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Chairman

PDC N° 23/19

Paris, May 6th, 2019

Mr Jean-Paul GAUZES
Chairman EFRAG Board
35 Square de Meeùs
B-1000 BRUXELLES

Dear Jean-Paul,

Following our previous communications concerning IFRS 17 and based on the feedback received to date, we are happy to share with you an amended draft version of our documents commenting on the following topics (in no particular order of priority): Acquisition cash-flows, Balance-sheet presentation, CSM allocation related to investment services, Level of aggregation, Reinsurance and Transition.

These documents have been sent to the IASB.

Please do not hesitate to contact us should you want to discuss any aspect of them.

Yours sincerely, Bien amicalement.

Patrick de Cambourg

Patrick de CAMBOURG

IFRS 17 issues – Acquisition cash flows

Amended draft for discussion

1 Current IASB requirements and TRG discussions

1.1 IFRS 17

1 IFRS 17.26: […] An entity is required to determine whether any contracts form a group of onerous contracts applying paragraph 16 before the earlier of the dates set out in paragraphs 25(a) and 25(b) if facts and circumstances indicate there is such a group.

2 IFRS 17.27: An entity shall recognise an asset or liability for any insurance acquisition cash flows relating to a group of issued insurance contracts that the entity pays or receives before the group is recognised, unless it chooses to recognise them as expenses or income applying paragraph 59(a). An entity shall derecognise the asset or liability resulting from such insurance acquisition cash flows when the group of insurance contracts to which the cash flows are allocated is recognised (see paragraph 38(b)).

3 IFRS 17.35: An entity shall not recognise as a liability or as an asset any amounts relating to expected premiums or expected claims outside the boundary of the insurance contract. Such amounts relate to future insurance contracts.

4 IFRS 17.59: In applying the premium allocation approach, an entity:

(a) may choose to recognise any insurance acquisition cash flows as expenses when it incurs those costs, provided that the coverage period of each contract in the group at initial recognition is no more than one year.

(b) shall measure the liability for incurred claims for the group of insurance contracts at the fulfilment cash flows relating to incurred claims, applying paragraphs 33–37 and B36–B92. However, the entity is not required to adjust future cash flows for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received in one year or less from the date the claims are incurred.

5 IFRS 17.109: For insurance contracts other than those to which the premium allocation approach described in paragraphs 53–59 or 69–70 has been applied, an entity shall disclose an explanation of when it expects to recognise the contractual service margin remaining at the end of the reporting period in profit or loss, either quantitatively, in appropriate time bands, or by providing qualitative information. Such information shall be provided separately for insurance contracts issued and reinsurance contracts held.

6 Appendix A: Insurance acquisition cash flows: Cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.

7 IFRS17.B65: Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash

flows for which the entity has discretion over the amount or timing. The cash flows within the boundary include:

(a) premiums (including premium adjustments and instalment premiums) from a policyholder and any additional cash flows that result from those premiums.

(b) payments to (or on behalf of) a policyholder, including claims that have already been reported but have not yet been paid (ie reported claims), incurred claims for events that have occurred but for which claims have not been reported and all future claims for which the entity has a substantive obligation (see paragraph 34).

(c) payments to (or on behalf of) a policyholder that vary depending on returns on underlying items.

(d) payments to (or on behalf of) a policyholder resulting from derivatives, for example, options and guarantees embedded in the contract, to the extent that those options and guarantees are not separated from the insurance contract (see paragraph 11(a)).

(e) an allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.

(f) claim handling costs (ie the costs the entity will incur in investigating, processing and resolving claims under existing insurance contracts, including legal and loss-adjusters' fees and internal costs of investigating claims and processing claim payments).The cash flows within the boundary include an allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.

(g) costs the entity will incur in providing contractual benefits paid in kind.

(h) policy administration and maintenance costs, such as costs of premium billing and handling policy changes (for example, conversions and reinstatements). Such costs also include recurring commissions that are expected to be paid to intermediaries if a particular policyholder continues to pay the premiums within the boundary of the insurance contract.

(i) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or that can be attributed to them on a reasonable and consistent basis.

(j) payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder, and related receipts.

(k) potential cash inflows from recoveries (such as salvage and subrogation) on future claims covered by existing insurance contracts and, to the extent that they do not qualify for recognition as separate assets, potential cash inflows from recoveries on past claims.

(l) an allocation of fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent, and maintenance and utilities) directly attributable to fulfilling insurance contracts. Such overheads are allocated to groups of contracts using methods that are systematic and rational, and are consistently applied to all costs that have similar characteristics.

(m) any other costs specifically chargeable to the policyholder under the terms of the contract.

8	IFRS 17.B125:	An entity shall determine insurance revenue related to insurance acquisition cash flows by allocating the portion of the premiums that relate to recovering those cash flows to each reporting period in a systematic way on the basis of the passage of time. An entity shall recognise the same amount as insurance service expenses.
9	IFRS 17.BC 176:	The measurement approach required in IFRS 17 represents a change from many previous accounting models that measure insurance contract liabilities initially at the amount of the premiums received, with deferral of insurance acquisition cash flows. Such models treat insurance acquisition cash flows as a representation of the cost of a recognisable asset, which, depending on the model, might be described as a contract asset or a customer relationship intangible asset. The Board concluded that such an asset either does not exist, if the entity recovers insurance acquisition cash flows from premiums already received, or relates to future cash flows that are included in the measurement of the contract. The Board noted that an entity typically charges the policyholder a price the entity regards as sufficient to compensate it for undertaking the obligation to pay for insured losses and for the cost of originating the contracts. Thus, a faithful representation of the remaining obligation to pay for insured losses should not include the part of the premium intended to compensate for the cost of originating the contracts.
10	IFRS 15.101:	An entity shall recognise an impairment loss in profit or loss to the extent that the carrying amount of an asset recognised in accordance with paragraph 91 or 95 exceeds: (a) the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates; less (b) the costs that relate directly to providing those goods or services and that have not been recognised as expenses (see paragraph 97).
11	IFRS 15.102:	For the purposes of applying paragraph 101 to determine the amount of consideration that an entity expects to receive, an entity shall use the principles for determining the transaction price (except for the requirements in paragraphs 56–58 on constraining estimates of variable consideration) and adjust that amount to reflect the effects of the customer's credit risk.
12	IFRS 15.103:	Before an entity recognises an impairment loss for an asset recognised in accordance with paragraph 91 or 95, the entity shall recognise any impairment loss for assets related to the contract that are recognised in accordance with another Standard (for example, IAS 2, IAS 16 and IAS 38). After applying the impairment test in paragraph 101, an entity shall include the resulting carrying amount of the asset recognised in accordance with paragraph 91 or 95 in the carrying amount of the cash-generating unit to which it belongs for the purpose of applying IAS 36 Impairment of Assets to that cash-generating unit.

13 IFRS 15.104: An entity shall recognise in profit or loss a reversal of some or all of an impairment loss previously recognised in accordance with paragraph 101 when the impairment conditions no longer exist or have improved. The increased carrying amount of the asset shall not exceed the amount that would have been determined (net of amortisation) if no impairment loss had been recognised previously.

1.2 TRG

14 Issues relating to acquisition cash-flows have been discussed at the TRG meeting in February 2018.

15 TRG 2018-02 AP04.4: For a group of contracts accounted for under:

(a) the general requirements, insurance acquisition cash flows are included in the measurement of the contractual service margin (see paragraph 38 of IFRS 17).

(b) the premium allocation approach, insurance acquisition cash flows reduce the liability for remaining coverage (see paragraph 55 of IFRS 17).

16 TRG 2018-02 AP04.14: Incorporating all available information by applying paragraph 33 of IFRS 17, the acquisition cash flows are triggered solely when the contract is initially written. Therefore, the acquisition cash flows are within the boundary of the initially written contracts.

17 TRG 2018-02 AP04.15: Additionally, even if the entity contemplates that most contracts will be renewed, applying paragraph 35 of IFRS 17, an entity cannot recognise part of the acquisition cash flows as an asset for future groups that will be recognised when the contracts are renewed. The renewals are outside the boundary of the initially written contracts. Applying this view, the acquisition cash flows are considered only in the measurement of the group to which the initially written contract belongs.

18 TRG 2018-02 Summary.19(e): When a “commission is paid unconditionally on the initially written contract (i.e. it is not refundable) […] it cannot be allocated to future groups and accordingly the specified commission is included in the measurement of the group to which the initially issued contract belongs”.

1.3 Tentative Board’s decisions

19 Issues relating to acquisition cash-flows have been discussed at the June 2018 and January 2019 IASB Board meetings.

20 During the June 2018 meeting, IASB Staff suggested the following amendments

21 IFRS 17.27: An entity shall recognise an asset or liability for any insurance acquisition cash flows relating to a group of ~~issued~~ insurance contracts issued or expected to be issued that the entity pays or receives before the group is recognised, unless it chooses to recognise them as expenses or income applying paragraph 59(a). An entity shall derecognise the asset or liability resulting from such insurance acquisition cash flows when the group of insurance contracts to which the cash flows are allocated is recognised (see paragraph 38(b)).

22 During the January 2019, IASB agreed on staff's recommendations.

23 IASB 2019-01.AP 2A.2: The staff recommend the International Accounting Standards Board (Board) amend IFRS 17 to require an entity to:

(a) allocate to any anticipated contract renewals part of the insurance acquisition cash flows directly attributable to newly issued contracts.

(b) recognise the insurance acquisition cash flows allocated to anticipated contract renewals as an asset applying paragraph 27 of IFRS 17 until the renewed contracts are recognised.

(c) assess the recoverability of the asset recognised according to paragraph 27 of IFRS 17 each period before the related contracts are recognised. The recoverability assessment would be based on the expected fulfilment cash flows of the related group of contracts.

(d) recognise a loss in profit or loss for any unrecoverable carrying amounts of the asset recognised by applying paragraph 27 of IFRS 17.

24 Tentative decisions as summarised for the March 2019 board meeting:

25 IASB 2019-03.AP 2.A3: The Board tentatively decided to:

(a) amend the terminology in paragraph 27 of IFRS 17 to include insurance acquisition cash flows relating to insurance contracts in the group yet to be issued.

(b) amend IFRS 17 to require an entity to allocate to any expected contract renewals their related part of the insurance acquisition cash flows directly attributable to newly issued contracts.

(c) amend IFRS 17 to require an entity to recognise the insurance acquisition cash flows allocated to expected contract renewals as assets applying paragraph 27 of IFRS 17 until the renewed contracts are recognised.

(d) amend IFRS 17 to require an entity to assess the recoverability of any asset recognised applying paragraph 27 of IFRS 17 each period before the related contracts are recognised. The recoverability assessment would be based on the expected fulfilment cash flows of the related group of contracts.

(e) amend IFRS 17 to require an entity to recognise a loss in profit or loss for any unrecoverable carrying amounts of the asset recognised by applying paragraph 27 of IFRS 17.

(f) amend IFRS 17 to require an entity to recognise in profit or loss the reversal of some or all of any such loss previously recognised when the impairment conditions no longer exist or have improved.

26 IASB 2019-03.AP 2G § 20: The proposed amendments would extend the period for which such an asset exists for acquisition cash flows related to renewals, and consequently is expected to increase the amount of the asset. Furthermore, the timing of when the entity expects that asset to be derecognised and included in the measurement of the group of contracts will vary depending on the entity's assumptions related to renewals such as the timing and number of renewals. Consequently, even though such assets existed in IFRS 17 before

the proposed amendments, the staff think it is appropriate to reconsider the related disclosure requirements.

27 IASB 2019-03.AP 2G § 22: The staff think that quantitative information about such insurance acquisition cash flows will be more important for users of financial statements after the proposed amendments to IFRS 17. This is because, as discussed in paragraph 20 of this paper, there could be a longer period until the cash flows are included in the measurement of a group of insurance contracts and hence a greater amount not yet included in that measurement compared to those arising under the existing IFRS 17 requirements. Therefore, the staff recommend the Board amend IFRS 17 to require specific reconciliation of the acquisition cash flows asset at the beginning and the end of the period and its changes, specifically recognition of any impairment loss or reversals.

28 IASB 2019-03.AP 2G § 25: Consequently, the staff recommend the Board amend IFRS 17 to require a quantitative disclosure, similar to that required in paragraph 109 of IFRS 17 on when the entity expects to recognise the contractual service margin in profit or loss (see paragraph 9 of this paper). This new disclosure would require an entity to disclose when it expects to include insurance acquisition cash flows as part of the initial measurement on recognition of a group of insurance contracts.

1.4 Current understanding of the accounting treatment

29 The accounting treatment of cash flows relating to the acquisition of insurance contracts is currently understood to be the following:

30 Before a group of contracts is issued or recognised, pre-recognition cash flows relating to the acquisition of issued contracts (or expected to be issued) are to be accounted for as an asset or a liability (IFRS 17.27). There is no specific requirement for an impairment of such an asset if the asset appears not recoverable, however the provisions relating to onerous contracts apply before recognition (IFRS 17.26).

31 At the time of recognition of the group of contracts, the asset or liability is transferred to the contractual service margin (IFRS 17.27). The post-recognition acquisition cash flows are part of the fulfilment cash flows and as a consequence affect also the contractual service margin (IFRS 17.B 65(e)).

32 According to the TRG staff analysis (TRG 2018-02 AP04.34), because acquisition costs incurred (pre and post-recognition) are paid unconditionally on the initially written contract, the commission is within the boundary of the initial contract and not to the group of contracts it belongs to and as a consequence may not relate to future groups to which the future contract once renewed would belong. This provision therefore prohibits keeping any asset or liability in relation to expected renewals irrespective of the underlying pricing assumptions.

33 In the provisions relating to the treatment of onerous contracts there is no specific provision allowing for excluding from the computation the acquisition costs related to expected renewals.

34 There is an option for expensing acquisition costs related to contracts accounted for under the premium allocation approach (IFRS 17.59(a)). This option applies to pre and post-recognition acquisition cash flows.

35 Provisions set out under IFRS 17.B65 indicate that acquisition cash flows can be allocated on a portfolio approach (e) and, as a general rule, do consider an allocation of fixed and variable overheads that are directly attributable (l). As a consequence acquisition cash flows include both direct and indirect costs as well as both external and internal costs.

36 On the whole, suggestions made in this document are in line with the suggestions made by IASB in the June 2018 and January 2019 meetings.

37 IASB also expressed the view that it would be appropriate to reconsider the disclosure requirements, since the proposed amendments would extend the period for which such an asset exists for acquisition cash flows related to renewals, and consequently is expected to increase the amount of the asset.

38 Accordingly following requirement have been tentatively added:

- A specific reconciliation of the acquisition cash flows asset at the beginning and the end of the period and its changes, specifically recognition of any impairment loss or reversals;
- A quantitative disclosure (similar to IFRS 17.109) on when the entity expects to include insurance acquisition cash flows as part of the initial measurement on recognition of a group of insurance contracts (in appropriate time bands).

2 Issue

2.1 Substance of the transactions

39 Costs incurred for initiating a new insurance contract with a policyholder (acquisition costs *per se)* are generally significantly higher than costs incurred following inception for servicing (contract renewal with information update, premium determination and collection, claims handling costs, customer relationship programme…) that contractual relationship in the context of an ongoing stream of renewals (which are most of the time concluded tacitly, i.e. the initial contract is ongoing unless one of the two parties - the policyholder or the insurer - takes the initiative of terminating the contractual relationship). Acquisition costs can be incurred before issuance of the contract, between issuance and recognition of the contract and after recognition. Incidentally ongoing servicing costs are incurred by the insurer either upon renewal (commissions for instance) or during the coverage period of the renewed contract and beyond (for instance claims handling costs).

40 The structure of commissions generally reflects such a situation. In other words, an analysis of costs incurred in the first period shall be performed in order to separate acquisition costs relating to the acquisition/creation of a new customer relationship from those relating to servicing the contractual relationship while performing the obligation. The former being in line with the definition of "insurance acquisition cash flows" in IFRS 17 as "costs of selling, underwriting and starting" insurance contracts attributable to a portfolio.

41 As a consequence, a fair representation of the substance of the transactions implies:

- linking acquisition costs relating to the creation of a new customer relationship with the period during which the insurer is actually expecting benefits from that relationship. This period includes the initial period as well as expected future periods derived from probable renewals, unless acquisition costs are financed by the policyholder via a different premium in the first year (which appears to be seldom the case);
- providing different accounting treatments for the two natures of costs incurred during the initial period: acquisition costs *per se* and servicing costs.

42 In addition, when reflecting the substance of the transaction:

- the recognition of an asset for acquisition costs relating to the creation of a new customer relationship does not depend on whether such costs have already been paid or not.
- the period to which acquisition costs relating to the creation of a new customer relationship are allocated does not depend on whether such costs are refundable or not. Acquisition costs are generally non-refundable.

2.2 Illustration

<u>EU Case study</u>

43 Participants to the EU case study have illustrated the impact of IFRS 17 requirements (and current TRG conclusions) on short term contracts in a motor portfolio applying the PAA. They noted that attributing the acquisition costs to new clients only can lead to identifying more onerous contracts (especially when the combined ratio of the underlying product is close to 100% as it is the case in the motor insurance sector). On the opposite, when spread over both new clients and renewals, no contract was identified as onerous. The latter better reflects the economic characteristics of the

business, as a significant part of contracts related to new clients is underwritten with relatively high levels of commission initially paid to the intermediary. These commissions are then financed by the renewals of these new contracts. If the volume of business is stable from one year to the other, similar results are expected, but there is an asset not accounted for. Conversely in the development phase of a new portfolio, the new standard would have a negative impact in the first years.

Other EU illustrations of the issue raised

44 In addition to the case study itself, preparers have also explained that, in the case of a business combination, the separate recognition of an intangible including customer lists (which may be broader than existing customers) is required under certain conditions (IFRS 3.B33) to properly reflect the substance that would otherwise be accounted for in the goodwill. This intangible incorporates as a basis, but not exclusively, the acquisition cash flows that can be allocated to contracts expected to be renewed.

