CFO FORUM

CFO Forum presentation to the EFRAG TEG

21 March 2019

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Attendees

We are grateful for the opportunity to present today, those issues which the CFO Forum believe still remain unresolved by the current proposed draft of IFRS 17.

Presenting to you today are:-

- Christophe Boizard – CFO, Ageas
- Harm van de Meerendonk – Chair of the CFO Forum’s Insurance Accounting Group and Head of Financial Accounting and Reporting, NN
- Roman Sauer - Chief Accountant, Allianz
- Jo Clube – Group Technical Accounting Director, Aviva

Introduction (1/2)

We are here today to present an update on the issues identified by EFRAG's field testing and the status of resolution by the IASB. In particular we will:

- Provide an explanation of the CFO Forum's views on the current status of the issues raised by EFRAG and the CFO Forum in relation to the IASB's deliberations and the reasons for their importance, and

- To the extent that time permits, discuss illustrative information, based on the field testing previously undertaken, as to why the CFO Forum believes that all of the issues are material from a financial reporting and/or operational perspective and the logic of the Forum's proposed solutions.

Through this the Forum hopes to give greater clarity on the issues and what they mean for companies and their financial reporting.

It should be noted that the actual wording in the final standard will be important in fully understanding whether the issues are resolved since at this stage the IASB have discussed the approach rather than specific wording.

Introduction (2/2)

- The CFO Forum remains committed to the development of high quality financial reporting standards that meet the needs of all stakeholders.
- CFO Forum members participated in EFRAG's full case study (9 CFO Forum members) and simplified case study (11 CFO Forum members) during 2018. We continue to invest significant time and effort in discussions around the development of IFRS 17.
- We remain committed to this process and are keen to work together to resolve the remaining issues with the standard as currently drafted.
- We appreciate the continuing support by the EFRAG staff throughout this process, as we work together to bring the standard to full implementation.

CFO Forum contribution to development of IFRS17 since 2016

Time period	IASB and EFRAG activity	CFO Forum contribution
July-October 2016		External testing of IFRS 17 draft (including 3 members of the CFO Forum)
December 2016	Editorial review of IFRS 17 draft	
May 2017	IFRS 17 issued	
September 2017	IFRS 17 Transition Resource Group established	
February-June 2018	EFRAG testing of IFRS 17 (Case studies)	Participation by several CFO Forum members in EFRAG case studies
August 2018		CFO Forum letter to EFRAG and IASB on 11 issues identified during IFRS 17 testing
September 2018	EFRAG letter to IASB, summarising six issues identified during IFRS 17 testing	
October 2018		CFO Forum letter to EFRAG and IASB suggesting solutions to the 11 issues identified in August 2018.
November 2018	Deferral of effective date of IFRS 17 proposed by IASB	
December 2018-February 2019	IASB meetings held to discuss changes to IFRS 17	

CFO Forum* EFRAG case study participation

Italy: 1

- **Life, VFA model**: Participating business
- **Non life, PAA**: Motor

Germany: 2

- **Life, VFA model**: Participating business and corporate life & health
- **Non life, General Model**: Multi year P&C
- **Non-Life, PAA**: P&C, reinsurance held

UK: 3

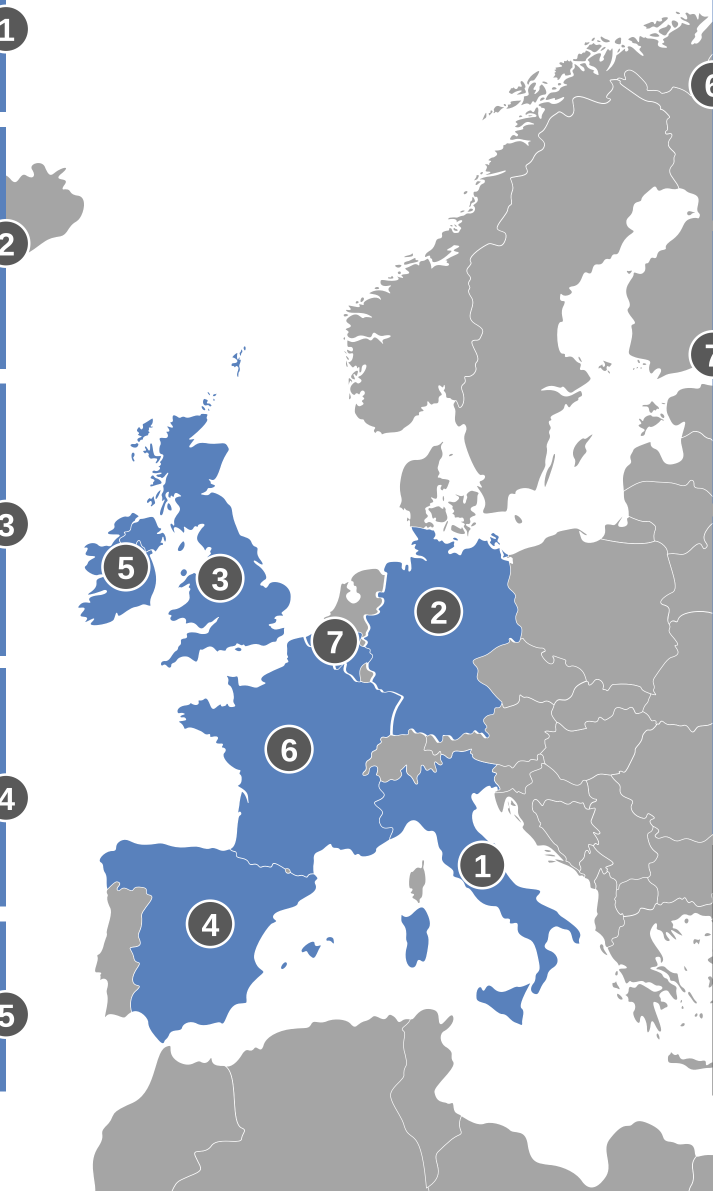
- **Life, VFA model**: Unit linked, with profits.
- **Life, General Model**:, Annuities (Individual and Bulk purchase), Individual protection reinsurance ceded
- **Non life, PAA**: Motor, P&C, reinsurance held

Spain: 4

- **Life, VFA model**: Unit linked, participating business, fixed index annuity
- **Life, General model**: Annuities
- **Non life, General model**: Motor, PAA, P&C

Ireland: 5

- **Life, VFA model**: Participating business,
- **Life, General model**: Loan/credit insurance



France: 6

- **Life, VFA model:** Unit Linked, participating business, life savings, multi-support,
- **Life, General model:** Loan/credit insurance
- **Non life, General model:** Multi-year P&C, motor, reinsurance assumed, and held

Belgium: 7

- **Life, VFA model:** Corporate life and health,
- **Life, General Model:** Corporate life and health,
- **Non life, General Model:** P&C, reinsurance assumed and held

Non-EEA jurisdictions (Switzerland, US, Canada & Asia):

- **Life, VFA model:** Unit linked
- **Life, General model:** Individual protection, fixed index annuities
- **Non life, General model:** Multi-year P&C
- **Non life, PAA:** P&C, reinsurance assumed

*The CFO Forum comprises 23 member firms: AEGON, ageas, Allianz, Aviva, AXA, BNP Paribas Cardif, CNP, Generali, Groupama, hannover re, NN, Legal & General, Mapfre, Munich RE, Phoenix Group, Prudential, SAMPO Group, Scottish Widows, SCOR, Swiss Re, talanx., VidaCaixa and Zurich.

