.1 (i.e., providing the accounting policy choice to reclassify any remaining liability OCI after derecognition of the group of contracts from accumulated OCI to retained earnings within equity).

Treatment of LIC in contract modifications

37 A contract modification according to IFRS 17.72 requires de-recognition of the old, and recognition of the new, amended contract. This treatment makes sense for the LRC relating to the old contract. The Standard does not clearly prescribe how to deal with an LIC recognized on the old contract. There could be three possible interpretations:

(a) The LIC remains in the group of contracts covering the old contract;

(b) The LIC is transferred to the new group of contracts as a LIC; or

(c) The LIC is derecognized and needs to be reflected when determining the LRC for the modified contract.

38 Based on constituents' understanding, interpretation 1 is adequate. The modification relates to future service only (i.e., a new premium is charged for a new/different coverage/service). The LIC relates to past service and thus relates to revenues already earned for the old contract in the old group of contracts in prior periods. These claims are not reflected in the premiums for the modified contracts, nor do they refer to "remaining coverage" for the new/modified contract. Reflecting these claims in the LRC for the modified contract would result in a misstatement of the financials:

39 Derecognizing the LIC would result in a positive run-off, without economic substance; and

40 Reflecting the LIC in the fulfilment cash flows (LRC) of the new contract would impair the CSM, and potentially even result in a loss component for an economically profitable contract.

Consequential amendments to IAS 16 Property, Plant and Equipment

41 The consequential amendments to IAS 16 as laid out in paragraph 29A of IAS 16 provides an option to measure some owner-occupied properties which are included in a fund or are underlying items of groups of insurance contracts with direct participation features using the fair value model.

42 Constituents welcome the amendments. However, this amendment to IAS 16 is limited to the owner-occupied property. Some insurers invest in alternative assets, e.g. wind park, which are underlying items of insurance contracts with direct participation features. There is no clear guidance in IAS 16, whether such assets can be classified as owner-occupied properties. However, paragraph 5 of IAS 40 implies that property is land or a building – or part of a building – or both. Based on this, it appears difficult to classify the wind park as a whole as property. Consequently, the option provided in IAS 16.29A is not applicable to such assets. As a result, accounting mismatch will arise, because part of the underlying items of contracts accounted for under the VFA are not measured at fair value.

43 They recommend that the option granted in IAS 16.29A should be applicable to Property, Plant and Equipment accounted for under IAS 16 rather than limited to owner-occupied properties. Against the background that the investments in infrastructure will be noticeably increasing in the low interests environment, our recommendation would facilitate investment in infrastructure that would be beneficial for the whole economy.

Technical correction to VFA Illustrative Examples (not in the ED)

44 It was noted that the Illustrative Example paragraphs 112(e) and 185(b) make reference to paragraph 87(c) in support of why an entity recognises changes in the fair value of underlying items as insurance finance income or expenses. However, section (c) of Paragraph 87 is specific to loss component requirements. As such,

the reference in the IE.112(e) and IE.185(b) should be corrected (likely to just paragraph 87 in general, or paragraph 87(a) and (b), if that is what the IASB intended).

Measurement inconsistencies – IFRS 17 implies applying a fair value measurement to assets

45 Since insurance contracts are measured at current value, any corresponding asset is best matched when also measured at current value, leading to application issues (for instance by segregating assets into ring-fenced pools or accepting the created mismatch). Constituent suggests targeted improvements facilitating the alignment of the measurement of underlying assets with the measurement of the insurance contract: e.g. by allowing measuring loans at FVOCI even if the IFRS 9 business model is held-to-collect; by splitting investment property providing returns to different types of contracts.

Mutual entities

46 It is noted that if the IASB intends to clarify how IFRS 17 applies to certain mutual entities, it should do it in the standard itself (and not in the BC) and also explicitly highlight the specific contractual/legal circumstances deserving such a treatment (neither CSM nor equity).

47 Also, as a result, it was suggested that the IASB's separately published educational material, *Insurance contracts issued by mutual entities*, should be amended or withdrawn.

Additional terminology improvements

48 It was noted that users would like the term “duration” to be defined.