Macroeconomic approach

45 An « order of magnitude » approach, for illustration purposes only, can be derived from considering a significant market and estimating what could be the acquisition costs to be allocated to expected contracts at balance sheet level. Assuming (i) that the contracts eligible to the PAA model represent a premium income of 100 b€, this amount being assumed fairly stable and paid on January 1st and (ii) that any initiated contract is likely to be renewed four times, every percentage point of acquisition costs incurred should give rise at market level to assets of 0,6 b€ (premium income/5 x (1%+0,8%+0,6%+0,4%+0,2%)). For five/seven percentage points the assets would be 3,0/4,2 b€ for such a market. Incidentally, it must be considered that the issue appears to be significant for contracts eligible to the PAA.

2.3 Consistency with other standards

Consistency with IFRS 15

46 With regards to “revenue”, IFRS 15.99 states that incremental costs of obtaining a contract with a customer that are recognised as an asset “in accordance with paragraph 91 or 95 shall be amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated contract (as described in paragraph 95(a)).” Such an asset is also subject to impairments requirements according to IFRS 15.101-104.

Consistency with US GAAP ASC 944

47 Main features regarding acquisition costs under US-GAAP are as follows:

- ASC 944-30-25 stipulates that costs that may be deferred are limited and that only acquisition costs resulting from actually acquiring a contract (i.e. successful efforts) can be capitalised as DAC (deferred acquisition costs);
- The amortisation method is required to be applied consistently over the expected term of the related contracts;
- Under the new guidance, DAC is not subject to impairment testing. The principle is that deferred costs represent historical rather than future cash flows.

3 Suggested solution (tentative)

3.1 Discussion

48 The current standard already provides for:

- Recognising pre-recognition acquisition cash flows as a separate asset or a liability (IFRS 17.27);
- Recoverability / impairment test of such an asset tested according to IFRS 17.26;
- Allocating acquisition costs to different groups, even if not yet issued, when they relate to different portfolios (IFRS 17.B 65(e));
- Amortising acquisition costs (paid or not yet paid, i.e. in the fulfilment cash flows) for long duration insurance contracts over a duration that (i) may exceed one year and that (ii) may be less than the contractual term (taking into account the expected duration of a group, i.e. considering potential cancellation options). Accordingly, there is no "over-prudence" requiring immediately expensing such costs (the option offered to contracts with duration of less than one year is rather a practical expedient than prudence even if there is prudence as a consequence). In addition the amortisation period not only depends on the contractual period but also factors in certain economic behaviours (IFRS 17.B125).

49 The rationale of the accounting treatment is not convincing:

- BC 176 concludes on the reasons for not recognising acquisition costs as an asset for customer relationship in a way that does not correspond to the substance of the transactions:
  - "such an asset […] does not exist, if the entity recovers insurance acquisition cash flows from premiums already received". => there is confusion here between cash flows received from the initial premium and cash-flows expected from the future benefits linked with the asset. The comment does not consider the situation where the entity intends to recover insurance acquisition cash flows from premiums already received and from premiums expected to be received in the future following renewals. In addition, acquisition costs are related to a service provided by the intermediary facilitating insurance business. Once the commission is paid, the undertaking has the right to be part of the contract without paying further commissions. Thus, the asset reflects this right and needs to be allocated along all the service received, which is the whole relationship with the policyholder including future renewals. Therefore the asset does exist and reflects a right acquired by the undertaking.
  - "such an asset […] relates to future cash flows that are included in the measurement of the contract. The Board noted that an entity typically charges the policyholder a price the entity regards as sufficient to compensate it for undertaking the obligation to pay for insured losses and for the cost of originating the contracts". => assuming that such an asset only relates to the future cash flows of the contract (and potentially onerous because not properly priced) does not reflect the substance of the transaction (§ 2.1). This assumption leaves aside the situation where acquisition costs also relate to expected future renewals. The argument is not valid since the conclusion for not recognising a customer relationship asset is actually included in the assumption not to consider future renewals.

- Recognising an asset would be required applying IFRS 3.B 33 in case of a business combination.
- There is no conceptual linkage between the non-refundability of costs and the duration of the expected benefits of incurring them.
- Immediately expensing acquisition costs in IFRS 17.59(a) is less an “option” than a “practical expedient”.

3.2 Suggested modifications to the standard

50 An interpretation does not appear sufficient to properly address the issue.

51 Amending IFRS 17.27 in order to separately recognise as an asset acquisition costs that (i) actually relate to the creation of a new customer relationship and (ii) are expected to generate benefits for the initial period and subsequent periods, (iii) provided that test of impairment/ onerousness is performed and (iv) disregarding the date of payment.

52 It would consequently be also required to provide additional information in the notes on the major assumptions retained on expected renewals as well as on how the unallocated costs are allocated to renewals.

53 Finally, several solutions may be contemplated regarding the required valuation test of that asset:

(a) build on the “onerous” test included in IFRS 17.26 requiring “to determine whether ***any contracts*** form a group of onerous contracts applying paragraph 16 ***before*** [the recognition of that group] if facts and circumstances indicate there is such a group”. By contract, we may refer to the amendments proposed by the staff in IFRS 17.27 referring to “contracts issued or expected to be issued”. Accordingly, the standard as currently written would already require to assess whether a contract expected to be issued may be onerous before it is recognised.

(b) add an assessment on whether contract renewals happened as expected and where they did not, the associated unallocated acquisition costs being released to profit or loss immediately.

(c) add an impairment test.

54 There are two possible approaches: one centred on the idea of amortising an asset (if the renewal pattern changes the amortisation pattern should change, possibly only in case of a need for quicker amortisation) and the other centred on the idea of allocating costs (if the renewal pattern changes, more costs will then be borne by future groups of contracts with a risk of them becoming onerous).

55 In the approach discussed in January 2019, IASB has retained the amortisation approach and added an impairment test. Suggested amendment have not yet been presented but ANC also considered such a solution (see below § 60).

56 ANC also suggested an alternative simpler to apply but that would lead to recognise a loss based exclusively on a renewal pattern not happenning as expected i.e. even when the group is not onerous. Since acquisition cash flows are mainly an issue for short term contracts, e.g. PAA contracts, this alternative is providing a simple impairment test that does not require extensive analysis of future cash flows in order to assess whether the group of contracts becomes onerous.

57 If a full impairment test is preferred (as already expressed by IASB in its tentative decisions in January 2019), in our view, an onerous test should be performed only if the change in the renewal pattern introduces a significant risk of group of contracts becoming onerous.

3.3 Suggested modifications (on the basis of the staff suggestion)

58 IFRS 17.27 (marked-up): An entity shall recognise an asset or liability for any insurance acquisition cash flows relating to a group of ~~issued~~ insurance contracts issued or expected to be issued ~~that the entity pays or receives before the group is recognised~~, unless it chooses to recognise them as expenses or income applying paragraph 59(a). An entity shall derecognise the asset or liability resulting from such insurance acquisition cash flows ~~when~~ upon initial recognition of the group of insurance contracts and expected subsequent renewals to which the cash flows are allocated ~~is recognised~~ (see paragraph 38(b))

59 IFRS 17.27 (clean): An entity shall recognise an asset or liability for any insurance acquisition cash flows attributable to insurance contracts issued or expected to be issued, unless it chooses to recognise them as expenses or income applying paragraph 59(a). An entity shall derecognise the asset or liability resulting from such insurance acquisition cash flows upon initial recognition of the group of insurance contracts and expected subsequent renewals to which the cash flows are allocated (see paragraph 38(b))

3.4 Impairment test

60 The following specific requirement might be added if IFRS 17.26 as it stands is not considered sufficient to address the valuation test of the asset recognised according to IFRS 17.27(option B see § 53):

"An entity shall recognise an impairment loss of the carrying amount of the assets related to expected renewals to the extent such amount is related to future groups expected to be onerous.

3.5 ANC suggested alternative solution

61 The following specific requirement might be added if IFRS 17.26 as it stands is not considered sufficient to address the valuation test of the asset recognised according to IFRS 17.27 (option B see § 53):

"An entity shall assess whether contract renewals are likely to happen as expected and where they did not, the associated not yet allocated acquisition costs being then released to profit or loss immediately".

IFRS 17 issues – Balance sheet presentation

Amended draft for discussion

1 Current IASB requirements and TRG discussions

1.1 IFRS 17

1 IFRS 17.32: On initial recognition, an entity shall measure a group of insurance contracts at the total of:

(a) the fulfilment cash flows, which comprise:

(i) estimates of future cash flows (paragraphs 33–35);

(ii) an adjustment to reflect the time value of money and the financial risks related to the future cash flows, to the extent that the financial risks are not included in the estimates of the future cash flows (paragraph 36); and

(iii) a risk adjustment for non-financial risk (paragraph 37).

(b) the contractual service margin, measured applying paragraphs 38–39.

2 IFRS 17.40: The carrying amount of a group of insurance contracts at the end of each reporting period shall be the sum of:

(a) the liability for remaining coverage comprising:

(i) the fulfilment cash flows related to future service allocated to the group at that date, measured applying paragraphs 33–37 and B36–B92;

(ii) the contractual service margin of the group at that date, measured applying paragraphs 43–46; and

(b) the liability for incurred claims, comprising the fulfilment cash flows related to past service allocated to the group at that date, measured applying paragraphs 33–37 and B36–B92.

3 IFRS 17.55: Using the premium allocation approach, an entity shall measure the liability for remaining coverage as follows:

(a) on initial recognition, the carrying amount of the liability is:

(i) the premiums, if any, received at initial recognition;

(ii) minus any insurance acquisition cash flows at that date, unless the entity chooses to recognise the payments as an expense applying paragraph 59(a); and

(iii) plus or minus any amount arising from the derecognition at that date of the asset or liability recognised for insurance acquisition cash flows applying paragraph 27.

(b) at the end of each subsequent reporting period, the carrying amount of the liability is the carrying amount at the start of the reporting period:

(i) plus the premiums received in the period;

(ii) minus insurance acquisition cash flows; unless the entity chooses to recognise the payments as an expense applying paragraph 59(a);

(iii) plus any amounts relating to the amortisation of insurance acquisition cash flows recognised as an expense in the reporting period; unless the entity chooses to recognise insurance acquisition cash flows as an expense applying paragraph 59(a);

(iv) plus any adjustment to a financing component, applying paragraph 56;

(v) minus the amount recognised as insurance revenue for coverage provided in that period (see paragraph B126); and

(vi) minus any investment component paid or transferred to the liability for incurred claims.

4 IFRS 17.59: In applying the premium allocation approach, an entity:

(a) may choose to recognise any insurance acquisition cash flows as expenses when it incurs those costs, provided that the coverage period of each contract in the group at initial recognition is no more than one year.

(b) shall measure the liability for incurred claims for the group of insurance contracts at the fulfilment cash flows relating to incurred claims, applying paragraphs 33–37 and B36–B92. However, the entity is not required to adjust future cash flows for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received in one year or less from the date the claims are incurred.

5 IFRS 17.63: In applying the measurement requirements of paragraphs 32–36 to reinsurance contracts held, to the extent that the underlying contracts are also measured applying those paragraphs, the entity shall use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurance contracts held and the estimates of the present value of the future cash flows for the group(s) of underlying insurance contracts. In addition, the entity shall include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

6 IFRS 17.78: An entity shall present separately in the statement of financial position the carrying amount of groups of:

- insurance contracts issued that are assets;
- insurance contracts issued that are liabilities;
- reinsurance contracts held that are assets; and
- reinsurance contracts held that are liabilities.

7 IFRS 17.79: An entity shall include any assets or liabilities for insurance acquisition cash flows recognised applying paragraph 27 in the carrying amount of the related groups of insurance contracts issued, and any assets or liabilities for cash flows related to groups of reinsurance contracts held (see paragraph 65(a)) in the carrying amount of the groups of reinsurance contracts held.

8 IFRS 17.99: An entity shall provide enough information in the reconciliations to enable users of financial statements to identify changes from cash flows and amounts that are recognised in the statement(s) of financial performance. To comply with this requirement, an entity shall:

(a) disclose, in a table, the reconciliations set out in paragraphs 100–105; and

(b) for each reconciliation, present the net carrying amounts at the beginning and at the end of the period, disaggregated into a total for groups of contracts that are assets and a total for groups of contracts that are liabilities, that equal the amounts presented in the statement of financial position applying paragraph 78.

9 IFRS 17.100: An entity shall disclose reconciliations from the opening to the closing balances separately for each of:

(a) the net liabilities (or assets) for the remaining coverage component, excluding any loss component.

(b) any loss component (see paragraphs 47–52 and 57–58).

(c) the liabilities for incurred claims. For insurance contracts to which the premium allocation approach described in paragraphs 53–59 or 69–70 has been applied, an entity shall disclose separate reconciliations for:

(i) the estimates of the present value of the future cash flows; and

(ii) the risk adjustment for non-financial risk.

10 IFRS 17.101: For insurance contracts other than those to which the premium allocation approach described in paragraphs 53–59 or 69–70 has been applied, an entity shall also disclose reconciliations from the opening to the closing balances separately for each of:

(a) the estimates of the present value of the future cash flows;

(b) the risk adjustment for non-financial risk; and

(c) the contractual service margin.

11 IFRS 17.B126: When an entity applies the premium allocation approach in paragraphs 55–58, insurance revenue for the period is the amount of expected premium receipts (excluding any investment component and adjusted to reflect the time value of money and the effect of financial risk, if applicable, applying paragraph 56) allocated to the period. The entity shall allocate the expected premium receipts to each period of coverage:

(a) on the basis of the passage of time; but

(b) if the expected pattern of release of risk during the coverage period differs significantly from the passage of time, then on the basis of the expected timing of incurred insurance service expenses.

12 IFRS 15.105: When either party to a contract has performed, an entity shall present the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable.

1.2 TRG outreach

13 TRG staff is considering that presentation "challenges" reported by preparers via an outreach the conclusions of which have been reported to the TRG in May 2018 (TRG 2018-05 AP 06), are a mere implementation issue (e.g. not a conceptual one).

1.3 Tentative board's decisions

14 Issues relating to the balance-sheet presentation have been discussed at the December 2018 IASB Board meeting. The following amendment has been suggested

15 IFRS 17.78: An entity shall present separately in the statement of financial position the carrying amount of ~~groups~~ portfolios of:

- insurance contracts issued that are assets;
- insurance contracts issued that are liabilities;
- reinsurance contracts held that are assets; and
- reinsurance contracts held that are liabilities.

16 IASB 2018-12.AP 2A.37: On balance, the staff recommend that entities are required to offset groups at the portfolio level for presentation purposes. This means that an entity would present separately assets and liabilities for insurance contracts subject to similar risks that are managed together. The staff think that offsetting at an entity level risks a greater loss of useful information. The staff also note that in the 2010 Exposure Draft Insurance Contracts and 2013 Exposure Draft Insurance Contracts, the Board proposed presentation at a portfolio level when the unit of account was a single contract.

17 IASB 2018-12.AP 2A.50: The staff think that amending IFRS 17 to require the separate presentation of premiums receivable and claims payable from the insurance contract asset or liability could:

(a) reduce comparability between entities—the staff understand that systems currently used by entities recognise premiums receivable over different periods for different contracts. For example, one entity may only recognise premiums due in the current month that were not yet received, while another entity may reflect premiums due in the next 12 months in premiums receivable.

(b) unduly disrupt implementation already under way and risk undue delays in the effective date of IFRS 17 if the Board were to develop a consistent definition of premiums receivable and claims payable.

18 IASB 2018-12.AP 2A.51: The staff note that paragraph 55 of IAS 1 Presentation of Financial Statements permits the presentation of additional line items including by disaggregation of required line items, headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position. Applying that requirement, an entity may be able to present a disaggregation which shows the components of each of those line items (for example, to present the amounts of premiums receivable and claims payable included in the carrying amount of the insurance contract liability). The staff observe that requirement does not permit an entity to present premiums receivable or claims payable as separate line items, it only permits for the required line items to be disaggregated when such presentation is relevant to an understanding of the entity's financial position.

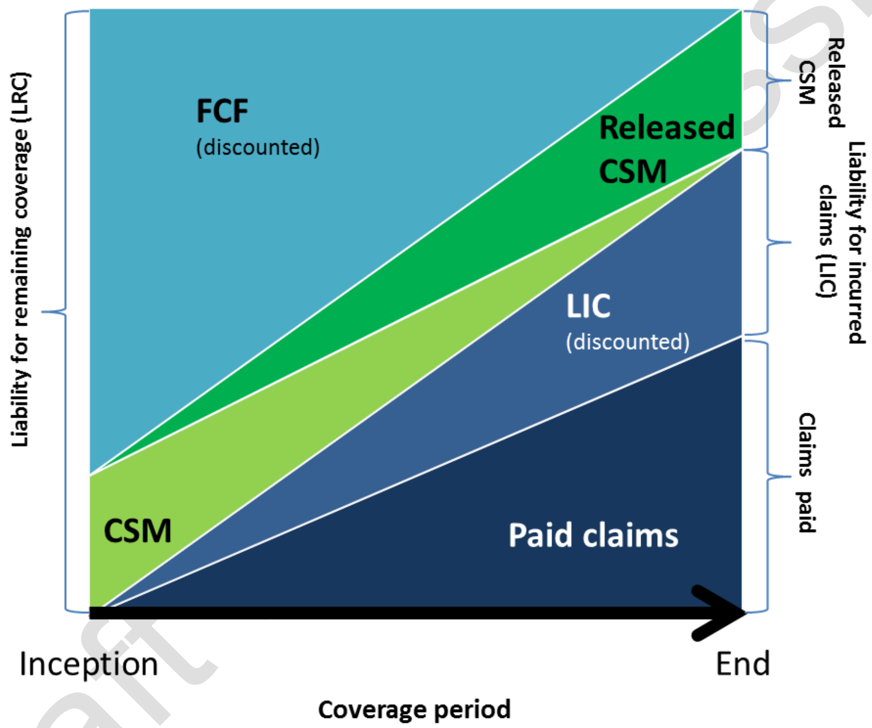
19 IASB 2019-03.AP 2H.6§7: The staff expect the Exposure Draft to propose a consequential amendment to paragraph 99 of IFRS 17 so that when an entity discloses the reconciliations required by paragraphs 100–105 of IFRS 17, the entity presents, for each reconciliation, the net carrying amounts at the beginning and at the end of the period, disaggregated into a total for portfolios (rather than groups) of contracts that are

assets and a total for portfolios (rather than groups) of contracts that are liabilities, that equal the amounts presented in the statement of financial position applying paragraph 78 of IFRS 17. The staff also expect the Exposure Draft to propose a consequential amendment to paragraph 79 of IFRS 17 about the presentation of portfolios (rather than groups) of insurance contracts in the statement of financial position.