CFO Forum assessment of Status of Issues identified by EFRAG (1/2)

Issue	Description of issue	Status of IASB considerations	Does recommended change address the issue?
Transition	The modified retrospective approach is very restrictive.	Changes rejected (February 2019)	No change proposed
	The option to set OCI to nil under the fair value approach is not available to assets accounted at fair value through OCI.	Changes rejected (February 2019)	No change proposed
Level of aggregation	The prohibition to aggregate contracts that are issued more than one year apart is unduly complex.	No change proposed*	No change proposed*
CSM amortisation	CSM cannot be amortised over the period in which investment services/activity are provided.	Change proposed (January 2019)	Partly – Addresses issue only for certain products
Reinsurance	Mismatch of recognition of loss on onerous contracts vs relief from corresponding reinsurance contract.	Changes proposed (January 2019)	Yes
	Reinsurance held cannot be accounted for under the VFA model, even if the VFA model is applied to the underlying insurance contracts.	Changes rejected (January 2019)	No change proposed
	Contract boundaries for reinsurance are inconsistent with those for the underlying insurance contracts.	Changes rejected (January 2019)	No change proposed

*Based on March IASB board meeting papers

CFO Forum assessment of Status of Issues identified by EFRAG (2/2)

Issue	Description of issue	Current status	Does recommended change address the issue?
Presentational issues	Requirement that groups of contracts be presented as asset or liability based on its entirety.	Changes proposed (December 2018).	Partially, limited changes were proposed
	Requirement to include premiums and claims in the insurance provision on a cash paid/received basis.	Changes rejected (December 2018).	No changes proposed
	Requirement to segregate non-distinct investment components, even for contract that do not have a specified account balance or component.*	Not Considered by the IASB	No changes proposed
	Requirement that the frequency of reporting (i.e. annual, semi-annual or quarterly reporting) creates differences in annual results.*	Changes rejected (December 2018).	No changes proposed
Acquisition cash flows	Acquisition cash flows on new business that is expected to renew cannot be allocated to future periods.	Changes proposed (January 2019)	Yes

*Additional issues identified by the CFO Forum

CFO Forum assessment of Status of additional issues identified by the CFO Forum through the EFRAG field testing (1/2)

Issue	Description of issue	Current status	Does the recommended change address the issue
Scope of the VFA model vs General model and PAA	The testing has shown that the results are very different depending on the measurement model applied, whilst there is a continuum in the nature of insurance products.	Changes rejected (December 2018)	Issue can be addressed through solutions to other issues.
Discount rates	• The use of a locked in discount rate for the CSM in the general model. • Inconsistencies arising due to the different discount rates for BEL (current rate) and CSM (locked-in rate).	Change rejected (December 2018).	Change rejected
	Uncertainty regarding whether changes in asset mix will result in changes to the discount rate when the discount rate is determined top down using actual assets as a reference portfolio.	TRG meeting resolved issue. (September 2018).	
Multi-component contracts	Capture in scope of contracts exposing the issuer to credit risk that are in substance loans.	Changes proposed (February 2019)	Yes

CFO Forum assessment of status of additional issues identified by the CFO Forum through the EFRAG field testing (2/2)

Issue	Description of issue	Current status	Does the recommended change address the issue
Scope of hedging adjustment	The hedging adjustment is only available for contracts in scope of the VFA.	Changes rejected (December 2018)	No change proposed
	The hedging adjustment cannot be applied retrospectively on the date of initial application. Note that this item also has an impact on transition	Change proposed*	Partly - Proposal applies only from first period of application
	The hedging adjustment can only be used when derivatives are used as hedging instrument.	Changes rejected but minor extension to reinsurance of financial risk only. (January 2019)	Partly – Extended only to reinsurance of financial risk
Business combinations	The requirement to assess classification at the acquisition date instead of the original inception date adds significantly to complexity.	Change rejected (December 2018).	No change proposed
	The treatment of claims in payment at the acquisition date adds significantly to complexity	Changes proposed (February 2019)	Partly – For combinations pre transition but not post

*Based on IASB March board meeting papers

Summary of principal impact if issues identified within the current draft of IFRS 17 remain unresolved

	Increase in operational complexity and cost	Financial reporting impact*	Impact on comparability amongst reporting entities
Transition	X	X	
Level of aggregation	X		
CSM Amortisation		X	X
Reinsurance	X	X	
Presentational issues	X		
Acquisition cash flows			
Scope of VFA vs General Model and PAA		X	
Discount rates	X	X	
Multicomponent contracts			
Scope of hedging adjustment		X	X
Business combinations	X		X

With the financial reporting impact, as noted above, companies may feel obliged to try to report parallel Alternative Performance Measures either by highlighting adjusted IFRS operating results and / or equity.

*For example, accounting mismatch, misstated equity / income statement, inconsistent approach applied between in force business on adoption of the standard and subsequent new business.

CFO Forum Key points for each issue identified with IFRS 17

In this section, for each issue, we explain

- The issue that needs addressing.
- Briefly, why the issue is material and gives rise to concern from a financial reporting or operational perspective.
- The Forum solution as proposed.
- Changes (if at all) proposed by the IASB.
- The implications if the issue remains unresolved.

Illustrative examples to support this analysis are shown in the appendix.

CFO FORUM ASSESSMENT OF FIELD TESTING ISSUES RAISED BY EFRAG WITH IASB

Not addressed by the IASB

1. Transition
2. Level of aggregation

Partially addressed by the IASB

3. CSM Amortisation
4. Reinsurance
5. Presentational issues

Fully addressed by the IASB

6. Acquisition cash flows

1. Transition

Further illustration of this topic is shown on pages 64 to 66 of the attached appendix

Transition

Current status of issue

Issues

i. The modified retrospective approach is very restrictive and will not provide the simplifications that make retrospective application possible in practice. The conditions which apply to the modified retrospective approach are, in practice, too restrictive and complex for firms to use.

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

CFO Forum solutions

i. Extend relief available to enable widespread capability to use the modified retrospective model and remove requirements to allocate contracts between separate profitability groupings.

ii. Extend the ability to set cumulative OCI on liabilities on transition equal to the cumulative OCI balance on the underlying assets to all insurance contracts, rather than just those measured using the VFA

Changes proposed by the IASB

The IASB discussed both issues in February 2019 and rejected any change to IFRS 17.

Transition

Key points

- The restrictive nature of the modified retrospective approach makes it not possible to apply in a number of areas and this is likely to lead to increased use of the fair value approach.
- Increased use of the fair value approach impacts the level of comparability between the basis of reporting for in force business at the date of application of IFRS and that for subsequent new business
- The relevance of the fair value approach vs a retrospective approach is dependent on the characteristics of the contracts and application of the fair value approach can present challenges.
- The absence of the ability to set OCI as the cumulative OCI balance on the underlying assets for contracts that are measured by the General Model will distort financial information on transition and impact future financial reporting.

Transition

Implications if issues remain unresolved

	Increase in operational complexity and cost	Financial reporting impact	Decrease in comparability amongst reporting entities
Transition	X	X	

- In many instances a retrospective approach would lead to more comparable and reliable information but it is often unavailable due to the restrictions in the standard.
- While the fair value approach is a useful expedient in some cases, it may not always provide an appropriate profit recognition pattern. Testing indicates that this approach results in a lower CSM on transition than a retrospective approach (for onerous contracts it may result in a higher CSM).
- Setting the cumulative OCI balance on insurance liabilities to nil on transition, while not doing so for the cumulative OCI balance on assets measured at FVOCI, will distort components of equity on transition; and impact financial information post transition.

2. Level of aggregation

Further illustration of this topic is shown on pages 67 to 72 of the attached appendix

Level of aggregation

Current status of issue

Issue

The prohibition to aggregate contracts that are issued more than one year apart is unduly complex and will give rise to very material operational burdens. In addition, the second profitability bucket (no significant possibility of becoming onerous) is highly subjective and adds to the complexity.

CFO Forum solution

Remove the requirement to group contracts by annual cohorts, under the condition that contracts issued in different years would be in the same profitability group.

Changes proposed by the IASB

No changes proposed (based on March IASB board meeting papers).

Level of aggregation

Key points

- The prohibition to aggregate contracts issued more than one year apart results in groupings that are inconsistent with the way firms manage their business. This is particularly evident for business where mutualisation between different generation of policyholders exist.
- It will require the capture of cash flow and other data at an annual cohort level and subsequent annual updating of output at each reporting period.

Level of aggregation

Implications if issue remains unresolved

	Increase in operational complexity and cost	Financial reporting impact	Decrease in comparability amongst reporting entities
Level of aggregation	X		

- The requirement for annual cohorts is not consistent with current management practices and will lead to excessive granularity which will cause significant operational complexity.
- The prohibition to aggregate contracts issued more than one year apart results in groupings that are inconsistent with the way firms manage their business. This is particularly evident for business where mutualisation between different generations of policyholders exists.
- As the CSM is a retrospective calculation, output will need to be stored, referenced and updated at each subsequent reporting period.
- Projected cash flows will need to be segmented and stored at an annual cohort level to facilitate roll-forward and unlocking of the CSM despite the fact that no information will be presented externally on this basis.
- The requirement to make significant changes to existing valuation systems and processes would result in extensive resource requirements and increased costs.