1.4 Current understanding of the accounting treatment

Presentation of the different IFRS 17 components

20 Presentation follows the approach retained for measurement purposes (fulfilment cash flows (FCF), contractual service margin (CSM), liability for incurred claims (LIC)). Liability for incurred claims is an additional liability. See simplified diagram below.



Measurement and presentation based on cash-flows

21 Applying the general model (IFRS 17.32-37), a group of insurance contracts recorded as a liability or an asset (e.g. reinsurance contracts) is measured including all future expected cash flows at the date of measurement. The standard is based upon a pure future cash-flows approach.

22 Consequently, the future cash flows aggregate a number of assets and liabilities the nature of which may differ from the liability for remaining coverage. For example and principally: liability for incurred claims (including IBNR), premium receivables, reinsurance collateral …

23 Recognition, measurement and presentation according to the VFA are based upon the same “expected” cash-flow basis.

24 Recognition, measurement and presentation according to the PAA (IFRS 17.55 and IFRS 17.59) are based upon a pure premium received and liability for remaining coverage approach.

Recognition and measurement of PAA contracts for which premium is not yet received

25 PAA recognises and measures insurance contracts when the premium has been received, even if the coverage has already started.

26 When the premium has not yet been paid, the accounting treatment is not explicit but derives from:

- IFRS 17.55 (b)(v) that refers to "the amount recognised as insurance revenue for coverage provided" according to IFRS 17.B126;
- IFRS 17.B126 that further indicates that "insurance revenue for the period is the amount of expected premium receipts […] allocated to the period".

27 Therefore, PAA insurance revenue has to be recognised even if the premium has not been received since only the expected premium receipts matters. In that case, revenue is recognised against a credit in the insurance liability, e.g. against an asset representing the receivable on the policyholder.

2 Issue

2.1 Issue 1: Separate presentation of accruals in the balance sheet

Cash basis approach

28 Standards are generally adopted on the basis of rights and obligations and recorded accordingly on an accrual basis and not on a cash basis.

29 From a general standpoint, balance sheet presentation is deemed to be useful when the following principles are met:

- providing insights on the nature and level of reliability of the recorded amounts in terms of valuation and liquidity of assets or liabilities;
- excluding offsetting of assets and liabilities exposed to different risks and commitments, or counterparties (beneficiaries may differ from the policyholder);
- reflecting the volume of or the relationship to activities;
- being informative and predictive.

30 In the balance sheet presentation of insurance business, the emphasis is currently put on:

- separating assets and liabilities in accordance with their respective nature and underlying key risks: credit risk on premium due, insurance risk on liabilities for remaining coverage, valuation risk on liabilities for incurred claims, liquidity risk and profitability on deposits;
- reflecting the asset/liability management key characteristics.

31 By contrast IFRS 17 (i) is based upon a cash basis approach for recognition, measurement and presentation purposes and (ii) aggregates assets and liabilities of a different nature in a combined amount for each and every group of contracts.

The decisions taken to elaborate IFRS 17 have the following consequences in terms of B/S presentation:

32 – **Premium receivables** (corresponding to a coverage period that has already started but for which payment has not yet been received) are not shown separately. This information is key for a proper understanding of the activity and risks involved. Generally, in case of non-payment, the coverage will remain in force for a period of time, i.e. until the contract is terminated following certain legally/contractually organised procedures. Following termination, the insurer is entitled to the payment of the premium up to that date and will have to cover any claim incurred during the coverage period.

Illustrative example 1: presentation of premium due in the general model

33 Assuming a one-year motor insurance policy is issued on 15 December N that covers third party liability. On 31 December N, the policyholder has still not paid the insurance premium of 240 CU. Under the local jurisdiction, not paying premium at the exact moment when due does not invalidate the insurance coverage. The estimates of future outflows relating to future claims and costs amount to 192.

34 As of 31 December N, applying IFRS 17.32-37, a liability for remaining coverage is recognised and measured as the difference between the premium due (240 CU), the other fulfilment cash flows relating to expected claims (192 CU) and the CSM (48*345/360=46 CU). Finally, the amount presented for that insurance contract will be an asset amounting to 2 CU. The usefulness of information conveyed by the amount presented on the balance sheet and resulting from offsetting different components is questionable.

35 – **Liabilities for claims incurred and liabilities for remaining coverage** are not shown separately. This information is key for a proper understanding of the activity and risks involved. When an insured event occurs, there is a fundamental change in nature from liability for remaining coverage (LRC) to liability for incurred claim (LIC). The key factor for the former is the probability of occurrence in the future, the key factor for the latter is the quality of estimates (from very simple estimates to more complex ones and IBNR).

36 – **Collateral deposits related to reinsurance accepted and held** are not shown separately. This information is key for a proper understanding of the activity and risks of the reinsurer as well as of the cedant. The information on the liability for remaining coverage of the reinsurer does not depend on the nature of the guaranty provided by the reinsurer (deposit in cash, assets pledged or third party guarantee). This issue is the same for the insurer and the insurance contract held. Accordingly, deposits made or received are considered within the boundaries of the reinsurance contract.

Conceptual basis

37 From a conceptual standpoint IASB considers that:

- absent a claim, rights and obligations in an insurance contract are with the same counterpart even if sometimes the insurer acts as an agent on behalf of the policyholder. A separation could not be contemplated at group level.
- amounts recorded in liability and as a receivable generally depend from each other since the insurance commitment may lapse if the premium is not paid in due course.

38 We are of the view that presenting separately premium receivables, liabilities for remaining coverage, contractual service margin, liabilities for incurred claims and collaterals is useful information. In addition, it reflects the way the business is managed and information systems are organised.

39 In addition (when possible) relevant information shall rather be presented in the balance sheet instead of being disclosed in the notes (IFRS 17.100 on liabilities for remaining coverage and for incurred claims; IFRS 17.101(c) on the CSM).

Premium receivables

40 IFRS 17 does not require information on premium receivables in the balance sheet or in the notes. A definition of “premium receivables” should clarify whether they encompass “due and payable” (expected cash flows) or only “due and payable and enforceable” amounts (expected enforceable cash flows).

41 A common definition of a receivable shall not depend on the payment schedule i.e. be different when settled in one payment upfront compared with 12 instalments.

42 The impact of separately presenting premium receivables on the simplifications offered by the premium allocation approach has to be assessed in balance with the IT complexity raised by the current standard (See also § 49).

Measurement of premium receivables and liabilities for incurred claims

43 The nature of premium receivables and liabilities for incurred claims may put them under IFRS 9. It remains to be demonstrated that the risks covered under IFRS 9 (in particular related to premium receivables) are properly taken into account in the estimated FCF following IFRS 17.32 and IFRS 17.40.

44 We are of the view that there is no need for changing *measurement*, i.e. referring to IFRS 9 and therefore strongly suggest restricting the issue raised to the *presentation* of accruals in the balance sheet.

2.2 Issue 2: Presentation as an asset or a liability at group level

45 According to IFRS 17.78, each group of insurance contracts has to be presented in the balance sheet either as an asset or a liability. A presentation at this level of granularity does not provide useful information since it derives from accounting principles rather than from a business or conceptual approach. Groups may move from a liability to an asset position or the other way around without such information being meaningful.

46 In addition, from an accounting standpoint, offsetting the presentation of assets and liabilities of different nature and with different counterparts appears to be in contradiction with the conceptual framework.

47 Moreover, such presentation requirements would generate a burdensome complexity in providing net amounts at group or portfolio level where IT systems are on a “due-date” basis not on a cash basis.

2.3 Operational issues: modifying IT and management systems

48 Information systems of insurance companies generally distinguish:

- Underwriting, premium income and premium collection,
- Claims, claims occurrence, claims handling, claims payments and claims estimates,
- Actuarial estimates and models, in particular for the determination of the remaining coverage and, from a business perspective for the determination of pricing conditions.

49 The first two IT systems operate on an accrual basis reflecting risks and obligations. The third one reflects a number of assumptions and, in order to ensure consistency, is reconciled with the other two on a "due-date" basis (not on a cash-basis). The IT systems reflect a management structure organised to regroup competencies and promote efficiency. Modifying this typical structure and the related IT systems (e.g. from due-date to cash basis) may prove costly and may be a challenge to efficiency.

2.4 Illustration in the EU case study

Separating the presentation of certain assets and liabilities would provide a more understandable and relevant information

50 It is common practice to present components from insurance contracts in different financial statement line items. Some of these items are assets (e.g. premium receivables, deferred acquisition costs) others are liabilities (i.e. unearned premium reserve, loss reserve, aggregate policy reserve…). Each line item in the balance sheet addresses a specific information requirement that may be different from one component to the other.

Presenting insurance contract groups in aggregate does not provide understandable and relevant information and generates undue costs

51 Under IFRS 17, a presentation organised around groups of insurance contracts requires connecting accounting-, claim- and cash- management systems which are currently running separately and reconciled at a higher level (TRG 2018-05 AP 6.27).

52 This not only provides difficult to understand and irrelevant information for business purposes but is also very complex and costly. Costs may consequently exceed benefits.

Consistency of IFRS 17 with internal and regulatory reporting

53 For steering purposes, reconciliation between IFRS 17 and Solvency II in the future closing process is useful because both frameworks have conceptual similarities. The approach retained for the presentation of insurance contracts in the balance sheet under IFRS 17 would complicate such reconciliation.

2.5 Consistency with other IFRS standards

54 IFRS 15.105 requires that a separate presentation of a receivable defined as "any unconditional rights to consideration".

2.6 Consistency with regulatory reporting (Solvency II)

55 According to Solvency II, the best estimate liability is based on a cash flow basis, but the regulation requires recognising certain accruals as separated assets and liabilities.

56 EIOPA Guideline 68 on the valuation of technical provisions states that "Insurance and reinsurance undertakings should establish the future premium cash-flows contained within the contract boundaries at the valuation date and include within the calculation of its best estimate liabilities those future premium cash flows which fall due after the valuation date. Insurance and reinsurance undertakings should treat premiums which are due for payment by the valuation date as a premium receivable on its balance sheet until the cash is received".

3 Suggested solution (tentative)

3.1 Issue 1: Separate presentation of accruals in the balance sheet

57 Removing or offsetting current information commonly used by analysts on accruals would obscure relevant information. Such information actually required in the notes would be better presented on the face of the balance sheet.

58 IASB recalls that IAS 1 and IFRS 17 do not preclude a more detailed presentation of the liabilities, e.g. by presenting accruals (such as liability for remaining coverage, liability for incurred claims or even premium receivables as a debit) within the liability.

59 Amending the standard in order to require for a separate presentation of the main accruals would however significantly improve understandability. It would also improve relevance. From an operational standpoint, implementation would be simplified and costs would be saved.

60 In addition to the modifications to the standard suggested below, amendments to IFRS 17.79 and disclosure requirements (IFRS 17.98-109) have to be revised consequently. As mentioned in the IASB tentative decisions in March 2019, changes in the unit of account for presentation purpose also induce similar changes in the unit of account for disclosure requirements (amending IFRS 17.99).

61 It is also necessary that a non-ambiguous definition of certain accruals (such as premium receivables) is clarified in order to provide comparative and useful information on them.

62 We suggest supplementing appendix A with a common definition of premium receivables that could be based on the IFRS15.105 definition of the "unconditional rights to consideration" taking into account the effective (not the theoretical) period before policyholder's rights (to coverage) actually lapse.

3.2 Issue 2: Asset/liability presentation

63 IASB has suggested to aggregate assets and liability at portfolio level instead of at group level. At portfolio level, virtually all insurance contracts will then be presented as liabilities which would be very similar to presenting assets and liabilities at entity level.

64 We therefore support the IASB amendment, provided the assessment of whether the remaining operational issues are acceptable. Indeed presentation at portfolio level may still require disaggregating / allocating certain positions (e.g. commissions due to distribution agents that may relate to several portfolios).

65 We therefore still prefer removing the reference to groups instead of replacing it by portfolios.

3.3 Other matters

66 According to IFRS 17.79, "an entity shall include any assets or liabilities for insurance acquisition cash flows recognised applying paragraph 27 in the carrying amount of the *related* groups of insurance contracts issued". However, IFRS 17.27 addresses acquisition cash flows before their attribution to groups of insurance contracts issued.

3.4 Suggested modifications to the standard

67 We suggest amending the presentation requirement in order to:

- Remove the aggregated presentation at group level;
- Introduce direct requirements to present the main accruals in the face of the balance sheet (instead of in the notes).

68 IFRS 17.78: An entity shall present separately in the statement of financial position the carrying amount of~~groups of~~:

(a) ~~insurance contracts issued that are assets~~ premium receivables related to insurance contracts,

(b) liabilities for remaining coverage (including contractual service margin) related to insurance contracts,

(c) liabilities for incurred claims related to insurance contracts,

(d) premium receivables (reinsurer) and payables (insurer) related to reinsurance contracts,

(e) liabilities for remaining coverage (reinsurer) and asset for reinsurance contracts held (insurer) for reinsurance contracts,

(f) liabilities for incurred claims (reinsurer) and assets for reinsurance contracts held (insurer) for reinsurance contracts,

(g) liabilities for deposits received (insurer) and assets for deposits made (reinsurer) related to reinsurance contracts.

~~(b) insurance contracts issued that are;~~

~~(c) reinsurance contracts held that are assets;~~.

~~(d) reinsurance contracts held that are liabilities.~~

69 IFRS 17.99: An entity shall provide enough information in the reconciliations to enable users of financial statements to identify changes from cash flows and amounts that are recognised in the statement(s) of financial performance. To comply with this requirement, an entity shall:

(a) disclose, in a table, the reconciliations set out in paragraphs 100–105; and

(b) for each reconciliation, present the net carrying amounts at the beginning and at the end of the period, disaggregated into ~~a total for groups of contracts that are~~ assets and ~~a total for groups of contracts that are~~ liabilities, that equal the amounts presented in the statement of financial position applying paragraph 78.

70 Appendix A: Premium receivable: represents the unconditional right of the entity to consideration for the coverage to be provided. It takes into account the effective, not the theoretical, period before policyholder's rights to coverage actually lapse.

IFRS 17 issues – CSM allocation related to investment services

Amended draft for discussion

1 Current IASB requirements and TRG conclusions

1.1 IFRS 17 requirements

1 IFRS 17.44: For insurance contracts without direct participation features, the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for:

(a) the effect of any new contracts added to the group (see paragraph 28);

(b) interest accreted on the carrying amount of the contractual service margin during the reporting period, measured at the discount rates specified in paragraph B72(b);

(c) the changes in fulfilment cash flows relating to future service as specified in paragraphs B96–B100, except to the extent that:

(i) such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48(a)); or

(ii) such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).

(d) the effect of any currency exchange differences on the contractual service margin; and

(e) the amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period applying paragraph B119.

2 IFRS 17.45: For insurance contracts with direct participation features (see paragraphs B101–B118), the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for the amounts specified in subparagraphs (a)–(e) below. An entity is not required to identify these adjustments separately. Instead, a combined amount may be determined for some, or all, of the adjustments. The adjustments are:

(a) the effect of any new contracts added to the group (see paragraph 28);

(b) the entity's share of the change in the fair value of the underlying items (see paragraph B104(b)(i)), except to the extent that:

(i) paragraph B115 (on risk mitigation) applies;

(ii) the entity's share of a decrease in the fair value of the underlying items exceeds the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48); or

(iii) the entity's share of an increase in the fair value of the underlying items reverses the amount in (ii).

(c) the changes in fulfilment cash flows relating to future service, as specified in paragraphs B101–B118, except to the extent that:

(i) paragraph B115 (on risk mitigation) applies;

(ii) such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48); or

(iii) such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).

(d) the effect of any currency exchange differences arising on the contractual service margin; and

(e) the amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period, applying paragraph B119.

3 IFRS 17.66: Instead of applying paragraph 44, an entity shall measure the contractual service margin at the end of the reporting period for a group of reinsurance contracts held as the carrying amount determined at the start of the reporting period, adjusted for:

(a) the effect of any new contracts added to the group (see paragraph 28);

(b) interest accreted on the carrying amount of the contractual service margin, measured at the discount rates specified in paragraph B72(b);

(c) changes in the fulfilment cash flows to the extent that the change:

(i) relates to future service; unless

(ii) the change results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for the group of underlying insurance contracts.

(d) the effect of any currency exchange differences arising on the contractual service margin; and

(e) the amount recognised in profit or loss because of services received in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period of the group of reinsurance contracts held, applying paragraph B119.

4 IFRS 17.71: An investment contract with discretionary participation features does not include a transfer of significant insurance risk. Consequently, the requirements in IFRS 17 for insurance contracts are modified for investment contracts with discretionary participation features as follows:

(a) the date of initial recognition (see paragraph 25) is the date the entity becomes party to the contract.

(b) the contract boundary (see paragraph 34) is modified so that cash flows are within the contract boundary if they result from a substantive obligation of the entity to deliver cash at a present or future date. The entity has no substantive obligation to deliver cash if it has the practical ability to set a price for the promise to deliver the cash that fully reflects the amount of cash promised and related risks.

(c) the allocation of the contractual service margin (see paragraphs 44(e) and 45(e)) is modified so that the entity shall recognise the contractual service margin over the duration of the group of contracts in a systematic way that reflects the transfer of investment services under the contract.

5 IFRS 17.App A: coverage period: The period during which the entity provides coverage for insured events. This period includes the coverage that relates to all premiums within the boundary of the insurance contract.

6 IFRS 17.App A: investment component: The amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.

7 IFRS 17.B 65: Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. The cash flows within the boundary include:

(a) premiums (including premium adjustments and instalment premiums) from a policyholder and any additional cash flows that result from those premiums.

(b) payments to (or on behalf of) a policyholder, including claims that have already been reported but have not yet been paid (ie reported claims), incurred claims for events that have occurred but for which claims have not been reported and all future claims for which the entity has a substantive obligation (see paragraph 34).

(c) payments to (or on behalf of) a policyholder that vary depending on returns on underlying items.