3. CSM amortisation

Further illustration of this topic is shown on pages 73 to 77 of the attached appendix

CSM amortisation

Current status of issue

Issue

The requirements on coverage units to be used for CSM amortisation are only appropriate for certain types of contracts. A key issue is that the CSM (of which the initial amount is impacted by investment spreads) cannot be amortised over the period in which investment services are provided.

CFO Forum solution

CSM amortisation should reflect insurance and investment activity, including related activities performed to deliver the insurance benefits.

Changes proposed by the IASB

- In January 2019, the IASB proposed changes to include investment return services in the calculation of coverage units if an investment component exists within the contract.
- The CFO Forum considers additional changes are necessary because the current solution does not address the issue for all contract types.

CSM amortisation

Key points

- For variable annuities measured using the VFA, the change proposed by the IASB allows CSM amortisation to accurately reflect the investment and insurance services provided at different stages of the contract. However, it adds significant complexity for other products.
- Limiting the proposed change to the existence of investment components does not reflect investment related activity in many contracts which is essential to the appropriate reflection of the insurance services, e.g. deferred annuities. In these circumstances investment components do not provide a suitable basis for CSM recognition.
- As discussed in the section on presentation the definition of an investment component should be limited to those that have features of deposits such as unit or account balances. The current definition includes many product features which are not savings/investment in substance and creates inconsistency.
- The IASB should clarify in the drafting of the recommended change that Investment components should only be relevant in CSM amortisation if their existence impacts the pattern of services delivered to the policyholder.
- The definition of coverage units should be clarified to allow the measurement of benefits provided in a period to reflect the potential value of the insured event rather than simply the amounts paid in a particular period.

CSM amortisation

Implications if issue remains unresolved

	Increase in operational complexity and cost	Financial reporting impact	Decrease in comparability amongst reporting entities
CSM Amortisation		X	X

- For contracts with significant investment related activity but small or no investment components such as some deferred and in payment annuities the pattern of profit recognition, if based on investment components, will not reflect the provision of services.
- Economically similar contracts or combinations of contracts with a similar economic effect would have different profit recognition profiles as a consequence of the proposed definition of an investment component, reducing comparability.
- There will be an differing patterns of profit recognition depending on existence or not of specific product features that determine whether investment components exist or not but do not impact the overall expected benefits to the policyholder.
- There will be an increased need for alternative profitability metrics to demonstrate the economics of the business, increasing the use of non GAAP disclosures.

4. Reinsurance

Further illustration of this topic is shown on pages 78 to 84 of the attached appendix

Reinsurance

Current status of issues (1/2)

Issues

i. For an onerous contract a cedant has to recognise a loss component though profit or loss at inception whereas the relief from a corresponding reinsurance contract held has to be deferred and recognised over the coverage period.

ii. Reinsurance held and assumed cannot be accounted for under the VFA model, even if the VFA model is applied to the underlying insurance contracts.

iii. Contract boundaries for reinsurance are inconsistent with those for underlying insurance contracts, meaning that the reinsurance accounting requires the inclusion of an estimate of underlying insurance business that is not yet written/ recognised.

CFO Forum solutions

i. For contracts which are onerous at inception, recognise gain on proportionate reinsurance to the extent reinsurance covers the loss.

ii. Allow VFA measurement where the reinsured contracts have direct participation features.

iii. Proportional reinsurance to include cash flows in respect of recognised underlying contracts.

Reinsurance

Current status of issues (2/2)

Changes proposed by the IASB

i. At the January 2019 meeting, the IASB proposed a change to require a gain on reinsurance to be recorded in profit or loss on initial recognition, to the extent it covers losses recognised on underlying insurance contracts. This change is expected to resolve the issue noted above for proportionate reinsurance.

ii. Discussed by the IASB in January 2019 – changes rejected

iii. Discussed by the IASB in January 2019 – changes rejected

Reinsurance

Key points

- The IASB change addresses the issue of matching the relief of reinsurance to the loss component recognition for proportionate reinsurance.
- There remains a requirement to measure insurance contracts with direct participation features using the VFA, while associated reinsurance treaties are measured under the general model. This issue is equally present for both external and intragroup reinsurance. We note that the impact of this was reduced by the extension of the risk mitigation option to reinsurance contracts held.
- The inconsistency of contract boundaries between reinsurance and underlying contracts results in the inclusion of the impact of estimated underlying future new business within the reinsurance asset. This causes a number of complexities and challenges.

Reinsurance

Implications if issues remain unresolved

	Increase in operational complexity and cost	Financial reporting impact	Decrease in comparability amongst reporting entities
Reinsurance	X	X	

- Changes in financial assumptions adjust the CSM for underlying VFA insurance contracts, while the impact of the same assumption changes on reinsurance measured under the general model are recorded in either the income statement or OCI. This accounting mismatch can be significant, particularly for contracts that are heavily influenced by discount rates and other financial assumptions, such as annuities.
- Differences in measurement between reinsurance and underlying insurance contracts reduces transparency.
- The impact of including estimated underlying future new business within the reinsurance asset leads to accounting mismatches when discount rates change over time.

5. Presentational issues

Further illustration of this topic is shown on pages 85 to 88 of the attached appendix

Presentational issues

Current status of issue (1/2)

Issues

i. 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, etc. are managed separately and administered in different systems. Groups of contracts may frequently switch from an asset to liability position.

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

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

Presentational issues

Current status of issue (2/2)

CFO Forum solutions

i. Amend disclosure requirements to remove need for separate disclosure of groups in an asset and liability position.

ii. Measurement of liabilities based on premiums receivable and claims payable (rather than received/paid). Receivable / payable amount to be measured separately.

iii. Amend definition of non-distinct investment component so it is restricted to items like unit or account balances.

Changes proposed by the IASB

i. At the December 2018 meeting, the IASB proposed a portfolio rather than “group” basis for this requirement , meaning that portfolios of insurance contracts that are assets / liabilities will be presented separately. This change went some way to addressing the issue although operational challenges still remain.

ii. Discussed by the IASB in December 2018 – changes rejected

iii. Change not considered by the IASB

Presentational issues

Key points

- The IASB proposal to present these a portfolio rather than “group” basis for this requirement went some way to addressing the issue although operational challenges still remain.
- Accounting and reserving for insurance companies is generally based on due dates for transactions rather than cash settlement dates. Cash processes are typically operationally separate from other key systems. For general insurance business basing liabilities on premium received rather than receivable will have a major impact on the financial statement presentation.
- Many non distinct investment components are not calculated at contract inception and this calculation is required for accounting in future periods. Further the inclusion of certain items in the scope of non distinct investment components can skew certain standard insurance KPIs.

Presentational issues

Implications if issues remain unresolved

	Increase in operational complexity and cost	Financial reporting impact	Decrease in comparability amongst reporting entities
Presentational issues	X		

Operational impact

- The impact of recording premiums and claims on a cash, rather than an accruals basis may require significant investment in actuarial and finance systems to ensure that the results are correctly presented.
- In instances, insurers will need to calculate the value of non distinct investment components at inception introducing the need for significant system changes. Interpretation of what constitutes an investment component remains unclear.

Financial impact

- The removal of insurance receivables from the balance sheet reduces the value of information presented in respect of both life and general insurers.
- The inclusion of certain items within the scope of non distinct investment components will skew certain standard industry KPIs (e.g. profit and sliding scale commissions will impact loss and combined ratios for general insurers)
- Insurers will need to report adjusted combined ratios and loss ratios, which will not correspond with the reported IFRS income statement amounts.

6. Acquisition cash flows

Acquisition cash flows

Current status of issue

Issue

Acquisition cash flows on new business that is expected to renew cannot be allocated to future periods. This is inconsistent with other industries which capitalise acquisition costs over multiple contracts. This was particularly evidenced in the testing of P&C contracts.

CFO Forum solution

Allow allocation of acquisition cash flows to expected future renewals.

Changes proposed by the IASB

At the January 2019 meeting, the IASB agreed to amend IFRS 17 to require the allocation of part of the insurance acquisition cash flows on newly issued contracts to expected future renewals.

The change agreed by the IASB is expected to resolve the issue raised by EFRAG and the CFO Forum.

Acquisition cash flows

Key points

- The IASB's proposed amendment is expected to resolve the issue

ADDITIONAL ISSUES RAISED BY THE CFO FORUM

CFO FORUM

Not addressed by the IASB/ Addressed and changes rejected

7. Scope of the VFA model vs general model and PAA
8. Discount rates

Fully addressed by the IASB

9. Multi-component contracts

Partially addressed by the IASB

10. Scope of the hedging adjustment
11. Business combinations

7. Scope of the VFA model vs general model and PAA

Scope of the VFA model vs general model and PAA

Current status of issue

Issue

Testing indicated that financial results are very different depending on the measurement model applied, whilst there is a continuum in the nature of insurance products. Several elements in the VFA model that deal more appropriately with specific elements of insurance products are not available under the general model or premium allocation approach. These include the alignment of liability discount rates with (accounting for) asset returns and the transitional amount in OCI.

CFO Forum solution

Address issues with each model separately rather than amend their scope. By resolving other issues included in the presentation such as discount rate and CSM amortization results under different models will be more aligned.

Changes proposed by the IASB

The IASB discussed the definition of an insurance contract with direct participation features in December 2018 but declined to make any changes to IFRS 17.

Scope of the VFA model vs general model and PAA

Key points

- The measurement of insurance contracts differs between the VFA and general model, and the criteria for applying the VFA are very precise. In contrast, the range of insurance products on sale in Europe is a continuum from pure savings to pure protection, with no clear lines between different groups.
- As such, it is likely that two insurance contracts that are economically similar may fall into different measurement models, creating significant differences in the financial results reported.

Scope of the VFA model vs general model and PAA

Implications if issue remains unresolved

	Increase in operational complexity and cost	Financial reporting impact	Decrease in comparability amongst reporting entities
Scope of VFA vs General Model and PAA		X	

- The measurement of insurance contracts differs between the VFA and general model, and the criteria for applying the VFA are precise.
- Insurance contracts that are economically similar may fall into different measurement models, creating significant differences in the financial results reported.
- The difference in reported results between contracts lessens the value of IFRS 17 financial information and may require insurers to develop alternative non-GAAP measures for communicating with investors.

8. Discount rates

Discount rates

Current status of issue

Issue

i. Under the general model the impact of assumption updates is absorbed in the CSM at the locked in rate whereas the BEL is measured at the current rate. The different approaches will give rise to significant distortions to the current period results and shareholders' equity.

ii. In the situation where the BEL component of the insurance liability is an asset and the CSM component is a liability, inconsistencies arise due to the different discount rates for BEL (current rate) and CSM (locked-in rate).

iii. There was uncertainty regarding whether changes in asset mix will result in changes to the discount rate when the discount rate is determined top down using actual assets as a reference portfolio.

CFO Forum solution

Remeasure CSM at current discount rates where FVPL treatment is adopted. This would be consistent with measuring insurance contracts as a single bundle of rights and obligations. Note that part iii) above was addressed by the TRG in September 2018.

Changes proposed by the IASB

Discussed by the IASB in December 2018 – changes rejected

Discount rates

Key points

- The issue regarding whether changes in asset mix will result in changes to the discount rate when the discount rate is determined top down using actual assets as a reference portfolio was resolved by a TRG interpretation in September 2018
- For insurers not using the OCI option the use of a locked in discount rate for the CSM in the general model leads to the impact of assumption updates being absorbed in the CSM at that locked-in rate. The BEL is measured at the current rate. The difference between the locked-in and the current rate is reflected in the P&L and will significantly distort the current period result.
- For companies applying FVTPL, changes in non-financial assumptions relating to future service lead to a profit or loss being recognised in the investment result. This can be a material component of the overall non-financial assumption change due to the differential in interest rates over time.

Discount rates

Implications if issues remain unresolved

	Increase in operational complexity and cost	Financial reporting impact	Decrease in comparability amongst reporting entities
Discount rates	X	X	

Financial reporting impact

- For companies applying FVTPL, changes in non-financial assumptions relating to future service lead to a profit or loss being recognised in the investment result.
- Applying a current discount rate to the CSM (for accretion of interest and remeasurement) means that changes of non-financial assumptions relating to future service do not give rise to a profit or loss in the period (assuming there is a CSM).
- There would be no material impact on the timing or amount of the insurance service result, instead the timing of the investment result would change.
- Whatever investment strategy an insurer chooses for assets “backing” the CSM, the investment result will be volatile and difficult to rationalize likely needing the use of non GAAP measures.

Operational impact

- A considerable amount of data will need to be stored over the life of each contract.

9. Multi-component contracts

Multi component contracts

Current status of issue

Issue

Certain contracts exposing the issuer to credit risk that are in substance loans (for example equity release mortgages in the UK) contain a small insurance element which causes the entire contract to be subject to IFRS 17.

CFO Forum solution

Provide specific scope exclusions in IFRS 17.

Changes proposed by the IASB

In February 2019, the IASB proposed a change to permit entities to apply IFRS 9 in its entirety rather than IFRS 17 to contracts for which the only insurance risk is the settlement of some or all of the obligation created by the contract. This change satisfactorily resolves the issue.

Multi component contracts

Key points

- The change proposed by the IASB successfully resolves this issue.

10. Scope of the hedging adjustment

Further illustration of this topic can be found on pages 89 to 95 of the attached appendix

Scope of the hedging adjustment

Current status of issue (1/2)

Issue

Whilst IFRS 17 includes a specific hedging adjustment, its use is limited to specific circumstances:

i. It is only available for contracts in scope of the VFA.

ii. It cannot be applied retrospectively on the date of initial application.

iii. It can only be used when derivatives are used as a hedging instrument.

This was highlighted as part of the testing for a material book of business with guarantees that are hedged.

CFO Forum solution

i. Extend scope of eligibility for hedging to general measurement model.

ii. Enable retrospective hedging adjustment as part of transition.

iii. Scope extension for VFA risk mitigation extended to financial instruments and reinsurance held in addition to derivatives.

Scope of the hedging adjustment

Current status of issue (2/2)

Changes proposed by the IASB

i. Discussed by the IASB in December 2018 – changes rejected

ii. Discussed by the IASB in March 2019 and partly addressed

iii. Discussed by the IASB in January 2019 and partly addressed – reinsurance of financial risk added to scope of risk mitigation; other financial instruments not.

The IASB staff, in their March papers, have recommended two limited amendments to the hedge adjustment option which are

a. to permit the option to be applied prospectively from the transition date (i.e. one year earlier) providing appropriate designation of the risk mitigation is in place, and

b. to permit an entity that can apply IFRS 17 retrospectively under the VFA to alternatively use the fair value transition approach if they apply the risk mitigation prospectively and have hedged retrospectively, even if they are able to use a fully retrospective approach."

Scope of the hedging adjustment

Key points

- Not being able to apply the hedging adjustment to non VFA contracts results in a number of financial reporting issues, which give rise to accounting mismatches.
- The inability to apply the hedging adjustment retrospectively for VFA business on the date of initial application could lead to significant impacts on the measurement of the CSM on transition and distort future results.
- The ability to only use derivatives and reinsurance as hedging instruments results in accounting challenges and by creating a disincentive to economically hedge with non-derivative instruments, potentially leads to suboptimal (less effective, more costly) hedging solutions.

Scope of the hedging adjustment

Implications if issues remain unresolved (1/2)

	Increase in operational complexity and cost	Financial reporting impact	Decrease in comparability amongst reporting entities
Scope of hedging		X	X

It is only available for contracts in scope of the VFA:

- Additional income statement volatility will arise from hedging, both reducing the incentive to mitigate risk and requiring significant effort to analyse results.
- This could potentially negatively impact willingness and ability of companies to offer certain product types to consumers, particularly “indirect par” contracts.

It cannot be applied retrospectively on the date of initial application:

- The inability to apply the hedging adjustment retrospectively fully may lead to significant impacts on the CSM at Transition and distort future results. Our companies’ testing results shows that for representative portfolios with such significant hedging programmes there could be material distortions to CSM, impacting shareholder equity and subsequent results.