(d) payments to (or on behalf of) a policyholder resulting from derivatives, for example, options and guarantees embedded in the contract, to the extent that those options and guarantees are not separated from the insurance contract (see paragraph 11(a)).

(e) an allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.

(f) claim handling costs (ie the costs the entity will incur in investigating, processing and resolving claims under existing insurance contracts, including legal and loss-adjusters' fees and internal costs of investigating claims and processing claim payments).

(g) costs the entity will incur in providing contractual benefits paid in kind.

(h) policy administration and maintenance costs, such as costs of premium billing and handling policy changes (for example, conversions and reinstatements). Such costs also include recurring commissions that are expected to be paid to intermediaries if a particular policyholder continues to pay the premiums within the boundary of the insurance contract.

(i) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or that can be attributed to them on a reasonable and consistent basis.

(j) payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder, and related receipts.

(k) potential cash inflows from recoveries (such as salvage and subrogation) on future claims covered by existing insurance contracts and, to the extent that they do not qualify for recognition as separate assets, potential cash inflows from recoveries on past claims.

(l) an allocation of fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent, and maintenance and utilities) directly attributable to fulfilling insurance contracts. Such overheads are allocated to groups of contracts using methods that are systematic and rational, and are consistently applied to all costs that have similar characteristics.

(m) any other costs specifically chargeable to the policyholder under the terms of the contract.

8 IFRS 17.B 98: The terms of some insurance contracts without direct participation features give an entity discretion over the cash flows to be paid to policyholders. A change in the discretionary cash flows is regarded as relating to future service, and accordingly adjusts the contractual service margin. To determine how to identify a change in discretionary cash flows, an entity shall specify at inception of the contract the basis on which it expects to determine its commitment under the contract; for example, based on a fixed interest rate, or on returns that vary based on specified asset returns.

9 IFRS 17.B 119: An amount of the contractual service margin for a group of insurance contracts is recognised in profit or loss in each period to reflect the services provided under the group of insurance contracts in that period (see paragraphs 44(e), 45(e) and 66(e)). The amount is determined by:

(a) identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage duration.

(b) allocating the contractual service margin at the end of the period (before recognising any amounts in profit or loss to reflect the services provided in the period) equally to each coverage unit provided in the current period and expected to be provided in the future.

(c) recognising in profit or loss the amount allocated to coverage units provided in the period.

10 IFRS 17.BC 222: The key service provided by insurance contracts is insurance coverage, but contracts may also provide investment-related or other services. The measurement of a group of insurance contracts at initial recognition includes a contractual service margin, which represents the margin the entity has charged for the services it provides in addition to bearing risk. The expected margin charged for bearing risk is represented by the risk adjustment for non-financial risk (see paragraphs BC206–BC214).

11 IFRS 17.BC 279: As discussed in paragraph BC21, the Board views the contractual service margin as depicting the unearned profit for coverage and other services provided over the coverage period. Insurance coverage is the defining service provided by insurance contracts. The Board noted that an entity provides this service over the whole of the coverage period, and not just when it incurs a claim. Consequently, IFRS 17 requires the contractual service margin to be recognised over the coverage period in a pattern that reflects the provision of coverage as required by the contract. To achieve this, the contractual service margin for a group of insurance contracts remaining (before any allocation) at the end of the reporting period is allocated over the coverage provided in the current period and expected remaining future coverage, on the basis of coverage units, reflecting the expected duration and quantity of benefits provided by contracts in the group. The Board considered whether:

(a) the contractual service margin should be allocated based on the pattern of expected cash flows or on the change in the risk adjustment for non-financial risk caused by the release of risk. However, the Board decided the pattern of expected cash flows and the release of the risk adjustment for non-financial risk are not relevant factors in determining the satisfaction of the performance obligation of the entity. They are already included in the measurement of the fulfilment cash flows and do not need to be considered in the allocation of the contractual service margin. Hence, the Board concluded that coverage units better reflect the provision of insurance coverage.

(b) the contractual service margin should be allocated before any adjustments made because of changes in fulfilment cash flows that relate to future service. However, the Board concluded that allocating the amount of the contractual service margin adjusted for the most up-to-date assumptions provides the most relevant information about the profit earned from service provided in the period and the profit to be earned in the future from future service.

12 IFRS 17.BC 280: The Board considered whether the allocation of the contractual service margin based on coverage units would result in profit being recognised too early for insurance contracts with fees determined based on the returns on underlying items. For such contracts, IFRS 17 requires the contractual service margin to be determined based on the total expected fee over the duration of

the contracts, including expectations of an increase in the fee because of an increase in underlying items arising from investment returns and additional policyholder contributions over time. The Board rejected the view that the allocation based on coverage units results in premature profit recognition. The Board noted that the investment component of such contracts is accounted for as part of the insurance contract only when the cash flows from the investment component and from insurance and other services are highly interrelated and hence cannot be accounted for as distinct components. In such circumstances, the entity provides multiple services in return for an expected fee based on the expected duration of contracts, and the Board concluded the entity should recognise that fee over the coverage period as the insurance services are provided, not when the returns on the underlying items occur.

1.2 TRG

13 TRG 2018-05 AP 5.38: […] The staff plan to recommend to the Board that it proposes a narrow amendment to IFRS 17 to modify the definition of coverage period for VFA contracts to clarify that it includes the period in which investment-related services are provided.

14 TRG 2018-05 AP 5.41: In contrast to the VFA, the staff observe the general model in IFRS 17 does not treat contracts as providing investment-related services. […]

15 TRG 2018-05 AP 5.42: […] IFRS 17 uses the scope of the VFA to identify insurance contracts that provide investment-related services as well as insurance services. For contracts outside the scope of the VFA, there is not a sufficient link between the amounts promised to policyholders and the returns on assets for the entity to receive a fee from the policyholder for investment-related services. Instead, the assets arising from the premiums received are the entity's assets that it manages on its own behalf. The amounts promised to policyholders other than insurance benefits (ie the investment components) are not related to service, but are instead a form of financial instrument. The difference between the investment income from the entity's assets and insurance finance expenses is presented as a finance result.

16 TRG 2018-05 Summary.39: Most TRG members disagreed that insurance contracts under the general model should be treated as providing only insurance services.

17 TRG 2019-04 Summary AP 1.7(a): […] an investment component is defined in Appendix A of IFRS 17 as the amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur. Paragraph BC34 of the Basis for Conclusions on IFRS 17 explains that an investment component is an amount that is paid to the policyholder in all circumstances. The staff noted the recommendation in Agenda Paper 2D Annual improvements for the April 2019 Board meeting that the **Board propose an annual improvement to that definition to better reflect the Board's intention and to include explicitly the requirement that an investment component is the amounts**

that an insurance contract requires the entity to repay to a policyholder *in all circumstances*.

1.3 Tentative Board's decisions

June 2018 meeting

18 IASB 2018-06 AP 2B § 9: The Board acknowledges that some insurance contracts provide services other than insurance coverage: paragraph BC222 of the Basis for Conclusions on IFRS 17 states 'The key service provided by insurance contracts is insurance coverage, but contracts may also provide investment-related or other services'. However, BC279 of the Basis for Conclusions on IFRS 17 observes 'Insurance coverage is the defining service provided by insurance contracts'. The focus in these statements on insurance coverage reflects the fact that contracts are in the scope of IFRS 17 because they provide insurance coverage.

19 IASB 2018-06 AP 2B § 10: In determining coverage units, IFRS 17 requires an entity to assess the services provided to the policyholder. For general model contracts, the Board decided that useful information is provided by recognising the contractual service margin in profit or loss over the period in which insurance coverage is provided. Not considering any other service avoids complexity and subjective or arbitrary allocations, and reflects the key service of insurance. The Board decided a different approach to reflect the effect of investment-related services was appropriate only for those contracts that fall within the scope of the variable fee approach (see discussion in paragraphs 13–16 of this paper).

20 Suggested amendments would be as follows:

21 IFRS 17.App A: coverage period: For insurance contracts without direct participation features ~~The~~ period during which the entity provides coverage for insured events. This period includes the coverage that relates to all premiums within the boundary of the insurance contract. For insurance contracts with direct participation features, the period during which the entity provides coverage for insured events or investment-related services. This period includes the coverage for insured events or investment-related services that relate~~s~~ to all premiums within the boundary of the insurance contract.

22 IFRS 17.B 119: An amount of the contractual service margin for a group of insurance contracts is recognised in profit or loss in each period to reflect the services provided under the group of insurance contracts in that period (see paragraphs 44(e), 45(e) and 66(e)). The amount is determined by:

(a) identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage period ~~duration~~.

January 2019 meeting

23 IASB 2019-01 AP 2E § 27: The staff think it is possible to justify the recognition of the contractual service margin over a period that includes the period in which the policyholder gets a return, even when this extends beyond the period when insurance coverage is provided, on the grounds that the entity is providing a service in that period. **The service is** not an asset management service because the entity is not managing assets on behalf of the policyholders. Rather it is **providing the policyholder with access to an investment return that would not otherwise be available to the policyholder because of the amounts invested, liquidity, complexity and expertise**. The staff use the term 'investment return service' for this service.

24 IASB 2019-01 AP 2E § 45: Some stakeholders have questioned whether the costs of managing assets that form underlying items for insurance contracts can be included in the fulfilment cash flows for the contracts, both for variable fee contracts and for general model contracts.

25 IASB 2019-01 AP 2E § 46: The staff observe that IFRS 17 includes in the fulfilment cash flows those cash flows that relate directly to the fulfilment of the contract, including an allocation of fixed and variable overheads directly attributable to fulfilling insurance contracts. For variable fee contracts, where the policyholder is regarded as investing in assets that the entity manages on its behalf, it follows that the asset management costs should be regarded as part of the costs of fulfilling the contracts. Hence, they will be included in the fulfilment cash flows. Further, the staff think that to the extent that an entity includes an investment return service for general model contracts in the determination of coverage units, it should also include cash flows related to the fulfilment of that service in the fulfilment cash flows.

26 The Board tentatively decided:

- a.to amend IFRS 17 so that in the general model the contractual service margin is recognised in profit or loss on the basis of coverage units that are determined by considering both insurance coverage and investment return service, if any;
- b.to amend IFRS 17 to establish that **an investment return service exists only when an insurance contract includes an investment component**;
- c.to amend IFRS 17 to require an entity to use judgement applied consistently in deciding whether an investment return service exists when determining coverage units, and not provide an objective or criteria for that determination. However, the Board instructed the staff to consider including in the Basis for Conclusions some of the analysis in the Board paper, to indicate what such judgements might involve;
- d.to amend IFRS 17 to establish that the period of investment return services should be regarded as ending when the entity has made all investment component payments to the policyholder of the contract and should not include any period of payments to future policyholders;
- e.to amend IFRS 17 to require assessments of the relative weighting of the benefits provided by insurance coverage and investment return services and their pattern of delivery to be made on a systematic and rational basis;
- f.to confirm that, applying IFRS 17, cash flows relating to fulfilling the investment return service are included in the measurement of the insurance contract;

- g.not to change the requirements of IFRS 17 relating to changes in fulfilment cash flows that adjust the contractual service margin in the general model; and
- h.to amend IFRS 17 to establish that the one-year eligibility criterion for the PAA should be assessed by considering insurance coverage and an investment return service, if any.

April 2019 meeting

27 IASB 2019-04 AP 2D § 11: Amendment to clarify the definition of an investment component. IFRS 17 defines an investment component as the amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur. Paragraph BC34 of the Basis for Conclusions on IFRS 17 explains that an investment component is an amount that is paid to the policyholder in all circumstances. That explanation is not entirely captured by the wording of the definition. For example, a contract may require the entity to pay an amount to the policyholder if the policyholder surrenders a contract during the coverage period. However, no amount is payable to the policyholder if the contract continues to the end of the coverage period without a claim being made. If the policyholder surrenders the contract, a payment is made even if an insured event does not occur. It was not the Board's intention that such a contract should be regarded as including an investment component. The recommended amendment clarifies the definition to achieve the Board's intention.

28 Suggested amendment to IFRS 17.App A: investment component: The amounts that an insurance contract requires the entity to repay to a policyholder ~~even if an insured event does not occur~~ in all circumstances..

1.4 Current understanding of the accounting treatment

29 The standard does not provide a definition of "coverage" or "investment return service".

30 The CSM for investment contracts is recognised over a period including the investment related service period. IFRS 17.71(c) explicitly mentions that investment contracts with discretionary participation features:

- shall recognise the contractual service margin over the duration of the group of contracts in a systematic way that reflects the transfer of investment services under the contract
- have "modified" requirements, as compared to the general model

31 The reference made to a "modification" to the general model highlights *a contrario* that such investment services might not be reflected in the general model.

32 Considering investment services in the allocation of the CSM in any kind of insurance contract is not explicitly precluded, but the point remains unclear (as acknowledged in the TRG 2018-05 AP 5 §38 referring to the last sentence of IFRS 17.BC 280 which can be read restrictively).

33 At its June 2018 meeting, the Board tentatively decided to clarify that the coverage period for VFA contracts includes periods in which the entity provides investment-related services. *A contrario* such periods would not be included in contracts under the general model.

34 In January 2019, IASB Board tentatively decided to amend IFRS 17 so that in the general model the contractual service margin is recognised in profit or loss on the basis of coverage units that are determined by considering both insurance coverage and investment-return service. An investment return service would only exist when the insurance contract includes an investment component.

35 In April 2019, IASB Board tentatively decided to clarify that an investment component is the amounts that an insurance contract requires the entity to repay to a policyholder in *all* circumstances.

2 Issue

2.1 VFA contracts are not the only ones to provide investment services

36 Investment-return services are not an accounting feature that is used for defining accounting types of insurance contracts in the standard. If participating contracts generally provide investment-return services, not all do.

37 Moreover investment services can be included in contracts with and without investment components and investment components can be repaid with or without being connected with investment services.

38 Examples of non-VFA contracts providing investment-return services have been mentioned in the EFRAG's case study:

- Contracts where premiums are held in an interest bearing deposit for an extended time before coverage commences (e.g. some forms of deferred annuities)
- Reinsurance contracts (currently not eligible to the VFA) where the underlying contracts are VFA contracts (e.g. Préfon).

39 The allocation period of the CSM should therefore be extended to the longest period including the investment phase. The latter may be prior (i.e. annuities) or after (life insurance with accumulated benefits) the insurance phase.

40 We therefore support the IASB's tentative decision to

- explicitly take into consideration "investment-related/return" services as well as the suggested definition;
- not restrict the consideration of such services to VFA contracts;
- not require a split of the CSM between those two components (that would otherwise have added another level of disaggregation in the current grouping requirements).

2.2 Existence of the service depending upon an "investment component"

41 In the March 2019 meeting, IASB tentatively restricted the existence of investment-return services when the insurance contract includes an "investment component". Furthermore, IASB has confirmed the definition of an investment component as being "the amounts that an insurance contract requires the entity to repay to a policyholder in all circumstances".

42 Based on the example of a deferred annuity that includes small or no investment component, following questions have been raised at EFRAG regarding the new requirements:

- When the insurance service is not (priced) the same if underwritten at the end of the accumulation period (compared with at inception), this demonstrates the time value progressively gained by the option offered to the survivors having initially contracted. Such an option could be considered as a genuine insurance service (if not as an investment service).
- Are costs incurred in managing the assets during the accumulation period belonging to the FCF (and then consistently recognised with the corresponding revenue)? IASB already acknowledged in its tentative decision in January 2019 (IASB 2019-01.AP 2E §45-46) that such costs belong to the FCF if VFA is applied or in the general model "to the extent that an entity includes an investment return service". More broadly, applying IFRS 17.B 65(m), wouldn't such costs belong to the FCF as long as they relate to a service provided (being investment return or insurance)?

3 Suggested solution (tentative)

3.1 Discussion

43 We suggest extending the definition of the coverage period in order to take into consideration investment-return services. Assuming such an extension, since IFSR 17.B 119 applies to all contracts, this should be sufficient, subject to a minor clarification, to extend the possibility to consider investment-return services for any contract and not only to VFA contracts.

44 Since "investment-return services" are not defined in the standard, there is a risk of limiting that feature to certain types of contracts. We therefore suggest making sure and clarifying such services are broadly understood, regardless of their IFRS 17 classification.

3.2 Suggested solution

45 IFRS 17.App A: **coverage period:** The period during which the entity provides coverage for insured events and/or investment-return services. This period includes the coverage that relates to all premiums within the boundary of the insurance contract.

46 IFRS 17.App A: **investment-return service:** is the service providing the policyholder with access to an investment return that would not otherwise be available to the policyholder because of the amounts invested, liquidity, complexity and expertise.

47 IFRS 17.B 119: An amount of the contractual service margin for a group of insurance contracts is recognised in profit or loss in each period to reflect the services provided under the group of insurance contracts in that period (see paragraphs 44(e), 45(e) and 66(e)). The amount is determined by:

(a) identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage for insured events and/or of investment-return services provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage period ~~duration~~.

IFRS 17 issues – Level of aggregation
Amended draft for discussion

1 Current IASB requirements and TRG conclusions

1.1 IFRS 17 requirements

1 IFRS 17.14: An entity shall identify portfolios of insurance contracts. A portfolio comprises contracts subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together. Contracts in different product lines (for example single premium fixed annuities compared with regular term life assurance) would not be expected to have similar risks and hence would be expected to be in different portfolios.

2 IFRS 17.15: Paragraphs 16–24 apply to insurance contracts issued. The requirements for the level of aggregation of reinsurance contracts held are set out in paragraph 61.

3 IFRS 17.16: An entity shall divide a portfolio of insurance contracts issued into a minimum of:

(a) a group of contracts that are onerous at initial recognition, if any;

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

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

4 IFRS 17.17: If an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group applying paragraph 16, it may measure the set of contracts to determine if the contracts are onerous (see paragraph 47) and assess the set of contracts to determine if the contracts have no significant possibility of becoming onerous subsequently (see paragraph 19). If the entity does not have reasonable and supportable information to conclude that a set of contracts will all be in the same group, it shall determine the group to which contracts belong by considering individual contracts.

5 IFRS 17.18: For contracts issued to which an entity applies the premium allocation approach (see paragraphs 53–59), the entity shall assume no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise. An entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently by assessing the likelihood of changes in applicable facts and circumstances.

6 IFRS 17.19: For contracts issued to which an entity does not apply the premium allocation approach (see paragraphs 53–59), an entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:

(a) based on the likelihood of changes in assumptions which, if they occurred, would result in the contracts becoming onerous.

(b) using information about estimates provided by the entity's internal reporting. Hence, in assessing whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:

(i) an entity shall not disregard information provided by its internal reporting about the effect of changes in assumptions on different contracts on the possibility of their becoming onerous; but

(ii) an entity is not required to gather additional information beyond that provided by the entity's internal reporting about the effect of changes in assumptions on different contracts.

7 IFRS 17.20: If, applying paragraphs 14–19, contracts within a portfolio would fall into different groups only because law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, the entity may include those contracts in the same group. The entity shall not apply this paragraph by analogy to other items.

8 IFRS 17.21: An entity is permitted to subdivide the groups described in paragraph 16. For example, an entity may choose to divide the portfolios into:

(a) more groups that are not onerous at initial recognition—if the entity's internal reporting provides information that distinguishes:

(i) different levels of profitability; or

(ii) different possibilities of contracts becoming onerous after initial recognition; and

(b) more than one group of contracts that are onerous at initial recognition—if the entity's internal reporting provides information at a more detailed level about the extent to which the contracts are onerous.

9 IFRS 17.22: An entity shall not include contracts issued more than one year apart in the same group. To achieve this, the entity shall, if necessary, further divide the groups described in paragraphs 16–21.

10 IFRS 17.23: A group of insurance contracts shall comprise a single contract if that is the result of applying paragraphs 14–22.

11 IFRS 17.24: An entity shall apply the recognition and measurement requirements of IFRS 17 to the groups of contracts issued determined by applying paragraphs 14-23. An entity shall establish the groups at initial recognition, and shall not reassess the composition of the groups subsequently. To measure a group of contracts, an entity may estimate the fulfilment cash flows at a higher level of aggregation than the group or portfolio, provided the entity is able to include the appropriate fulfilment cash flows in the measurement of the group, applying paragraphs 32(a), 40(a)(i) and 40(b), by allocating such estimates to groups of contracts.

12 IFRS 17.B37: The objective of estimating future cash flows is to determine the expected value, or probability-weighted mean, of the full range of possible outcomes, considering all reasonable and supportable information available at the reporting date without undue cost or effort. Reasonable and supportable information available at the reporting date without undue cost or effort includes information

about past events and current conditions, and forecasts of future conditions (see paragraph B41). Information available from an entity’s own information systems is considered to be available without undue cost or effort.

13 IFRS 17.B38: The starting point for an estimate of the cash flows is a range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome. The cash flows from each scenario are discounted and weighted by the estimated probability of that outcome to derive an expected present value. Consequently, the objective is not to develop a most likely outcome, or a more-likely-than-not outcome, for future cash flows.

14 IFRS 17.B39: When considering the full range of possible outcomes, the objective is to incorporate all reasonable and supportable information available without undue cost or effort in an unbiased way, rather than to identify every possible scenario. In practice, developing explicit scenarios is unnecessary if the resulting estimate is consistent with the measurement objective of considering all reasonable and supportable information available without undue cost or effort when determining the mean. For example, if an entity estimates that the probability distribution of outcomes is broadly consistent with a probability distribution that can be described completely with a small number of parameters, it will be sufficient to estimate the smaller number of parameters. Similarly, in some cases, relatively simple modelling may give an answer within an acceptable range of precision, without the need for many detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and may respond in a non-linear fashion to changes in economic conditions. This may happen if, for example, the cash flows reflect a series of interrelated options that are implicit or explicit. In such cases, more sophisticated stochastic modelling is likely to be necessary to satisfy the measurement objective.

15 IFRS 17.B40: The scenarios developed shall include unbiased estimates of the probability of catastrophic losses under existing contracts. Those scenarios exclude possible claims under possible future contracts.

16 IFRS 17.B41: An entity shall estimate the probabilities and amounts of future payments under existing contracts on the basis of information obtained including:

(a) information about claims already reported by policyholders.

(b) other information about the known or estimated characteristics of the insurance contracts.

(c) historical data about the entity’s own experience, supplemented when necessary with historical data from other sources. Historical data is adjusted to reflect current conditions, for example, if:

(i) the characteristics of the insured population differ (or will differ, for example, because of adverse selection) from those of the population that has been used as a basis for the historical data;

(ii) there are indications that historical trends will not continue, that new trends will emerge or that economic, demographic and other changes may affect the cash flows that arise from the existing insurance contracts; or

(iii) there have been changes in items such as underwriting procedures and claims management procedures that may affect the relevance of historical data to the insurance contracts.

(d) current price information, if available, for reinsurance contracts and other financial instruments (if any) covering similar risks, such as catastrophe bonds and weather derivatives, and recent market prices for transfers of insurance contracts. This information shall be adjusted to reflect the differences between the cash flows that arise from those reinsurance contracts or other financial instruments, and the cash flows that would arise as the entity fulfils the underlying contracts with the policyholder.

17 IFRS 17.B67: Some insurance contracts affect the cash flows to policyholders of other contracts by requiring:

(a) the policyholder to share with policyholders of other contracts the returns on the same specified pool of underlying items; and

(b) either:

(i) the policyholder to bear a reduction in their share of the returns on the underlying items because of payments to policyholders of other contracts that share in that pool, including payments arising under guarantees made to policyholders of those other contracts; or

(ii) policyholders of other contracts to bear a reduction in their share of returns on the underlying items because of payments to the policyholder, including payments arising from guarantees made to the policyholder.

18 IFRS 17.B68: Sometimes, such contracts will affect the cash flows to policyholders of contracts in other groups. The fulfilment cash flows of each group reflect the extent to which the contracts in the group cause the entity to be affected by expected cash flows, whether to policyholders in that group or to policyholders in another group. Hence the fulfilment cash flows for a group:

(a) include payments arising from the terms of existing contracts to policyholders of contracts in other groups, regardless of whether those payments are expected to be made to current or future policyholders; and

(b) exclude payments to policyholders in the group that, applying (a), have been included in the fulfilment cash flows of another group.

19 IFRS 17.B69: For example, to the extent that payments to policyholders in one group are reduced from a share in the returns on underlying items of CU350 to CU250 because of payments of a guaranteed amount to policyholders in another group, the fulfilment cash flows of the first group would include the payments of CU100 (ie would be CU350) and the fulfilment cash flows of the second group would exclude CU100 of the guaranteed amount.

20 IFRS 17.B70: Different practical approaches can be used to determine the fulfilment cash flows of groups of contracts that affect or are affected by cash flows to policyholders of contracts in other groups. In some cases, an entity might be able to identify the change in the underlying items and resulting change in the cash flows only at a higher level of aggregation than the groups. In such cases, the entity shall allocate the effect of the change in the underlying items to each group on a systematic and rational basis.

21 IFRS 17.B71: After all the coverage has been provided to the contracts in a group, the fulfilment cash flows may still include payments expected to be made to current policyholders in other groups or future policyholders. An entity is not required to continue to allocate such fulfilment cash flows to specific groups but can instead recognise and measure a liability for such fulfilment cash flows arising from all groups.

22 IFRS 17.B81: Alternatively, an entity may determine the appropriate discount rates for insurance contracts based on a yield curve that reflects the current market rates of return implicit in a fair value measurement of a reference portfolio of assets (a top-down approach). An entity shall adjust that yield curve to eliminate any factors that are not relevant to the insurance contracts, but is not required to adjust the yield curve for differences in liquidity characteristics of the insurance contracts and the reference portfolio.

23 IFRS 17.B 98: The terms of some insurance contracts without direct participation features give an entity discretion over the cash flows to be paid to policyholders. A change in the discretionary cash flows is regarded as relating to future service, and accordingly adjusts the contractual service margin. To determine how to identify a change in discretionary cash flows, an entity shall specify at inception of the contract the basis on which it expects to determine its commitment under the contract; for example, based on a fixed interest rate, or on returns that vary based on specified asset returns.

24 IFRS 17.B 104: The conditions in paragraph B101 ensure that insurance contracts with direct participation features are contracts under which the entity's obligation to the policyholder is the net of:

(a) the obligation to pay the policyholder an amount equal to the fair value of the underlying items; and

(b) a variable fee (see paragraphs B110–B118) that the entity will deduct from (a) in exchange for the future service provided by the insurance contract, comprising:

(i) the entity's share of the fair value of the underlying items; less

(ii) fulfilment cash flows that do not vary based on the returns on underlying items.

25 IFRS 17.B 112: Changes in the entity's share of the fair value of the underlying items (paragraph B104(b)(i)) relate to future service and adjust the contractual service margin, applying paragraph 45(b).

26 IFRS 17.B 119: B119 An amount of the contractual service margin for a group of insurance contracts is recognised in profit or loss in each period to reflect the services provided under the group of insurance

contracts in that period (see paragraphs 44(e), 45(e) and 66(e)). The amount is determined by:

(a) identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage duration.

(b) allocating the contractual service margin at the end of the period (before recognising any amounts in profit or loss to reflect the services provided in the period) equally to each coverage unit provided in the current period and expected to be provided in the future.

(c) recognising in profit or loss the amount allocated to coverage units provided in the period.

27 IFRS 17.BC 119: Once the Board had decided that the contractual service margin should be measured for a group, the Board considered what that group level should be. The Board considered whether it could draw on requirements for groups set by insurance regulators. However, as noted in paragraph BC15, regulatory requirements focus on solvency not on reporting financial performance. The decisions about grouping in IFRS 17 were driven by considerations about reporting profits and losses in appropriate reporting periods. For example, in some cases the entity issues two groups of insurance contracts expecting that, on average, the contracts in one group will be more profitable than the contracts in the other group. In such cases, the Board decided, in principle, there should be no offsetting between the two groups of insurance contracts because that offsetting could result in a loss of useful information. In particular, the Board noted that the less profitable group of contracts would have a lesser ability to withstand unfavourable changes in estimates and might become onerous before the more profitable group would do so. The Board regards information about onerous contracts as useful information about an entity's decisions on pricing contracts and about future cash flows, and wanted this information to be reported on a timely basis. The Board did not want this information to be obscured by offsetting onerous contracts in one group with profitable contracts in another.

28 IFRS 17.BC 120: The level of aggregation is also relevant to the recognition of the contractual service margin in profit or loss. Paragraph BC279 explains that, following the Board's principle for the allocation of the contractual service margin, an entity should systematically recognise the remaining contractual service margin in profit or loss over the current and remaining coverage period to reflect the remaining transfer of services to be provided by the insurance contracts.

29 IFRS 17.BC 121: In many cases, the coverage period of individual contracts in a group will differ from the average coverage period for the group. When this is the case, measuring the contracts on:

(a) an individual basis would mean that the contractual service margin associated with contracts with a shorter than average coverage period would be fully recognised in profit or loss over that shorter period;

(b) a group basis would mean that the contractual service margin associated with contracts with a shorter than average coverage period would not be fully recognised in profit or loss over that shorter period.

30 IFRS 17.BC 122: Thus, measuring the contracts as a group creates the risk that the contractual service margin for a group might fail to reflect the profit relating to the coverage remaining in the group, unless the entity tracked the allocation of the contractual service margin separately for groups of insurance contracts:

(a) that have similar expected profitability, on initial recognition, and for which the amount and timing of cash flows are expected to respond in similar ways to key drivers of risk. In principle, this condition would ensure the contractual service margin of a particularly profitable individual contract within a group is not carried forward after the individual contract has expired.

(b) that have coverage periods that were expected to end at a similar time. In principle, this condition would ensure the contractual service margin of an individual contract that expired was not carried forward after the contract had expired.

31 IFRS 17.BC 123: The Board concluded that it was necessary to strike a balance between the loss of information discussed in paragraphs BC119 and BC121–BC122, and the need for useful information about the insurance activity as discussed in paragraphs BC118 and BC120. The Board:

(a) did not want entities to depict one type of contract as cross-subsidised by a different type of contract, but also did not want to recognise losses for claims developing as expected within a group of similar contracts; and

(b) did not want the contractual service margin of an expired contract to exist as part of the average contractual service margin of a group long after the coverage provided by the contract ended, but also did not want to recognise a disproportionate amount of contractual service margin for contracts lapsing as expected within a group of similar contracts.

32 IFRS 17.BC 124: The Board concluded that the balance described above could be achieved in principle by:

(a) requiring contracts in a group to have future cash flows the entity expects will respond similarly in amount and timing to changes in key assumptions—meaning that losses on insurance contracts for one type of insurance risk would not be offset by gains on insurance contracts for a different type of risk, and would provide useful information about the performance of contracts insuring different types of risk.

(b) requiring contracts in a group to have similar expected profitability—meaning that loss-making contracts could not be grouped with profitable contracts, whether at initial recognition or if changes in conditions make a previously profitable group loss-making. Hence, such a requirement would provide information about loss-making groups of insurance contracts.

(c) requiring groups not be reassessed after initial recognition.

33 IFRS 17.BC 125: The Board also noted that, in principle, it would be possible to meet the objective of the recognition of the contractual service margin in profit or loss discussed in paragraph BC120 either by grouping only contracts with a similar size of contractual service margin and the same remaining coverage period, or by reflecting the different duration and profitability of the contracts within the group in the allocation of the contractual service margin.

34 IFRS 17.BC 130: To identify whether contracts (or sets of contracts) are onerous at initial recognition, an entity measures the contracts (or sets of contracts) applying the measurement requirements of IFRS 17. The Board decided that to assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently, an entity should use the information provided by its internal reporting system but need not gather additional information. The Board concluded that such information would provide a sufficient basis for making this assessment and that it would not be necessary to impose costs of gathering additional information. Some stakeholders nonetheless expressed the view that separating contracts that have no significant possibility of becoming onerous from other contracts that are not onerous was burdensome and unnecessary. The Board, however, concluded that in the absence of such a requirement, should the likelihood of losses increase, IFRS 17 would fail to require timely recognition of contracts that become onerous.

35 IFRS 17.B132: For groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholders:

(a) a systematic allocation for the finance income or expenses arising from the estimates of future cash flows can be determined in one of the following ways:

(i) using a rate that allocates the remaining revised expected finance income or expenses over the remaining duration of the group of contracts at a constant rate; or

(ii) for contracts that use a crediting rate to determine amounts due to the policyholders—using an allocation that is based on the amounts credited in the period and expected to be credited in future periods.

(b) a systematic allocation for the finance income or expenses arising from the risk adjustment for non-financial risk, if separately disaggregated from other changes in the risk adjustment for non-financial risk applying paragraph 81, is determined using an allocation consistent with that used for the allocation for the finance income or expenses arising from the future cash flows.

(c) a systematic allocation for the finance income or expenses arising from the contractual service margin is determined:

(i) for insurance contracts that do not have direct participation features, using the discount rates specified in paragraph B72(b); and

(ii) for insurance contracts with direct participation features, using an allocation consistent with that used for the allocation for the finance income or expenses arising from the future cash flows.

36 IFRS 17.B134: Paragraph 89 applies if an entity, either by choice or because it is required to, holds the underlying items for insurance contracts with direct participation features. If an entity chooses to disaggregate insurance finance income or expenses applying paragraph 89(b), it shall include in profit or loss expenses or income that exactly match the income or expenses included in profit or loss for the underlying items, resulting in the net of the two separately presented items being nil.

37 IFRS 17.BC 136: The Board noted that the decisions outlined in paragraph BC127 could lead to perpetual open portfolios. The Board was concerned that this could lead to a loss of information about the development of profitability over time, could result in the contractual service margin persisting beyond the duration of contacts in the group, and consequently could result in profits not being recognised in the correct periods. Consequently, in addition to dividing contracts into the groups specified in paragraph BC127, the Board decided to prohibit entities from including contracts issued more than one year apart in the same group. The Board observed that such grouping was important to ensure that trends in the profitability of a portfolio of contracts were reflected in the financial statements on a timely basis.

38 IFRS 17.BC 137: The Board considered whether there were any alternatives to using a one-year issuing period to constrain the duration of groups. However, the Board considered that any principle-based approach that satisfied the Board’s objective would require the reintroduction of a test for similar profitability, which as set out in paragraph BC126, was rejected as being operationally burdensome. The Board acknowledged that using a one-year issuing period was an operational simplification given for cost-benefit reasons.

39 IFRS 17.BC 138: The Board considered whether prohibiting groups from including contracts issued more than one year apart would create an artificial divide for contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group. Some stakeholders asserted that such a division would distort the reported result of those contracts and would be operationally burdensome. However, the Board concluded that applying the requirements of IFRS 17 to determine the fulfilment cash flows for groups of such contracts provides an appropriate depiction of the results of such contracts (see paragraphs BC171–BC174). The Board acknowledged that, for contracts that fully share risks, the groups together will give the same results as a single combined risk-sharing portfolio, and therefore considered whether IFRS 17 should give an exception to the requirement to restrict groups to include only contracts issued within one year. However, the Board concluded that setting the boundary for such an exception would add complexity to IFRS 17 and create the risk that the boundary would not be robust or appropriate in all circumstances. Hence, IFRS 17 does not include such an exception. Nonetheless, the Board noted that the requirements

specify the amounts to be reported, not the methodology to be used to arrive at those amounts. Therefore it may not be necessary for an entity to restrict groups in this way to achieve the same accounting outcome in some circumstances.

40 IFRS 17.BC 140: The Board considered whether an entity should recognise the obligations and associated benefits arising from a group of insurance contracts from the time at which it accepts risk. Doing so would be consistent with the aspects of IFRS 17 that focus on measuring the obligations accepted by the entity. However, such an approach would differ from that required for revenue contracts within the scope of IFRS 15, which focuses on measuring performance. Under IFRS 15, an entity recognises no rights or obligations until one party has performed under the contract. That model would be consistent with the aspects of IFRS 17 that focus on measuring performance.

41 IFRS 17.BC 162: However, it may be more difficult to decide the contract boundary if the contract binds one party more tightly than the other. For example:

(a) an entity may price a contract so that the premiums charged in early periods subsidise the premiums charged in later periods, even if the contract states that each premium relates to an equivalent period of coverage. This would be the case if the contract charges level premiums and the risks covered by the contract increase with time. The Board concluded that the premiums charged in later periods would be within the boundary of the contract because, after the first period of coverage, the policyholder has obtained something of value, namely the ability to continue coverage at a level price despite increasing risk.