Scope of the hedging adjustment

Implications if issues remain unresolved (2/2)

It can only be used when derivatives are used as a hedging instrument

- If non-derivatives are used for economic hedging, an accounting mismatch is created as the effect of the change in the embedded derivatives of the insurance liabilities is recognised in the CSM (under the VFA) but the effects of the hedging instruments are reported in the income statement or OCI.
- This creates a disincentive to economically hedge with non-derivative instruments, potentially leading to suboptimal (less effective, more costly) hedging solutions.

11. Business combinations

Further illustration of this topic can be found on pages 96 to 99 of the attached appendix

Business combinations

Current status of issue

Issue

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

i. The requirement to assess classification at the acquisition date instead of the original inception date.

ii. The treatment of claims in payment at the acquisition date.

CFO Forum solution

i. Allow classification to be assessed at contract inception date.

ii. Allowed incurred claims at acquisition to be included in the liability for incurred claims.

Changes proposed by the IASB

i. Discussed by the IASB in December 2018 – changes rejected

ii. This issue was discussed by the IASB in December 2018 and it was agreed that no change should be made. However, in February 2019, the IASB approved a change to the modified retrospective approach to transition that will require claims incurred before an acquisition that is made pre-transition to be included in the liability for incurred claims.

Business combinations

Key points

- The requirement to assess classification at the acquisition date instead of the original inception date means that there may be significantly different accounting treatments for the same contracts between the financial statements of the group and acquired subsidiary.
- The treatment of claims in payment at the acquisition date means that including loss reserves in the liability for remaining coverage after the acquisition date is likely to result in a number of financial and operational challenges.

Business combinations

Implications if issues remain unresolved

	Increase in operational complexity and cost	Financial reporting impact	Decrease in comparability amongst reporting entities
Business combinations	X		X

- Having different accounting treatments in the financial statements of the group and acquired subsidiary would add significant unnecessary complexity and costs.
- Including loss reserves in the liability for remaining coverage after the acquisition date is likely to reduce transparency and impair comparability with other portfolios and peers. Insurance revenue would be generated on claims that have already been incurred, when there is no further insurance service provided to the policyholders. As a result, insurers may be forced to introduce non-GAAP measures for capital market communication following an acquisition.
- In the case of a large takeover, it may be necessary to assess the classification of several million acquired contracts.
- A CSM and Insurance Revenue would need to be calculated for loss reserves, which is not possible in current systems and processes.

Appendix – Further illustration of issues

The following section includes examples which seek to further highlight the points set out in the preceding section.

1. Transition

Transition

The following slide provides a numerical example to illustrate the impact of the option to set the cumulative OCI on insurance liabilities to nil at transition.

Transition

Numerical example to illustrate impact of option to set cumulative OCI on insurance liabilities to nil at transition

Scenario:

- Indirect participating insurance contract under the general model
- A fixed income portfolio backing liabilities with a book yield of 5% (cumulative OCI on assets = 107)
- IFRS 17 current discount rate at transition date of 2.5 %
- Policyholders’ participation rate of 80%
- Expected cash outflows of 100 per year over 10 years

Impact at transition applying the simplification currently offered by IFRS 17

- Cumulative OCI on the asset side (107) results from the difference between the market value of liabilities at 2.5% current rate (918) and the amortised cost of the asset applying the 5.0% discount rate at inception (811=100+100/(1.05^1)+… +100/(1,05^9))
- Cumulative OCI on liability is set to 0 at transition.
- Net cumulative OCI on transition amounts to 107-0=107

2. Level of aggregation

Level of aggregation

The following slides provide three differing examples to illustrate the issues that are caused by the current drafting of the standard on aggregation.

Level of aggregation

Numerical example 1 to illustrate impact

	Contract	Premium collected	Investment	Underlying Asset at year end	Investment Return	Investment Return recognized to the customer		Company Profits	
	Signed 5 insurance contracts (A)	10.000	BUY Italian GOV Bond	10.000	1,30%				
2015				10.000	1,30%	120	1,20%	10	0,10%
	Signed 1 insurance contract (B)	1.000	BUY German GOV Bond	1.000	0,60%				
2016				11.000	1,24%	125	1,14%	11	0,10%

- Policyholder B receives, at the end of the first year, a yield of 1.14% at the end of 2016 (0.60% as the yield on German Bunds in which policyholder B's premiums are invested and 0.54% as a portion of the yield on Italian bonds in which the premiums of policyholders A are invested)
- Policyholder A gets 1.20% at the end of 2015 and 1.14% at the end of 2016, and in mutuality sustains the yield accruing to Policyholder B at the end of 2016

> - the **joint management of all the contracts belonging to the same Segregated Fund** is functional as well as formal, and the liabilities must be valued using the same rate of return
> - the **Segregated Fund should be considered in its entirety,** with no division into sub-groups of policies. This is the way the business is run and the only way the balance sheet can correctly represent the terms of the insurance contracts subscribed.

Assumptions

- 1% guaranteed minimum insurance product, placed for a period of two years as part of the *Segregated Funds* XYZ
- Charges to the policyholder of 0.1% annually
- the investment portfolio is fully matched with liabilities
- subscription of 5 new policies the first year and 1 policy the second
- the asset mix is such that even though some securities yield below the guaranteed minimum, the company is not forced to supplement the assets
- there are no claims paid in the period.

Numerical example 2 to illustrate impact (1/2)

To illustrate the concern, we have modelled deviations from the expected claims in a portfolio of annuities and we have compared how the related changes in the future cash flows in the liability for remaining coverage impact in cohorts with different number of policies.

Example details

Portfolio specifications:

- ✓ Life annuity product
- ✓ Accrual period: deferred/immediate income
- ✓ Premium payment: regular/single premiums
- ✓ Capital event of death: return of premiums/fixed capital

technical provisions
- ✓ 4.960 MM (EUR)

Issuing dates
- ✓ 1985 – 2017

Assumptions:
- ✓ Cash-Flow Matching has been applied to assets and liabilities
- ✓ The locked-in rate of the liabilities equals the buy rate of the underlying assets
- ✓ Investments income equals the locked-in rate at issue date
- ✓ Portfolios of assets underlying the technical provisions are given by Spanish public debt
- ✓ Coverage units equal the present value of the future technical provisions
- ✓ No change for projection assumptions

Portfolio financial statements

Balance 2017 IFRS 17 Actual			
Assets		**Liabilities**	
4,958.67	Assets	BE	4,404.94
		RA	7.49
		CSM	546.23
		Equity	
		Reserve 1ª	-
		OCI Liabilities -	805.49
		OCI Assets	805.49
		P&L	-

BE	169.53
RA	0.29
CSM	49.87
Insurance revenue	**219.69**
Payment of Claims	**166.88**
Insurance service result	**52.80**
Interest expense BE	147.41
Interest expense RA	0.25
Interest expense CSM	21.88
Interest expense- Liabilities	**169.54**
Interest income- Assets	**169.77**
Financial result	**0.22**
Total Result	**53.03**

It can be observed that the results obtained for the portfolio are consistent with the expected ones. In others words, the technical result is similar to the release of the CSM plus the Risk Adjustment. Because the volume of contracts is big enough, there is no significant change on the future service

Cohorts Analysis

In order to analyze the impact that deviations from expected claims have in cohorts with different number of contracts, we compare the results obtained for two selected cohorts of the portfolio: cohort A (with only 6 contracts) and cohort B (with 20,200 contracts included). We can see the results of the analysis in the next slide

Portfolio

Cohort A

Cohort B

Level of aggregation

Numerical example 2 to illustrate impact (2/2)

1) Cohort A: 6 contracts

Balance 2017 IFRS 17			
Assets		**Liabilities**	
111,091	Assets	BE	109,808
		RA	186
		CSM	1,096
		Equity	
		Reserve 1ª	-
		OCI Liabilities	18,127
		OCI Assets	18,127
		P&L	-

Balance 2018 IFRS 17			
Assets		**Liabilities**	
109,589	Assets	BE	108,548
		RA	183
		CSM	-
		Equity	
		Reserve 1ª	-
		OCI Liabilities	18,301
		OCI Assets	18,301
		P&L	856

2) Cohort B: 20,200 contracts

Balance 2017 IFRS 17			
Assets		**Liabilities**	
190,440,466	Assets	BE	170,492,245
		RA	289,836
		CSM	19,658,383
		Equity	
		Reserve 1ª	-
		OCI Liabilities	35,366,835
		OCI Assets	35,366,835
		P&L	-

Balance 2017 IFRS 17			
Assets		**Liabilities**	
198,122,485	Assets	BE	176,905,432
		RA	300,739
		CSM	19,310,529
		Equity	
		Reserve 1ª	-
		OCI Liabilities	32,670,359
		OCI Assets	32,670,359
		P&L	1,605,783

As we can see in the charts above, with a greater number of contracts per cohort, the CSM has a more powerful capacity of absorption of adjustment and the results obtained would modify the CSM but not significantly

It can be observed that, due to the low number of contracts, the results are very sensitive to the adjustments, a fact that should not occur usually for a portfolio with a greater number of policies. In this case, because there are only 6 policies within the group of contracts, the CSM is adjusted as a consequence of the increase in the BE, compared to the expected one. This is due to changes on the future service, which could not be absorbed and has generated a loss component. However, it could have been possible in a portfolio with a greater number of policies.

In each of the future periods, as the volume of contracts is low and the size of the technical provisions heterogeneous, it will lead to an adjustment of the future service of a big amount, obtaining a result for the unit of account which is not aligned to the expected result (ICS RA + CSM).

Level of aggregation

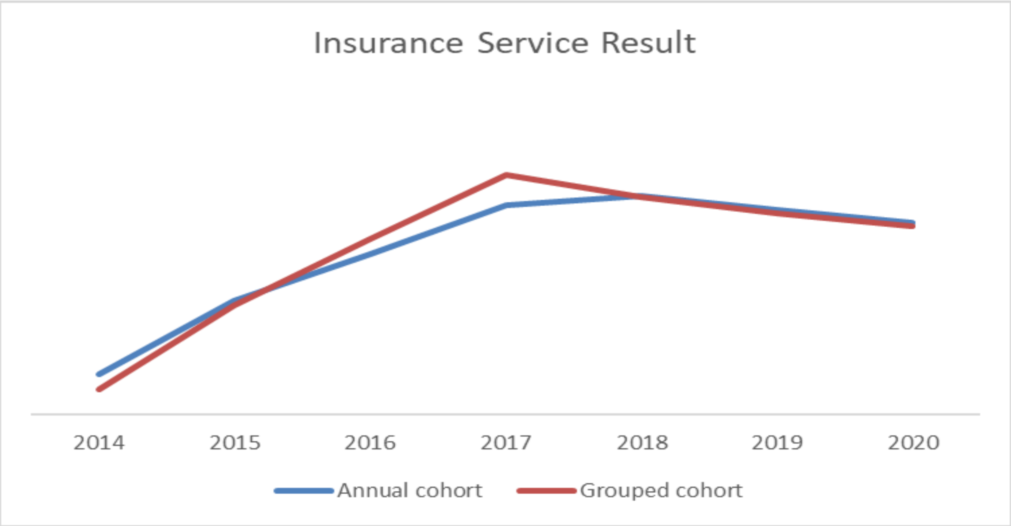
Numerical example 3 to illustrate impact

Case study findings – unit linked business

The following analysis for a portfolio of unit linked business with protection riders written over the period 2014-2017 demonstrates that a materially similar financial outcome can be achieved with or without the annual cohort restriction.

The following chart compares the insurance service result under the following two levels of aggregation scenarios:

- Separate annual cohorts
- Annual cohorts grouped together



The CSM has been determined on an fully retrospective basis with an assumed transition date of 31 December 2017 and has been amortised in line with coverage units based on the sum assured of the base unit linked policy as a proxy for the services provided under the contracts. Profitability of the business written over the 4 year period varied in line with changes in the mix of business and changes in financial and non-financial assumptions.

The insurance service result (CSM amortisation) increases over 2014-2017 as new business is written and then reduces in subsequent years as the business runs off (no new business is assumed post 2017).

3. Reinsurance

Reinsurance

The following slides provide further detail on

1) The issues caused by being unable to apply the VFA model to reinsurance

2) A numercial example of the impact on reinsurance values when:

- Future new underlying business is included in the reinsurance contract boundary.
- The CSM under the general model has not been adjusted for changes in financial assumptions.

Reinsurance

Expected impact of Reinsurance not being measured using the VFA model

- The requirement to measure insurance contracts with direct participation features using the VFA, while associated reinsurance treaties are measured under the general model, will produce accounting mismatches:
  - Changes in financial assumptions adjust the CSM for underlying VFA insurance contracts, while the impact of the same assumption changes on reinsurance are recorded in either the income statement or OCI. This mismatch can be significant, particularly for contracts that are heavily influenced by discount rates and other financial assumptions, such as annuities.
- Differences in measurement between reinsurance and underlying insurance contracts reduce transparency in financial reporting under IFRS 17.
- In the case of coinsurance on VFA contracts, the insurer reinsures a percentage of the direct contracts on the same terms as it receives, meaning the reinsurer shares in assets underlying the direct contracts
  - Although the economic terms of the insurance and reinsurance contracts are similar, only the insurance contract is eligible for the VFA.
- The scale of reinsurance on underlying VFA contracts is significant within Europe. For example, the value of reinsured liabilities on savings and retirement contracts in France in 2017 was EUR 63.6bn[1].

[1]Data source: Fédération Française de l'Assurance

Reinsurance

Numerical example to illustrate impact of reinsurance issues (1/2)

This example illustrates the impact of:

- The inclusion of future new underlying business in the reinsurance contract boundary
- The CSM under the general model not being adjusted for changes in financial assumptions

Scenario:

Two blocks of underlying endowment contracts are written:

- The first block has a premium of 100 at T0 and pays 105 at T1
- The second block has a premium of 100 at T2 and pays 105 at T3
- A single reinsurance treaty provides 100% cover for both blocks of endowment contracts and runs from T0 to T3
- The discount rate at T0 is 10%
- All premiums and claims occur as expected
- The discount rate decreases to 7% at T1

Reinsurance

Numerical example to illustrate impact of reinsurance issues (2/2)

Gross position	0	1	2	3
Balance sheet				
Cash	100.0	-5.0	95.0	-10.0
Assets	**100.0**	**-5.0**	**95.0**	**-10.0**
Cash flows	-95.5	0.0	-98.1	0.0
CSM	-4.5	0.0	-1.9	0.0
Ins Liab	**-100.0**	**0.0**	**-100.0**	**0.0**
Total	**0.0**	**-5.0**	**-5.0**	**-10.0**
Income statement				
Insurance service result		**5.0**		**2.0**
Investment result		**-10.0**		**-7.0**

At T0, the reinsurance contract includes the CSM from the first (4.5) and second (3.8) blocks of underlying endowments.

Reinsured position	0	1	2	3
Balance sheet				
Cash	-100.0	5.0	-95.0	10.0
Assets	**-100.0**	**5.0**	**-95.0**	**10.0**
FCF	91.7	-1.7	98.1	0.0
CSM	8.3	4.1	4.5	0.0
Reinsurance asset	**100.0**	**2.4**	**102.7**	**0.0**
Total	**0.0**	**7.4**	**7.7**	**10.0**
Income statement				
Insurance service result		**-5.0**		**-5.0**
Investment result		**12.4**	**0.3**	**7.3**

When the discount rate changes at T1, 10 is recognised for the impact on the first block, which offsets the impact on the underlying contracts. An additional 2.4 is recognised in profit or loss in respect of the change in discounting on the expected future new business. As future new business is outside the boundary of the gross cash flows, there is a net effect of 2.4.