(b) an insurance contract might bind the entity, but not the policyholder, by requiring the entity to continue to accept premiums and provide coverage but permitting the policyholder to stop paying premiums, although possibly incurring a penalty. In the Board’s view, the premiums the entity is required to accept and the resulting coverage it is required to provide fall within the boundary of the contract.

(c) an insurance contract may permit an entity to reprice the contract on the basis of general market experience (for example, mortality experience), without permitting the entity to reassess the individual policyholder’s risk profile (for example, the policyholder’s health). In this case, the insurance contract binds the entity by requiring it to provide the policyholder with something of value: continuing insurance coverage without the need to undergo underwriting again. Although the terms of the contract are such that the policyholder has a benefit in renewing the contract, and thus the entity expects that renewals will occur, the contract does not require the policyholder to renew the contract. The Board originally decided that ignoring the entity’s expectation of renewals would not reflect the economic circumstances created by the contract for the entity. Consequently, the Board originally proposed that if the entity can reprice an existing contract for general but not individual-specific changes in policyholders’ risk profiles, the cash flows resulting from the renewals repriced in this way lie within the boundaries of the existing contract.

42 IFRS 17.BC 171: Sometimes insurance contracts in one group affect the cash flows to policyholders of contracts in a different group. This effect is sometimes called 'mutualisation'. However, that term is used in practice to refer to a variety of effects, ranging from the effects of specific contractual terms to general risk diversification. Consequently, the Board decided not to use the term but instead to include in IFRS 17 requirements that ensure the fulfilment cash flows of any group are determined in a way that does not distort the contractual service margin, taking into account the extent to which the cash flows of different groups affect each other. Hence the fulfilment cash flows for a group:

(a) include payments arising from the terms of existing contracts to policyholders of contracts in other groups, regardless of whether those payments are expected to be made to current or future policyholders; and

(b) exclude payments to policyholders in the group that, applying (a), have been included in the fulfilment cash flows of another group.

43 IFRS 17.BC 173: The Board considered whether it was necessary to amend the requirements in IFRS 17 relating to the determination of the contractual service margin for insurance contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group. The Board concluded that it was not necessary because the fulfilment cash flows allocated to a group described in paragraph BC171 result in the contractual service margin of a group appropriately reflecting the future profit expected to be earned from the contracts in the group, including any expected effect on that future profit caused by other contracts.

44 IFRS 15.BC 295: However, many respondents to the 2010 and the 2011 Exposure Drafts disagreed with the onerous test and highlighted a number of practical application difficulties. Furthermore, many explained that strict application of the onerous test would have resulted in recognition of liabilities in cases in which the outcome of fulfilling a single performance obligation was onerous but the outcome of fulfilling the entire contract would be profitable. A number of respondents suggested removing the onerous test from the revenue proposals because, in addition to being complex and difficult to apply, the requirements for recognition of onerous losses are already sufficiently addressed in other Standards. Those respondents commented that:

(a) for IFRS, the onerous test in IAS 37 and the requirements in IAS 2 Inventories already provide sufficient guidance for determining when to recognise losses arising from contracts with customers.

(b) for US GAAP, existing requirements for recognition of losses from contracts are adequate and if a change to those requirements is necessary, that change could instead be handled in a separate project that addresses liabilities in Topic 450.

45 IFRS 15.BC 296: The boards agreed that existing requirements in both IFRS and US GAAP could adequately identify onerous contracts. Furthermore, the boards noted that although their existing requirements for onerous contracts are not identical, they are not

aware of any pressing practice issues resulting from the application of those existing requirements. Consequently, the boards decided that IFRS 15 should not include an onerous test. Instead, entities applying IFRS or US GAAP will use their respective existing requirements for the identification and measurement of onerous contracts.

46 IFRS 15.4: This standard specifies the accounting for an individual contract with a customer. However, as a practical expedient, an entity may apply this Standard to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this Standard to the portfolio would not differ materially from applying this Standard to the individual contracts (or performance obligations) within that portfolio. When accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

1.2 TRG

<u>TRG Staff analysis (2018-09 AP10)</u>

47 § 18: Contracts with policyholders that share in 100% of the returns on a pool of underlying items that includes the insurance contracts issued to those policyholders i.e. that fully share all risks, do not cause the entity to be ultimately affected by the expected cash flows of each individual contract issued. For those contracts, applying paragraph B68 of IFRS 17, the contractual service margin will be nil.

<u>TRG Conclusion (2018-09 Summary)</u>

48 § 40(d): when contracts share to a lesser extent [than 100%] in the return on a pool of underlying items consisting of the insurance contracts, an entity could be affected by the expected cash flows of each contract issued. Therefore, the contractual service margin of the groups of contracts may differ from the contractual service margin measured at a higher level, such as the portfolio level. To assess whether measuring the contractual service margin at a higher level would achieve the same accounting outcome as measuring the contractual service margin at an annual cohort level, an entity would need to determine what the effect would be of applying the requirements in IFRS 17. To be able to measure the contractual service margin at a higher level, the accounting outcome would need to be the same in all circumstances, i.e. regardless of how assumptions and experience develop over the life of the contract.

1.3 Tentative board's decisions

49 Issues relating to the level of aggregation have been discussed at the March 2019 IASB board meeting.

50 IASB 2019-03 AP 2A.17: On the other hand, measuring insurance contracts at too high a level of aggregation could obscure three types of information the Board regards as fundamentally important:

(a) trends in the entity's profits from insurance contracts over time (see example in paragraphs 18–19 of this paper);

(b) timely recognition of profit on profitable contracts so that all profit has been recognised by the end of the coverage period (see example in paragraphs 18–19 of this paper); and

(c) timely recognition of losses on onerous contracts (see example in paragraphs 20–21 of this paper).

51 IASB 2019-03 AP 2A.39: The allocation of the cash flows to the groups required by paragraphs B67–B71 of IFRS 17 prevents a group of contracts being onerous when the loss is borne by policyholders of other groups of contracts (column D in the table in paragraph 38 of this paper). But it does not average the profits of the two groups of contracts. Each group has its own separately determined contractual service margin which reflects the profit the entity makes from each group, after taking into account the extent to which the group supports or is supported by contracts in other groups.

52 IASB 2019-03 AP 2A.40. Some stakeholders think that determining the contractual service margin separately for each annual cohort does not provide useful information. They argue that because the returns on the underlying items are shared across policyholders in different

annual cohorts, the profit should be regarded as arising from the combined groups that share those returns (column E in the table in paragraph 38 of this paper).

53 IASB 2019-03 AP 2A.41. In contrast, the staff think that keeping the profit of the annual cohorts separate is necessary to avoid deferring the recognition of profit beyond the coverage period of a group and obscuring trends in profitability for an entity from its insurance contracts over time (see paragraphs 17(a) and 17(b) of this paper). In the example in Appendix A to this paper, using annual cohorts, the contractual service margin from the first group of contracts is considerably higher than from the second group of contracts. This appropriately depicts the entity's share of the higher fair value returns generated by the first group of contracts. The entity allocates the policyholders' share of fair value gain on the underlying items that arises in Year 1 between the policyholders in the two groups. But that does not mean that the entity's share of the fair value gain is not created by the contracts in Group 1.

1.4 Current understanding of the accounting treatment

Contracts grouping in order to track onerous contracts

54 IFRS 17 recognises the existence of portfolios of insurance contracts which comprise contracts subject to similar risks and managed together (IFRS 17.14).

55 For accounting purposes, portfolios must be divided into groups following two criteria:

- Onerous nature or not (IFRS 17.16),
- Annual cohorts (IFRS 17.22).

56 Even if it is suggested to create groups following IFRS 17.16 first then to subdivide them following IFRS 17.22, in practical terms it seems to be more appropriate to operate the other way around.

57 The annual cohorts requirement will generally be irrelevant for contracts eligible to the PAA, when their coverage period is of "one year or less" (IFRS 17.53(b)).

58 In order to apply the "onerous nature or not" criterion to divide portfolios when necessary, a first step is to investigate "sets of contracts" on the basis of reasonable and supportable information and conclude on their classification in one of the three relevant categories (onerous at initial recognition, no significant possibility of becoming onerous subsequently, other). If there is no reasonable and supportable information of a conclusive nature, the second step is to consider individual contracts. This way to proceed is a combination of a top-down approach (portfolio → "sets of contracts" → groups) and a bottom-up approach (individual contracts → groups) depending upon the quality of available information (IFRS 17.17).

59 In order to estimate fulfilment cash-flows, an entity may start from a higher level of aggregation than the group or portfolio, provided the allocation to each group is appropriate (IFRS 17.24).

Mutualisation

60 As explained in IFRS 17.BC 171, IASB decided not to refer to "mutualisation" since "that term is used in practice to refer to a variety of effects".

61 IFRS 17 however addresses some of these effects:

- (a) By acknowledging that "fulfilment cash flows may be estimated at a higher level of aggregation than the group or portfolio" (IFRS 17.24)
- (b) By introducing the concept of "contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group" also described as "cross-subsidisation" (IFRS 17.B67-.B70)
- (c) By considering the possibility of "contracts that fully share risks" (IFRS 17.BC 138)

Estimation of fulfilment cash flows at a higher level of aggregation

62 Opening the possibility of estimating fulfilment cash flows at a higher level of aggregation than the group of portfolio, the standard acknowledges that expected cash flows may not reliably or relevantly be determined at group or portfolio level but would rather result from a top-down pricing more efficiently set within a broader population.

Cross-subsidisation

63 IFRS 17.B68-B71 provides guidance on "contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group". No specific CSM provisions were required since the measurement at group level already "ensure[s] the fulfilment cash flows of any group are determined in a way that does not distort the contractual service margin, taking into account the extent to which the cash flows of different groups affect each other." (IFRS 17.BC 171 and .BC 173).

64 In addition, TRG staff has suggested that:

- IFRS 17.B70 allows for "allocating the effect of the change in the underlying items to each group on a systematic and rational basis" only when an entity cannot identify the change in the underlying items and resulting change in the cash flows at the level of aggregation of the groups but at a higher level.
- According to IFRS 17.B68 the extent to which the contracts in the group cause the entity to be affected by expected cash flows is reflected in the fulfilment cash flows of each group. In other words, the effect on the insurer (i.e. the CSM) has to be calculated at the level of each group, not at portfolio level.

Fully shared risks

65 When mentioning "contracts that fully share risks", IFRS 17.BC 138 (i) acknowledges that "the groups together will give the same results as a single combined risk-sharing portfolio" and (ii) notes that the requirements specify the amounts to be reported, not the methodology to be used to arrive at those amounts. In other words, the standard acknowledges that the level of aggregation proves unnecessary when contracts "fully share risks".

66 TRG staff has illustrated a very specific situation where "all risks are fully shared" since it does "not cause the entity to be ultimately affected by the expected cash flows of each individual contract issued", i.e. where the "contractual service margin will be nil". TRG did not agree on a definition of "full risk sharing".

67 In addition, TRG staff has suggested that, according to the standard, the annual cohort requirement applies except when not necessary to achieve exactly the same outcome. "Exact" meaning that the same outcome is expected at inception and achieved whatever happens.

<u>Reflecting performance and mutualisation with annual cohorts</u>

68 Notice can be taken that there is no "inception" *per se* for an annual cohort because it builds up during the one year period.

69 IASB 2019-03 AP 2A.17 recalls the 3 informative objectives set to annual cohorts in the bases for conclusions:

- Objective 1: Ensuring that onerous contract are immediately recognised in the P&L (BC 119 and BC 136);
- Objective 2: (i) Ensuring a “correct” allocation of the margin (CSM) during the contract (BC 120) and (ii) prohibiting open portfolios in order to ensure that the CSM is not allocated beyond the longest contract within the group (BC 123(b) and BC 136);
- Objective 3: Providing information on “trends in the profitability of a portfolio” (BC 136).

Analysis and comments on the examples

70 AP 10 of TRG 2018-09 §A4 (example 1) and §A11 (Example 2) mention that “claims incurred in group 1 amount to 4,000”. IFRS 17.32(a)(i) states that the fulfilment cash flows are measured at inception considering estimates of future cash flows, not actual ones. Consequently, the very specific assumption retained by the staff, that all claims were originally expected to happen solely on group 1 cannot be considered. Rather, absent any other information, it should be assumed that all contracts in the portfolio are exposed to the same risk and that therefore the risk of claim is evenly allocated on all contracts/groups within the portfolio. Consequently, the CSM, measured at portfolio level (600) could be evenly allocated to each of the 10 groups (i.e. 60). Other allocations methods may also be considered.

71 The conclusions of the IASB Staff on the example discussed in IASB 2019-03 AP 2A.39-40 are discussed in § 2.3.

2 Issue

2.1 Insurance business model and mutualisation

<u>Managing insurance risks in portfolios</u>

72 The insurance business model is based upon grouping contracts in portfolios in order to manage the (insurance and financial) risks. The law of large numbers provides insurers with a more reliable assessment of the probability and distribution of risks and therefore enables an appropriate risk management and pricing. Putting together risks within a portfolio enables this assessment and management, but does not in itself eliminate risks.

73 When managing similar risks together in a portfolio:

- The starting point for segregation is the “product line” level;
- The risk is considered from the standpoint of the insurer rather than from the standpoint of the policyholder;
- Additional guarantees generally belong to the same risk if not sold separately. For instance, loan insurance mainly provides death insurance coverage, i.e. indemnify the borrower in case of death. Additional optional coverages (such as job-loss) belong to the same risk and have not to be separately addressed.

74 The nature of risks in a portfolio priced and managed as such shall not be confused with the pattern or distribution of the occurrence of that risk within the population. In other words, the existence of drivers of the probability that a risk happens does not create a specific risk that would require dividing further the portfolio (except if actually not managed together). Accordingly, a portfolio has not to be further disaggregated, for instance:

- because of the age of a policyholder, even if the age is a factor increasing the probability that a risk happens (it changes the distribution of the risk, not its nature);
- Similarly, different durations are not in themselves a separate risk that would require being isolated.

75 Managing the risks, an insurer may:

- Organise a mutualisation by sharing risks among policyholders and generations,
- Hedge financial risk by investing in appropriate financial assets,
- Hedge insurance risk by transferring risks to a third party (through reinsurance or derivatives),
- Diversify its risk exposure in having different portfolios and activities.

<u>Mutualisation and risk sharing</u>

76 “Mutualisation” may be defined as the risk transfer accepted by a policyholder when he or she joins a defined population of policyholders the boundary of which is defined by the contract proposed by the insurer. The premium may be different from one policyholder to another because of certain characteristics of each policyholder (which may lead to introduce, within a single population of policyholders, different levels of risk intensity) and may also be adjusted from time to time on the basis of experience (in accordance with contractual terms), but once – and as long as – having joined the population on the agreed upon premium basis, each policyholder benefits from the same guarantees. This definition of “mutualisation” reflects what is happening in practice and also the policyholders’ understanding and acceptance of such practice.

77 Minimum financial guarantee may be offered to certain policyholders. Note that such guarantees are rare in our jurisdiction on current life insurance contracts in a context of low interest rate, except as a “zero-floor”. In a mutualised population, minimum financial guarantees granted to certain but not all policyholders represent a concentration of financial risks to be considered when assessing the profitability of the population taken as a whole. However, it does not, in itself, prevent from mutualising or sharing risks within that population.

78 Organising the mutualisation among policyholders is the primary goal of insurance activity. However, the insurer bears the risk that, ultimately, costs may exceed revenues so that the portfolio becomes onerous and that he will have to bear the loss (for instance in an investment contract with guaranteed participation features exceeding returns). Mutualisation therefore does not exclude sharing policyholders’ risks with the insurer who offers a second level of protection: if the organised mutualisation at policyholders’ level is not sufficient, the insurer will have to fill the gap.

Risks and returns to be shared

79 Insurance contracts may share risks and returns of two natures: a financial one and a “technical” one. The technical risks and results relate to any non-financial change in the insurance commitment, e.g. changes in biometric assumptions.

80 Both components are referred to as the “underlying items” in IFRS 17, among which the financial part mainly relates to the underlying assets whereas the technical part mainly relates to other changes in the insurance liability itself.

81 Participating contracts may share the returns in the underlying assets but not in insurance risk (e.g. risk of mortality). In other words, a death coverage (e.g. where one get paid out twice the premium) may be (i) funded in the contracts, i.e. taken from the underlying fund or (ii) paid by the insurer. For instance “Universal Life” policies share in the financial risk but not in the technical one (which is supported by the insurer only). In other policies, policyholders may share not only the financial result but also the technical result.

82 Changing its pricing or trying to expand its market share in a particular year, an entity may create a specific risk in that year. Mutualisation in such a case is where the additional risk created in a year is shared with other policyholders or other periods, i.e. the entity is not taking additional risk because that risk is actually carried by the other policyholders.

83 Changes in the underlying items of a mutualised group of contracts might be profitable on the underlying asset but onerous on the underlying liabilities (or the other way around). However from a contractual as well as from an accounting point of view, there is actually no such distinction within the CSM as if transfers between financial and technical sides exist until there is no capacity left in the mutualised portfolio to face those obligations and the insurer has to fill the gap. The latter situation would lead to a decrease in the entity’s share in the return (CSM) or even to onerous contracts (all contracts in the portfolio would then become onerous).

Types of mutualisation

84 Mutualisation is a core feature of the insurance business, which is actually to organise the solidarity of policyholders against the emergence of an adverse event.

85 One may distinguish two types of mutualisation:

- Mutualisation by tariff: based on the law of large numbers, the insurer assesses the probability of occurrence of a risk within a population and shares *ex ante* the costs of that risk among policyholders through a pricing factoring the key drivers of risk. Mutualisation by tariff is a mutualisation since each policyholder pays a premium without knowing who will eventually benefit from it, but knowing that, thanks to this premium and the premiums of the other policyholders, the insurer will be in a situation to indemnify future claims (examples: life insurance risk within loan insurance).

- Mutualisation by cross-subsidisation: in addition to the mutualisation by tariff, a cross-subsidisation mechanism is contractually organised in order to allocate expected and unexpected cash-flows among policyholders and possibly among generations (example: mutual funds, life insurance with participating features).