Net position	0	1	2	3
Balance sheet				
Cash	0.0	0.0	0.0	0.0
Assets	**0.0**	**0.0**	**0.0**	**0.0**
FCF	-3.8	-1.7	0.0	0.0
CSM	3.8	4.1	2.7	0.0
Ins Liab	**0.0**	**2.4**	**2.7**	**0.0**
Total	**0.0**	**2.4**	**2.7**	**0.0**
Income statement				
Insurance service result		**0.0**	**0.0**	**-3.0**
Investment result		**2.4**	**0.3**	**0.3**

(3.0) net result at T3 due to:

- 2.0 from gross (CSM determined using discount rate of 7% when 2nd block recognised) less;
- (5.0) from reinsurance (CSM determined using discount rate of 10% when reinsurance initially recognised)

4. CSM amortisation

CSM Amortisation

The following slides provide examples of areas where CSM Amortisation produces differing results between products. The two examples cover:

1) the profit profile for an annuity, spreading CSM based on annuity outgo;
2) the scale of the components of the CSM for an annuity contract to demonstrate the significance of the investment service element;
3) examples of product features which lead to investment component elements; and
4) a demonstration that the profit profile is significantly impacted by the structuring of the cash flows.

CSM amortisation

Numerical example to illustrate impact (1/2)

In the **Agenda Paper 2E** of the Technical Staff from January 2019, it was explained that an entity should **consider investment return services for the determination of coverage units** only when an insurance contract includes an investment component.

However, examples of **contracts <u>without investment components</u> include deferred annuities** with at least one of the following features:

(i) no surrender value in the accumulation phase;

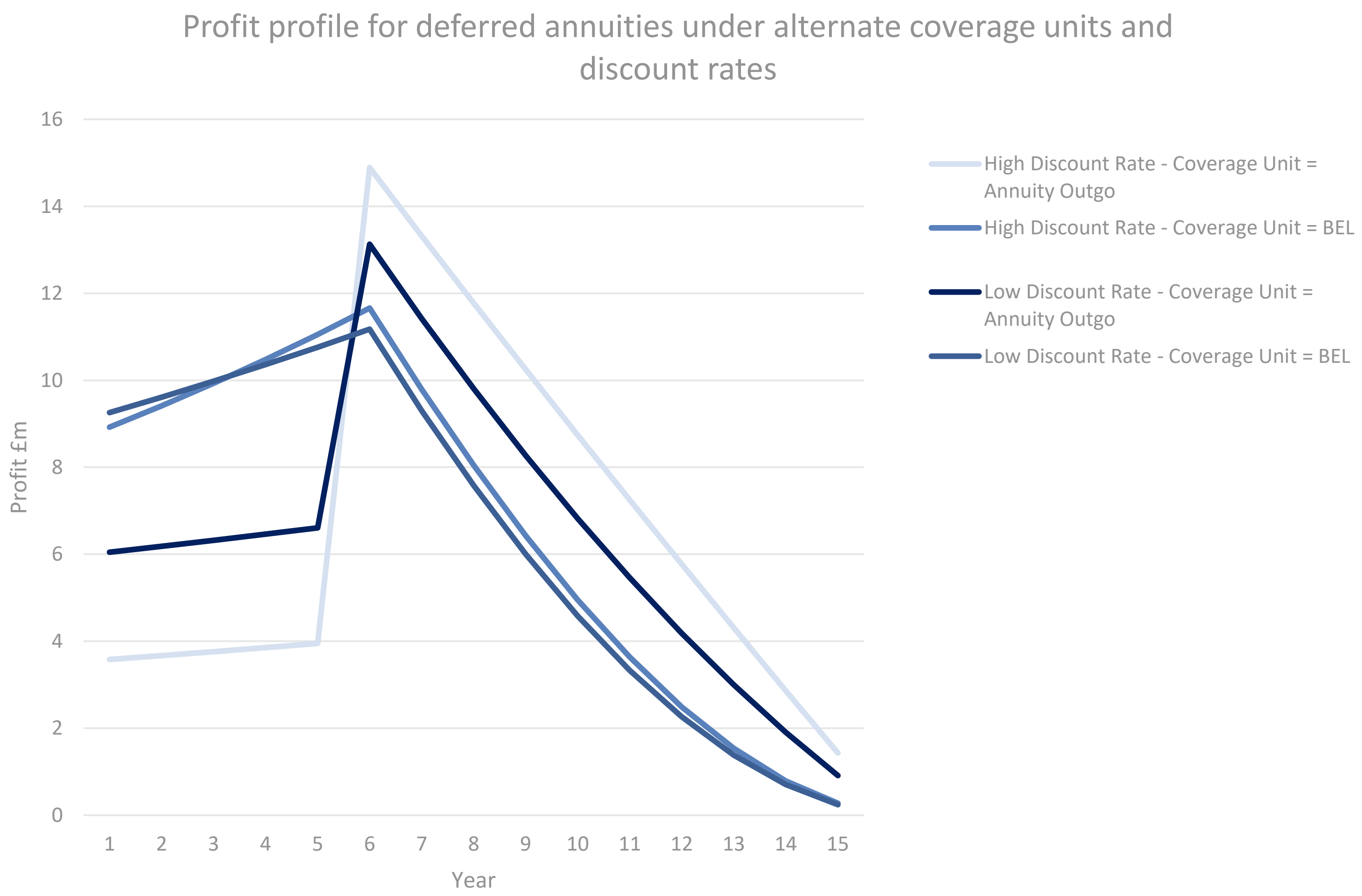
(ii) no payment on death in the accumulation phase; or

(iii) no guaranteed payments in the annuity phase.

Parameters	
Premium	1000
Benefit	200
Non IM Expenses	15
Interest Rate (Flat)	3.00%
Discount Rate (Flat) - High	2.50%
Discount Rate (Flat) - Low	2.25%
IM as % of BEL	0.15%

CSM amortisation

Numerical example to illustrate impact (2/2)



CSM amortisation

Approximate components of the CSM for a cohort of annuity contracts

Contractual Service Margin (£28m)	Economic profit margin (£23m) (A)	Profit for Insurance Services in excess of the Risk Adjustment	Profit within premium charged for risk accepted in excess of the risk adjustment
		A portion of the liquidity premium	Liquidity premium expected on the assets in excess of the amount included in the pricing (Assumes illiquid liabilities such as annuities)
		Profit for non-insurance activities	Profits incorporated in the pricing methodology to cover non-insurance activities provided over the contract life – for annuities principally in-house investment management
	CSM to cover costs excluded from FCF (£5m) (B)	CSM to cover costs not in BEL but in pricing of insurance premiums	CSM relating to costs which are expected but are excluded from the BEL (including investment management costs) and general operational risks excluded from risk adj.

The contractual service margin represents the economic profit of the contract expected at outset (A), augmented for the present value of any expected costs which are excluded from the future cash flows (B). The economic profit margin at inception of a contract can be considered as incorporating elements relating to insurance services (to the extent priced over the risk adjustment), the earning of the liquidity premium relating to the contract which matches against the investment return on the backing assets, and any priced in profit for non-insurance activities.

CSM amortisation

Existence of investment component depends on product features

Product features	Deferred phase	Payment phase	Investment component
Transfer value (expected value of future benefits)	100	Nil	No
Death benefit	Nil	Nil	
Guarantee	Nil	Nil	

Transfer value	100		No
Death benefit	Nil		
Guarantee	Nil	50 (5yrs at 10p.a.)	

Transfer value	100	Nil	Yes Investment component is 10 – lower of death benefit and guarantee
Death benefit	10	Nil	
Guarantee	Nil	50 (5yrs at 10.p.a.)	

Economic Similarity

- Deaths in guarantee period relatively low in practice
- Existence of a guarantee does not significantly impact expected value of future benefits (5 year guarantee increases expected present value of future benefits by c. 0 to 1% ; 10 year guarantee by c. 0 to 5%)
- Where the existence of an investment component does not significantly impact pattern of benefits then CSM recognition should be based on expected value of the benefits with no requirement to split between insurance and investment components.

CSM amortisation

Demonstration of different profit profile for identical economics

	Contract construction with identical economics	Profit pattern
1	**A single contract:** A guaranteed annuity – a monthly level payments until death, guaranteed to pay for first 5 years irrespective of death	IFRS 17 – profit in short guarantee period reflects investment service (distinct or non-distinct component), remaining profit following insurance service
2	**Separation into two insurance contracts:** Monthly level payments until death with no guarantee **PLUS** reducing life insurance which pays a monthly level amount until five year anniversary of purchase.	Both contracts under IFRS 17 – profit reflects two separate insurance services and no investment service at all
3	**Separation into an insurance contract and an investment contract:** A guaranteed level payment until expected date of death (at outset) **PLUS** a longevity swap to pay out if survival is longer than expected or to receive payments if survival is not as long as originally expected.	Investment service reflected for whole expected duration under IFRS 9 (significant component) with longevity swap CSM earned under IFRS 17 reflecting insurance service

Identical risks and cash flows result in different profit recognition depending on structuring and applicable standard. A principle based approach proposed by the CFO Forum would allow consistency in all three cases.