Where both mutualisation mechanisms are not sufficient to cover risks and contractual commitments, the insurer provides for the difference (§ 78).

Correlation of risk and pricing; definition of onerous

86 The occurrence of an expected risk in a contract does not make the individual contract “onerous”.

87 A transaction is onerous for the insurer when the pricing does not sufficiently cover the insured risk. This may happen (i) at inception if the pricing does not reflect the expected distribution of risks within a portfolio in order to ensure a proper margin or (ii) when risks evolve in an unexpected manner and when the insurer has to bear a loss as a consequence (§ 78).

88 Conversely, as long as adding contracts eventually contributes to increasing the entity’s share in the returns of the underlying assets, that new business is not onerous. This is the case even if these added contracts need transfers from other group of contracts to meet the contractual commitments of the insurer against its policyholders. This situation is illustrated in Example 1 § 184.

89 In a population where policyholders accept to share risks, a contract does not become onerous (for the insurer) before the cross-subsidisation among policyholders is not sufficient to cover the risks, so that the insurer is eventually exposed to a loss. There is no “onerous” contract in a mutualised population except if the whole population becomes onerous.

90 When the risk evolves with age, an insurer generally reflects this evolution in the pricing. He may however also decide not to reflect such changes but instead offer the same pricing along the duration of the coverage. A policyholder would accept a steady rate, i.e. to pay more in the first years (when the risk for the insurer is lower) if he gets a lower rate in the future. Such pricing mechanism may lead to group together policyholders currently having different risks priced the same. Steady pricing reflects levelling the risk distribution for one policyholder over the coverage period and is distinct from (but not contrary to) mutualising risks with several policyholders in a defined population.

Consistency with IFRS 15

91 A portfolio approach is also possible under IFRS 15.4. as a practical expedient and not for identifying onerous contracts. The onerous test has been removed from IFRS 15 mainly because it “would have resulted in recognition of liabilities in cases in which the outcome of fulfilling a single performance obligation was onerous but the outcome of fulfilling the entire contract would be profitable” (IFRS 15.BC 295-296).

92 In addition, the same argument could apply to IFRS 15 contracts where the selling price is unique (i.e. electricity or telecom distribution with unique price across a territory) but service costs vary depending on the customer (i.e. risks/costs significantly differ from one area to the other).

93 Finally, there are similarities between the situation of a single obligation in an IFRS 15 contract and the situation of a single contract/group in an IFRS 17 portfolio where groups and contracts are mutualised.

2.2 Issue 1: Underwriting policies and contracts grouping

94 The way insurers organise mutualised populations is a highly sensitive feature of insurance markets since it reflects and also shapes up a level of "social/societal" understanding of what is covered by insurance and what is left to the direct responsibility of the individual (natural or moral person). In this context the coherence and consistency of pricing and detailed coverage policies is a key element of stability and decision making for individuals and businesses in the development of their respective activities.

95 The perimeter of mutualised populations and the terms and conditions offered to them by insurers are the outcome of very long term evolutions and decisions reflecting fundamental choices made at the level of the society as a whole (explicitly via regulations, semi-explicitly when practices reflect or influence changes in behaviour). In many cases, the strategy of insurers is heavily influenced by a prevailing insurance environment (or culture) the evolution of which requires extensive debates.

96 Modifying the perimeter of mutualised populations for accounting purposes only may lead to unintended changes in the way insurers cover insurance risks. There is a significant difference between (i) reflecting, via accounting treatments, a slow and complex evolution of the insurance coverage system and (ii) introducing accounting treatments which may directly influence the way the insurance coverage system is organised. For instance, additional granularity as compared to the current understanding is a "social/societal" risk of reducing the current and accepted level of mutualisation, since insurers would have to reduce the risk to have onerous groups the loss of which is today covered by mutualisation and which would have to be borne tomorrow day one. The terms and conditions, including pricing, of the insurance coverage would probably be affected as a consequence.

2.3 Issue 2: Reflecting performance and mutualisation with or without annual cohorts

Recognition of onerous groups when the contracts' cash flows affect or are affected by cash flows to policyholders of other contracts
[IASB 2019-03 AP 2A.37-38]

97 We concur with the analysis laid down in § 38 of the March 2019 agenda paper 2A that when the contracts' cash flows affect or are affected by cash flows to policyholders of other contracts, IFRS 17 allows reflecting the intergenerational sharing of returns between cohorts.

Concept of "fair value returns"

98 The example of agenda paper 2A considers contracts whereby the policyholders receive 80% of the "fair value returns" from the underlying pool of assets with the entity having discretion over the timing and allocation across policyholders.

99 It is noteworthy that the examples about the level of aggregation (see 4.Appendix 1: Example 1 and 5.Appendix 2: Example 2) consider contracts whereby the contractual minimum participation to policyholders is determined based on the "historical cost measurement" returns (i.e. measured based on historical costs in the statutory

accounts) as required legally & contractually in the main European countries (see also § 4.8).

100 Accordingly, considering the theoretical case where all policyholders of a cohort would surrender their insurance contract at the same time, the leaving policyholders waive their right to possibly benefit from the unrealised accumulated changes in fair value of the underlying assets.

101 This does however not preclude that 80% of the fair value returns are paid to policyholders but nonetheless also depends on the discretionary assumptions / decisions made by management.

<u>Are the fair value changes of shared underlying items created by a group?</u>
<u>[IASB 2019-03 AP 2A.41]</u>

102 IASB 2019-03 AP 2A.41 concludes that the increase in the entity's share in the fair value returns is *created* by the group of contracts (G 1 in the example).

103 In a mutualised pool of underlying items, the entity's share in the fair value of the underlying items stems from the overall portfolio, which includes all the items acquired from investing the premiums collected from all policyholders. As a consequence, there is no contractual link between any subset of the portfolio of underlying items and a group of contracts. Those underlying items belong to the community of policyholders without any group having individual rights on any subset of the overall portfolio. This is also illustrated by the fact that an insurer may decide to use the premiums received from the new business to indemnify the lapse of policyholders instead of selling assets.

104 For the purpose of measuring the CSM, IFRS 17.B 101(b)(i) and .B 112 implicitly require allocating the entity's share of the fair value of the underlying items to groups of contracts. However, this does not mean that the fair value returns are *created* by the groups.

105 Whenever a change in interest rate takes place when two or more cohorts already exist, the fair value gain from the pool of underlying items has to be allocated to the groups. We have analysed that effect in example 2 (see Appendix 2 § 268-269).

106 In fact, considering that a change in the fair value of the assets acquired with the premium paid by a group solely belongs to this group would be equivalent to considering that the underlying items are ring-fenced on a cohort by cohort basis. This conclusion is contrary to the example's assumption that the returns on the underlying assets are shared between the groups.

107 In the example of agenda paper 2A, we do not think that the entity's share in the fair value of the underlying items is created by G 1 and should consequently be recognised over the coverage period of G 1 only. Instead, we believe that the entity's share of the fair value of the underlying items has been allocated to G 1 for measurement purpose but contractually stems from all policyholders taking into consideration the contractual intergenerational mutualisation.

108 Furthermore, as mentioned during the Board's discussion, we would like to highlight the operational complexity of applying IFRS 17 to such contracts as IFRS 17.B 68:

- allows taking into account the fulfilment cash flows (FCF) allocated to groups of contracts already written (G 1 in the example) for the determination of the CSM of a newly underwritten cohort (G 2);
- but does not reflect how FCF are expected to be allocated *between* the groups.

109 IFRS 17 implicitly requires tracking the part of the FCF included in the measurement of G 1, which will ultimately be paid to G 2. This therefore results in an artificial

division of the FCF allocated to the groups into layers (depending on the group to which the payment is expected to be made) that *de facto* creates an additional level of disaggregation contradicting the objective of “an operational simplification given for cost benefit reasons” as highlighted in IFRS 17.BC137.

110 For instance in the Example 2 hereafter, from year Y+1 to Y+3 (see Appendix 2 § 267 and § 276) the FCF of G 1 allocated to G 2 reflect the crediting rate of 4.1 % determined before the issuance of G 2 (i.e. expected final payments of 12 272, see Appendix 2 § 253) even though the entity’s expectation fell down to 3 % from year Y+1 onward.

<u>Does tracking the entity’s share of the underlying item at group level provide meaningful information?</u>
<u>[IASB 2019-03 AP 2A.43]</u>

111 The example addresses the case where, in a context of low interest rates, the entity receives from newly issued G 2 contracts an initial premium that is sufficient to serve the contractual minimum of 80 % of the return from the underlying pool of assets.

112 Applying paragraph 41 of the March 2019 agenda paper 2A, the entity’s share of the fair value of the underlying items is allocated to each group under the assumption that :

113 (i) insurance contracts are issued under current market conditions (regardless of the decision taken by the entity on previous groups) and

114 (ii) the underlying items purchased by investing the premium from the groups are segregated into ring-fenced fund backing specifically each group.

115 Arguably, this provides information as to whether adding such new business increases the overall share of the entity in the underlying pool of asset. However, the assumptions underlying such a calculation are contrary to the ones retained in the example, which assume mutualisation. And in fact, immediately after having been issued, G 2 is part of the mutualisation and the initial information provided by that CSM becomes obsolete.

116 Applying IFRS 17.B 68, the calculation of the CSM of G 2 is largely arbitrary as it depends on the amounts of discretionary cash flows initially assigned to G 1. We have described that effect in example 2 (see Appendix 2 § 261-263 and § 299-302). This highlights that the entity’s share in the fair value returns allocated to G 2 depends on discretionary assumptions made in the periods *before* issuing G 2.

117 In addition, any change in the market rate or in the return rate to policyholders has to be allocated between the groups on a discretionary way that is not necessarily related with the original expected entity’s share of the fair value returns (i.e. before mutualisation) of each group (see Appendix 2 § 268-269). Accordingly, even if the initial CSM of G 2 were deemed valuable, it becomes obsolete after initial recognition because of the discretion left with regards to the allocation of subsequent changes in discretionary estimates.

118 In that context, we are struggling with the supposed informative value of the CSM of G 2 *alone* which appears largely artificial. Thus, we do not concur with the statement (IASB 2019-03 AP 2A.43) that removing the distinction of the CSM of both groups in that context “would lead to an unacceptable loss of useful information”. We believe that, under these circumstances, the only relevant information about profitability is the cumulative CSM for both groups.

119 The CSM represents the expected profit to be recognised when the service will be rendered. It therefore relates to the evolution of groups (including upcoming new

cohorts) rather than to initial conditions ignoring the other groups it is supposed to be mutualised with.

Are separate annual cohorts necessary to prevent the CSM from being spread over a longer period than originally assessed?
[IASB 2019-03 AP 2A.41 and .45]

120 We concur with the objective set by the board to ensure that the allocation of the CSM in the P&L cannot be indefinitely postponed. We however do not consider that separate annual cohorts are necessary to achieve this goal.

121 The Example 2 shows (see Appendix 2 § 264 and 302) that by taking into account FCF from G 1 to G 2, the entity *duly* postpones a portion of G 1 CSM in a period that exceeds the initial G 1 coverage period. This is evidenced by a slight increase in the CSM due to the accretion effect by one year on that deferred part.

122 Further, we consider that adding new business to an existing group (in-Force) does not extend the portfolio duration indefinitely or make it "perpetual" since cash-flows attributable to the policyholders and the entity are permanently added and consumed. This mechanism is better and sufficiently reflected by the coverage units.

123 Therefore, we do not concur with the statement (IASB 2019-03 AP 2A.41 and .45) that "keeping the profit of the annual cohort separate is necessary to avoid deferring the recognition of profit beyond the coverage period of a group".

Overall conclusion

124 Current IFRS 17 provisions (and especially IFRS 17.B67-B71) make it possible to reflect the intergenerational mutualisation, even if removing cohorts would probably better reflect the business practice as well as the contractual and legal situation.

125 Adding annual cohort in that context is however a very burdensome route to follow with no conceptual substance. The additional information provided does not prove to be useful but artificial.

126 In our view, such case has already been addressed by the board, as mentioned in IFRS 17.BC 138. We therefore suggest crystallising that exception in an amendment to annual cohorts in that specific context (see § 3.1).

2.4 Issue 3: Improving information provided to users

Users' expectations

127 IASB explains that investors expects from the Insurance standard to provide information on (i) specific risks taken in a year as well as on (ii) trends in the profitability (i.e. whether new business is less or more profitable than the old one).

Limits of annual cohorts in providing such information

128 According to IASB annual cohorts provide a series of discrete yearly data that help analysing profitability trends.

129 Annual cohort is a unit of account for measuring and allocating the CSM, but does not lead to readable information separately presented or disclosed for users.

130 There is indeed limited evidence about the usefulness of the information provided by annual cohorts to users, as reported in an EFRAG's user outreach that rather refers to annual cohorts as a concern.

Merits of embedded value in providing the expected information

131 Users are generally interested in the effects of new business on in-force contracts, as referred to in the market consistent embedded value reports.

132 An analysis of the impact (contribution or dilution) of newcomers (new business) on an existing mutualised portfolio (In-force) is usual and represents very useful information since it clearly indicates business profitability trends. By contrast, identifying which of the former generations of policyholders is actually "subsidising" a new coming one, or the other way around, is not usual and the information usefulness is questionable in particular if groups are numerous on the basis of a very granular approach to contracts grouping.

133 There is a large practice of listed life-insurers in Europe (and a large support of users) on the performance content of information on the "embedded value". The financial communication on the embedded value is notably based on an analysis of in-force and new business. It generally provides for a reconciliation with IFRS financial statements over several periods of time, providing useful information on profitability trends.

3 Suggested solution (tentative)

134 The analysis of current provisions in the standard and their adequacy to the insurance business model leads to suggest addressing the following two concerns:

- Underwriting policies and contracts grouping:
  The relevance of subdividing a mutualised population at a level that does not reflect the insurer's underwriting policy and the policyholders' understanding and acceptance raises concerns regarding the onerous test. Current provisions in the standard may prove sufficient but a clarification may facilitate the implementation.
- Reflecting performance and mutualisation with annual cohorts:
  An exception to the application of annual cohorts should be considered when (as acknowledged by IFRS 17.BC 138) contracts fully share risks, so that "the groups together will give the same results as a single combined risk-sharing portfolio". The field test has demonstrated that applying annual cohorts in the case of intergenerational risk-sharing (mutualisation) is not conceptually necessary, does not provide useful information and adds complexity and costs. The concept of "fully shared risks" has to be defined in a broader way than contemplated by TRG staff (and rejected by TRG members) in order to address, for instance, life contracts with direct participation features where policyholders share financial and insurance risks. Limiting the use of the concept of "fully shared risks" to contracts where the CSM is nil or cannot be affected does not reflect reality.

3.1 Suggested modifications to the standard related to "fully shared risks" and annual cohorts

General

135 We suggest exempting applying annual cohorts where insurance and financial risks are fully shared among the generations of policyholders. A definition of "fully shared risk" has to be added in the standard.

136 Limiting the exception to VFA contracts may prove efficient. But on the one hand it potentially leaves out reinsurance contracts under the general model, and on the other hand it may improperly embed non mutualised VFA contracts.

137 As mentioned above, where "risks are fully shared", a contract or group may not become onerous until the whole portfolio is.

Suggested definition of "fully shared risks"

138 Contracts where "risks are fully shared" are referred to in the extreme situation presented in the TRG where cash flows are 100% shared among policyholders so that the insurer's share in the risks and returns is nil.

139 This feature is however not limited to that extreme scenario but should also be considered when:

- the existence of an insurer's share in the risks or in the returns on underlying items of a mutualised population of policyholders does not prevent from having first a genuine mutualisation (full risk sharing) among policyholders (see § 78);
- the existence of specific guarantees granted to certain policyholders, concentrating risks or returns on the underlying items on certain contracts, does not prevent from having also a genuine mutualisation (full risk sharing) among policyholders (see § 77).

140 Some suggested that in a portfolio where “risks are fully shared” among policyholders, the insurer’s share should remain stable (i.e. 10%) rather than being nil. This may actually address many situations but would not be sufficient. The key criterion is in fact the onerous nature or not of the group of contracts: a population actually becomes onerous when the insurer’s share in the risks increases to a point where the insurer is making or contemplating a loss.

141 We therefore suggest defining that risks are “fully shared” among policyholders when “policyholders share a significant amount of the financial returns and of the insurance risks across generations so that no set of contract within the group could possibly become onerous (alone)”. With regards to the classification referred to previously (§ 61), it is equivalent to a comprehensive cross-subsidisation scenario or to a broad definition of risk sharing.

Suggested modifications

142 IFRS 17.22: An entity shall not include contracts issued more than one year apart in the same group. This provision does not apply to contracts belonging to a portfolio where insurance and financial risks are fully shared among generations of policyholders. Risks are fully shared among policyholders when policyholders share a significant amount of the financial returns and of the insurance risks across generations so that no set of contract within the group could possibly become onerous alone. […]

3.2 Suggested clarification regarding contracts grouping and underwriting policies

General

143 The relevance of subdividing a mutualised population at a level that does not reflect the insurer’s underwriting policy and the policyholders’ understanding and acceptance raises concerns regarding the onerous test. These concerns may depend upon the accounting model used (PAA or general model).

Onerous test under the PAA

144 Under the PAA, IFRS 17.18 applies: rebuttable presumption that “no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise”. Similar presumption assessing whether contracts have “significant possibility of becoming onerous subsequently by assessing the likelihood of changes in applicable facts and circumstances.” The standard does not provide for a definition of facts and circumstances.

Onerous test under the general model

145 Under the general model, the “onerous test” has to be performed at inception (IFRS 17.16) and subsequently (IFRS 17.19). Applying IFRS 17.17 the test is first performed for “a set of contracts”. The standard does not provide a precise definition of “a set of contracts” but indicates its classification depends upon “reasonable and supportable information”.

146 IFRS 17.33 and IFRS 17.37 provide information on the level of details required for performing an assessment of the expected cash-flows which may help setting the scope of the onerous testing. In order to make that assessment, the entity has to “incorporate, in an unbiased way, all reasonable and supportable information available without undue cost or effort”. The concept of “undue cost or effort” is further detailed in IFRS 17.B36-B41. It is mentioned that “information available from an entity’s own information systems is considered to be available without undue cost or effort”. In providing this guidance, the standard does not refer to the relevance of the

information, assuming there is no criterion for limiting drilling down to the lowest level of granularity (the contract).