5. Presentational issues

Presentational issues

The following slide provides an example to illustrate the impact of reporting premiums and claims on a cash basis.

Presentational issues

Numerical example to illustrate impact of reporting premiums and claims on a cash basis (1/2)

Scenario:

- A motor insurance policy is issued on 20 December, with a premium of 100 due.
- On 30 December, the policyholder makes a claim for 100 following an accident. The premium has not been paid by this date.
- On 31 December, the policyholder has still not paid the premium but this does not invalidate the insurance cover under local law.

Balance sheet at 31 December under local GAAP and IFRS 4:

Assets		Liabilities	
Insurance receivables	100	Insurance liability	100
Total	100	Total	100

- The premium due from the policyholder is recorded as a receivable on the asset side of the balance sheet.
- The claim is shown as an insurance liability.

Presentational issues

Numerical example to illustrate impact of reporting premiums and claims on a cash basis (2/2)

Balance sheet at 31 December under IFRS 17:

Assets		Liabilities	
Insurance receivables	0	Insurance liability	0
Total	0	Total	0

- Assuming the expected cash outflow for the claim is 100, the IFRS 17 insurance liability will be 0, as the claim payment of 100 is offset by the premium receivable of 100 in fulfilment cash flows.
- There is no asset on the balance sheet because the premium receivable is now included as part of the fulfilment cash flows under IFRS 17.

10. Scope of the hedging adjustment

Scope of the hedging adjustment

The following slide provides further illustration of the issues arising with regards to the scope of the hedging adjustment and an example of the impact of the use of non-derivative instruments for VFA products.

Scope of the hedging adjustment – Key messages

- IFRS 17 provides challenges in the context of risk mitigation and the related accounting mismatches. Insurers (under IFRS 4) have, through the use of accounting treatments (e.g. shadow accounting, account for impact of guarantees at FVPL), addressed the accounting mismatch and risk mitigation aspects. These possibilities are not available under IFRS 17.
- It is important to note that IFRS 17 introduces accounting mismatches by virtue of introducing the Variable Fee Approach and the OCI option for insurance liabilities. IFRS 17 does not contain workable solutions for those accounting mismatches, for example if financial risk is mitigated by using other investments, nor if financial risk is mitigated for insurance contracts that are to be accounted for under the general measurement model. Any solution outside of IFRS 17 would be an artificial 'work around', requiring substantial investment and could call for an 'overhaul' of current hedging programs.
- Hedging issues under IFRS 17 are inherently complex because they involve the interaction of multiple accounting standards that include optionality.
- Although EFRAG's field testing appeared to indicate only limited industry concerns about hedging, hedging issues are becoming a greater industry concern as companies better understand how IFRS 17 impacts their financial statements.
- CFO Forum analysis to date indicates that the interaction of hedging with IFRS 17 could create undesirable incentives, produce significant P&L volatility, mislead users, and encourage non-GAAP measures.
- In contrast, Solvency II encourages a broader use of risk mitigation for regulatory capital reporting purposes through reduction in capital requirements.

Scope of hedging adjustment – Issues caused by risk mitigation solution not being available for products outside those eligible for the VFA

- Insurance products create an exposure to financial risks such as interest rate risk or equity risk, with some or all of these risks being economically hedged through derivatives, including:
  - Insurance products with fixed cash flows. These products are exposed to linear financial risks;
  - Insurance products with profit sharing features and minimum return guarantees are exposed to non-linear financial risks (in addition to any exposure to linear risks from fixed cash flows).
- For products accounted for under the IFRS 17 General Model, using the ‘Through OCI’ option for changes in interest rates will result in PL volatility caused by an accounting mismatch:
  - The effect of the derivatives used for economic hedging will be recognized in PL;
  - The entire effect of interest rate changes will be recognized in OCI.
- The option to use the ‘Through PL’ approach for the liabilities, together with using the fair value option for the financial assets, would eliminate this accounting mismatch. However, the PL could still show volatility from economic mismatches that otherwise could have been reported in OCI:
  - Based on the ALM objectives, financial risks may not be hedged in full (e.g. hedging based on a targeted duration gap or only hedging a minimum return guarantee);
  - Spread changes are not necessarily reflected equally in the liability measurement.

Scope of the hedging adjustment Issues caused by only derivatives being applicable as risk mitigating items

- Under the IFRS 17 risk mitigation approach for VFA products, risk mitigation can be applied only if derivatives are used as risk mitigating instruments.
- Minimum return guarantees (i.e. non-linear risks) can be hedged using both derivative and non-derivative instruments. Insurers currently use both strategies.
- If non-derivatives are used for economic hedging, an accounting mismatch is created as the effect of the change in the embedded derivatives of the insurance liabilities is recognized in the CSM (under the VFA) but the effects of the hedging instruments are reported in PL or OCI.
- IFRS 17 creates a disincentive to economically hedge with non-derivative instruments, potentially leading to suboptimal (less effective, more costly) hedging solutions.

Scope of the hedging adjustment

Case study – Use of non-derivative instruments for VFA products

Example

- For Variable Annuity business, most insurers will partly hedge interest rate risk with derivatives and partly with non-derivatives.
- In the example provided, approximately 2/3 of the interest rate risk is hedged with **derivative instruments** including Treasury futures and interest rate swaps. This part is eligible for VFA risk mitigation.
- The other 1/3 of the interest rate risk is managed with a **non-derivative program**, using 30-year Treasury bonds, for a variety of reasons – cost, diversification, liquidity constraints, and more.
  - This program meets the criteria that "an economic offset exists between the insurance contracts and the hedging instruments".
  - The non-derivatives are classified as FVTPL, and are not eligible for risk mitigation.
- This results in an **accounting mismatch in PL**, corresponding to the effect of the fair value changes of the portfolio Treasury bonds: fair value changes in PL, but changes in the interest rate risk are recognised in CSM.

Scope of the hedging adjustment – Issues caused by no retrospective application of risk mitigation

- Many insurers have applied its economic hedging program for several years to hedge certain financial risks.
- Under the (modified) retrospective approach of IFRS 17, the risk mitigation approach does not allow retrospective application when calculating the transitional CSM under the VFA.
- Not being able to apply risk mitigation under the (modified) retrospective approach would affect the transition CSM in a way that is inconsistent with the economics of the business. For example, IFRS 17 would effectively disregard historic practices of hedging the economic risk of guarantees. The "in-the-moneyness" of guarantees would impact the transition CSM even though historic hedging practices would have been intended to mitigate the impacts of "in-the-moneyness" on profitability.

11. Business combinations

Business combinations

The following slide provides an example of the impact of the current requirement to assess the classification of insurance contracts at the date of the acquisition of the business as opposed to the original inception date of the underlying contract.

Business combinations

Example to illustrate impact of requirement to assess classification at the acquisition date instead of the original inception date

- The acquisition of a book of annuities in payment may include contracts where the policyholder is deceased but payments continue until the end of a guaranteed period.
- An assessment at the date of acquisition would result in such contracts being out of scope of IFRS 17 and valued as financial instruments under IFRS 9.
  - Systems are unlikely to be able to value some annuity contracts under IFRS 17 and others under IFRS 9, requiring a significant system change.
  - The acquisition could include a contract by contract assessment of millions of contracts to identify those no longer in scope of IFRS 17.
- If an entity were acquired, these contracts would remain in scope of IFRS 17 within the acquired entity, resulting in different accounting treatment between the entity and the group.
- During 2018 there was at least one major transaction whereby a group acquired an insurance entity. If this transaction had been carried out after transition to IFRS 17, the group would have needed to re-examine the classification of c 2m policies, with liabilities of c £50bn.
  - These contracts would potentially need to have been reclassified at the group level on a contract by contract basis whilst maintaining their existing classification at entity level.
  - New accounting processes would have needed to be put in place for those contracts which as a consequence were deemed to be investment.

Any questions?