147 Applying IFRS 17.33 and IFRS 17.37 for identifying “onerous” sets of contracts may eventually leads to performing the assessment at contract level and hence prove contrary to the top-down approach introduced by IFRS 17.17. As a matter of fact, the more detailed the available information would be, the lower the level of granularity of a “set of contracts” for onerous test purpose could be, disregarding the relevance and usefulness of such information, and only considering the cost of gathering it (not even the cost of using this information for setting the level of aggregation).

148 In order to prevent applying the “onerous test” at the same level of granularity as the level required for defining expected cash-flows requires clarifying what could be the “reasonable and supportable information” referred to in IFRS 17.17.

149 For instance, assuming the relevant information for users being related to the profitability of contracts, it could be assumed that the granularity should not be lower than the one used for pricing policy, whereas regarding expected cash-flows, the standard refers to “any information system” that may encompass very detailed information. Profitability finally results from the pricing policy set by management and therefore also reflects (i) the exposure to risks at a level considered relevant by management as well as (ii) the pricing mutualisation organised by management.

150 Introducing a linkage with the pricing policy may also have the merit to converge the onerous concept under IFRS 17 to the one applied in other standards such as IFRS 15 (see § 92-93).

<u>Suggested amendment for clarification purposes</u>

151 The following solution may be contemplated: relating the top down approach to the existence of a defined population with defined terms and conditions.

152 IFRS 17.17 could therefore be amended as follows for clarification purposes:

153 IFRS 17.17: If an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group applying paragraph 16, it may measure the set of contracts to determine if the contracts are onerous (see paragraph 47) and assess the set of contracts to determine if the contracts have no significant possibility of becoming onerous subsequently (see paragraph 19). <u>Such measurement shall take into account the terms and conditions of the insurance coverage organised by the entity and offered to the policyholders.</u> If the entity does not have reasonable and supportable information to conclude that a set of contracts will all be in the same group, it shall determine the group to which contracts belong by considering individual contracts.

154 IFRS 17.19: For contracts issued to which an entity does not apply the premium allocation approach (see paragraphs 53–59), an entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:

(a) based on the likelihood of changes in assumptions which, if they occurred, would result in the contracts becoming onerous.

(b) using information about estimates provided by the entity’s internal reporting. Hence, in assessing whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:

(i) an entity shall not disregard information provided by its internal reporting about the effect of changes in assumptions on different contracts on the possibility of their becoming onerous; but

(ii) an entity is not required to gather additional information beyond that provided by the entity's terms and conditions of the insurance coverage ~~internal reporting about the effect of changes in assumptions on different contracts~~.

4 Appendix 1: Example 1

4.1 Assumptions

155 An insurance company issues the following participating contracts:

- In year Y : 10 contracts with an individual premium of 1 000
- In year Y+1 : 15 contracts with an individual premium of 1 000

156 The contracts share the returns of a common pool of assets segregated in a dedicated fund and are entitled contractually to a minimum of 80% of the returns from the pool yet with the insurer's discretion as to the timing and allocation among policyholders of the distribution. The contract duration is five year. Upon the contractual term, policyholders are entitled to the account balance including the accumulated premiums and discretionary bonuses. Discretionary bonuses are set by management on a yearly basis and credited to policyholders' account. Afterwards, policyholders have an enforceable right to the payment of the bonus. For commercial reasons, management credits all policyholders' accounts using a single crediting rate (no distinction by year of subscription). Furthermore, it is assumed that management only credits accounts with a view to abiding by the contractual profit sharing obligation of 80% of the returns. No additional bonuses are credited to policyholders' accounts beyond the contractual minimum.

157 The contracts are investment contracts with discretionary participation features that fall under IFRS 17. The example assumes that they meet the criteria for the variable fee approach (IFRS 17.B101).

158 The premiums are assumed to be paid on January 1st and immediately invested:

- in year Y : 10 000 in bonds with a 5 year maturity and an interest rate of 5% capitalised until maturity;
- in year Y+1: 15 000 in bonds with a 5 year maturity and an interest rate of 1% capitalised until maturity;

159 At the end of year Y, the market interest rate for bonds goes down to 1%. For simplicity reason, yield curves are assumed to be flat. The rates are constant afterwards.

160 In future periods, notwithstanding this drop of market interest rate, everything happens as expected at inception.

161 The credit risk of the bonds is assumed to be negligible. Coupons are not invested and remain on the insurer's bank account. The bonds are accounted for at amortised costs. Applying IFRS 17.B81, the entity determines the discount rate based on the yield curve implicit in the fair value measurement of the dedicated fund.

162 For simplicity reason, it is assumed that the company starts its activity in Y and has no other portfolios. Furthermore, the CSM is allocated to profit and loss based on the passage of time and no risk adjustment for non-financial risk is considered.

4.2 In year Y:

Recognition of the first group of contracts

163 Upon receipt of the premium, the entity recognises the group of contracts issued in year Y.

164 The investment in bonds will provide a cash inflow of 10 000 x 1.05 ^ 5 = 12 763 in year 5 (Y+4).

165 The insurance company expects to make a final pay-out upon year Y+4 with an implicit yearly yield rate of 4,1% for the policyholder. The final expected payment is therefore 10 000 x 1.041^5 = 12 225. The participation of the policyholders is therefore 2 225 / 2 763 = 80% and the insurer's fee amount to 538 (2 763-2 225).

166 The dedicated portfolio of assets is considered as the reference portfolio for the determination of the discount rate. The bonds bear no credit risk and the entity decides to apply the option in IFRS 17.B81 not to adjust the reference portfolio's rate for differences in the liquidity characteristics. Therefore, the discount rate equals the rate of return implicit in the fair value of the dedicated portfolio of assets. At initial recognition the discounted value of the payment is 12 225 / 1.05^5 = 9 579.

167 The initial CSM is therefore 10 000 – 9 579 = 421

	Debit	Credit
Cash	10 000	
Provision for remaining coverage		9 579
Contractual service margin		421
To record the initial recognition of group 1.		

At the end of year Y:

168 The bonds are accounted for at amortised cost, the entity records the interests earned over the period : 500

	Debit	Credit
Bonds	500	
Finance income		500
To record the amortised costs of the bonds at the end of year Y		

169 As interest rate have fallen to 1%, the fair value of the bonds purchased in year Y has increased to 10 000 x 1.05 ^ 5 / 1.01 ^ 4 = 12 265.

170 The discount rate for the determination of the liability for remaining coverage is updated to reflect the current market rate of returns implicit in the fair value measurement of the reference portfolio, which is 1 %.

171 The liability for remaining coverage under IFRS 17 is the discounted value of the expected terminal payment which is 10 000 x 1.041 ^ 5 / 1.01 ^ 4 = 11 748. The increase is 11 748 – 9 579 = 2 169.

	Debit	Credit
Insurance finance expense	2 169	
Liability for remaining coverage		2 169
To record the effect of the time value of money and the change in interest rate		

The increase in the liability for remaining coverage consecutive to the increase in the fair value of the assets represents the obligation of the entity to repay 80% of future interests received on the assets. It is not a liability against the current policyholders (G 1) only since the contractual obligation relates to the interest rates flows and not to changes in fair value.

Accordingly, if the mutualisation of the policy leads to share future interest returns on these assets with future policyholders, a portion of the 80% of the recorded change in fair value is attributable to future policyholders and consequently that change in fair value does not exclusively belong to current policyholders (G 1).

172 Furthermore, as the contracts are accounted for under the variable fee approach, the entity also updates the CSM up to 96, the difference between :

- the change in the fair value of the underlying assets : 12 265 - 10 000 = 2 265
- the change in the liability for remaining coverage : 9 579 - 11 748 = - 2 169

	Debit	Credit
Insurance finance expense	96	
Contractual service margin		96
To adjust the CSM for the entity's share in the fair value of the underlying items.		

The change in CSM by 96 results from a change in financial assets and how that change is reflected in the insurance liability.

The evolution of the CSM results from changes in the underlying items, e.g. both (i) changes in financial assets and (ii) changes in the liability for remaining coverage.

The liability for remaining coverage may also change for technical reasons, due to a change in the insurance risk (change in actuarial assumptions or pricing). For participating contracts sharing insurance risks, transfer between groups would be accounted for the same way.

173 In addition, as the entity holds the underlying items, it chooses to disaggregate the insurance finance income between profit and loss and OCI so as to eliminate the mismatch with the assets carried at amortised costs. The difference is 2 169 + 96 -500 = 1 765. The entry is therefore the following:

	Debit	Credit
Other comprehensive income	1 765	
Insurance finance expense		1 765
To disaggregate finance income according to IFRS 17.B134		

174 Finally, the entity allocates the contractual service margin to P&L:

New contracts issued	421
Change in the entity's share of the underlying items	96
Amounts before allocation to profit and loss	517
Allocation to profit and loss 1 / 5	-103
CSM at year end	414

	Debit	Credit
Contractual Service margin	103	

Insurance service income		103
To record the release of the contractual service margin		

Balance sheet	Year Y
Bonds	10 500
Liability for remaining coverage	(11 748)
Contractual service margin	(414)
Net income	(103)
Other comprehensive income	1 765

Profit and loss statement	Year Y
Insurance revenue	103
Finance income (Bonds)	500
Insurance finance expenses	(500)
Net income	103

4.3 In year Y + 1:

Recognition of the second group of contracts

Expected returns from the joint underlying assets

175 The implicit rate of return in the fair value measurement of the reference portfolio of assets is 1%.

176 The expected returns from the overall portfolios of investments in bonds amounts to: 10 000 x (1.05 ^ 5 – 1) + 15 000 x (1.01 ^ 5 – 1) = 3 528

177 Of which 80% will, by regulation, be returned to policyholders that is 2 822. The expected total insurer's fee is therefore 3 528 – 2 822 = 706.

Entity's decision to allocate 2% of actual assets' return to each group

By the term of the contracts, policyholders are collectively entitled to receive a minimum of 80% of the assets' returns. Since both groups 1 and 2 are managed together and mutualised (sharing risks and returns on their underlying items) the entity estimates a unique rate applicable to assets' return equivalent to meeting that obligation.

178 In the current case, that amount is equivalent to (80%@5%*10 000 on 4 years+80%@1%*15 000 on 5 years)=@2%*25 000 on 5 years.

179 In future periods, the entity intends to allocate evenly the financial returns between policyholders by crediting an implicit steady yearly rate to all policyholders' accounts (IFRS 17.B132), which amounts to 2%.

- The expected terminal payment to group 1 (G 1) is expected to be 10 400 x (1.02) ^ 4 = 11 257
- The expected terminal payment to group 2 (G 2) is expected to be 15 000 x (1.02) ^ 5 = 16 561
- Thus the expected returns to be passed to the policyholders amount to 1 257 + 1 561 = 2 819

180 In year Y, the entity had used a higher rate of discretionary bonus to compute the fulfilment cash flows assigned to group 1 (4.1% instead of 2%).

181 In year Y, the initial assumptions used to compute the CSM of group 1 relied on a discretionary participation of policyholders included in the terminal payment up to 10 000 x (1.041 ^ 5 – 1) = 2 225 with a difference of 2 225 – 1 257 = 968 as compared with the revised expectation. The provision for remaining coverage for G 1 should reflect the new expected terminal payment and would therefore amount to 11 257 / 1.01 ^ 4 = 10 818 instead of 12 225 / 1.01 ^ 4 = 11 748. This difference of 10 818 – 11 748 = (930) correspond to the discounted 968 @1% (930 = 968/1.01^4).

182 The estimates of the future cash flows arising from G 2 would also reflect the expected terminal payment of 16 561 and the discounted amount would be 16 561 x 1.01 ^ 5 = 15 757. The discounted amount is higher than the received premiums.

In a new group of contracts, if the amount of discretionary returns exceeds the discount rate implicit in the fair value of the underlying items (applying the top-down approach) the fulfilment cash flows are negative.

Applying VFA with no transfer of FCF

183 Applying the VFA approach, changing the FCF in G 1 would increase the amount of CSM to be released over the future periods by 930.

184 Conversely G 2 contracts would then be considered onerous and an immediate loss of 757 (and no CSM) would have to be recognised.

If the entity is organising the profitability of each group without transferring FCF among them (i.e. not applying IFRS 17.B68), corresponding changes in the CSM may lead to recognise “onerous” contracts in an accounting perspective.

In fact, since adding the new G 2 business eventually contributes to increasing the entity’s share in the returns of the underlying assets by 168 from 538 in year Y to 706 in year Y+1, group 2 should not “economically” be considered “onerous”.

Applying VFA with transfer of FCF according to B68

185 Applying IFRS 17.B68 (b) the entity decides to allocate 968 from G 1 FCF as future discretionary payments to G 2.

186 Thanks to the transferred FCF from G 1, the outflows to G 2 policyholders in year 6 would amount to 16 561 (15 597 +964), which correspond to a 2% return. However, as long as the transfer is accounted for as an outflow (not to G1 but to G2) of GA, the outflows under G2 remains 15 597, i.e. on the basis of a 0.78% return.

187 The basic case to represent the obligation to allocate 80% of the assets’ returns to the policyholders of each group is to consider that G 1 policyholders are entitled to 80%@5%, with roughly corresponds to the 4,1% (modulo the discounting effect) and G 2 policyholders are entitled to 80%@1%, with roughly corresponds to the 0,78% (modulo the discounting effect). Ensuring that both receive the 2% equalising rate for the whole population in the next 4 years, is equivalent for G 1 to transfer to G 2 the lacking @1,2% on 5 years: ~ roughly equivalent to 15 000@1,2%*5=900 (modulo the discounting effect).

188 The theoretical outflows allocated to G 1 remain 12 225. In fact, FCF of G 1 have been transferred to G 2 by 968: the whole outflow remains the same but is partly allocated to another group. Accordingly, the CSM of G 1 has not changed.

189 The discounted value of the future expected cash flows for G 2 is 15 597/1.01^5 = 14 840 and consequently the CSM is 160. In other words, G2 discounted outflows have decreased by 917 from 15 757 (before transfer) to 14 840 (with transfer). Instead of recognising an immediate loss of 757, G2 records a CSM of 160 (i.e. CSM has been correspondingly increasing by 160+757=917). The transferred amount corresponds to 917=964/1.01^5. The difference between 917 and 930 (see § 181) mainly comes from the deferral of cash-flows by one year.

	Debit	Credit
Cash	15 000	
Provision for remaining coverage		14 840

Contractual service margin		160
To record the initial recognition of group 2.		

Ensuring that policyholders of G 1 and G 2 get 80% of the returns on the underlying items, is equivalent to providing for a 2% return on the assets (in a 1% interest rate environment).

Not applying IFRS 17.B68 leads to unduly recognise onerous contracts in G 2 (see § 184).

Applying transfers among groups (IFRS 17.B68) enables to achieve the management's objective of allocating 2% return on each group.

On the one hand this objective is not represented in the assessment of G 1 flows or CSM which remains based on the original @4.1% return: the FCF gained on the decrease in crediting rate allocated to G1 policyholders (from 4.1 % down to 2.0%) have been fully transferred to G2 so that neither the FCF nor the CSM have changed.

On the other hand the transfer has not been neutral to the CSM of G 2, which is eventually not related with the @2.0% objective set to that group (which, alone, would have made the group onerous).

Amounts included in the measurement of IFRS 17 groups of contracts require a specific allocation pattern and an extensive historic follow-up, and eventually do not reflect in all circumstances the actual expectations or expected margin of the management.

Actually only a consolidated analysis of both groups provides a view corresponding to the management's expectation. That overarching approach also shows that the conclusions remain the same even if one group benefits from a minimum guaranteed return rate, as long as (i) transfers are possible between groups and (ii) consolidated FCF exceed guaranteed amounts so that the entity's share in the underlying items remains the same.

<u>At the end of year Y+1</u>

190 The bonds are accounted for at amortised costs, the entity therefore records the interest rate for the period that is 10 500 x 5% + 15 000 x 1% = 675

	Debit	Credit
Bonds	675	
Finance income		675
To record the amortised costs of the bonds at the end of year Y+1		

191 The current market interest rate is flat at 1%. The fair value of the bonds held by the entity amounts to 10 000 x1.05^5 /1.01^3 +15 000 x1.01^5 /1.01^4 =12 387 +15 150 =27 537. The fair value change is therefore 27 537 – 15 000 – 12 265 = 273.

192 The entity computes the liability for remaining coverage :

- For group 1, the liability is 12 225 /1.01^3 =11 866 with an increase of 11 866 - 11 748 =118
- For group 2, the liability is 15 597 /1.01^4 =14 988 with an increase of 14 988 - 14 840 =148.

	Debit	Credit
Insurance finance expense	266	
Liability for remaining coverage		266

To record the change in the liability for remaining coverage

193 Then the entity unlocks the CSM to record its share in the changes in the fair value of the underlying items that is 273 -266 =7.

The standard does not provide guidance on how to apply IFRS 17.B104(b)(i) and IFRS 17.B112 to groups of contracts that share in the same pool of underlying assets. As group 1 and 2 are backed by the same dedicated fund, the entity needs to perform an allocation of the changes in the fair value of the bonds to each group. In our example, by simplification the change to the variable fee is fully allocated to the most recent cohort. This example does not preclude other methodologies and does not consider whether this simplification would comply with the requirements of IAS 8.

194 Based on this assumption, the change in the variable fee is assigned to G 2.

	Debit	Credit
Insurance finance expense	7	
Contractual service margin		7
To adjust the CSM for the entity's share in the fair value of the underlying items.		

195 Then the entity applies IFRS 17.B134 and disaggregates its insurance finance expenses between profit and loss and OCI. The amount booked to OCI is therefore 266 + 7 – 675 = (402)

	Debit	Credit
Other comprehensive income		402
Insurance finance expense	402	
To record the disaggregation of finance expenses according to IFRS 17.B134		

196 Then the entity allocates CSM to P&L according to IFRS 17.B119

	Group 1	Group 2	Total
Opening balance	414		414
New contracts issued		160	160
Change in the entity's share of the underlying items		7	7
Amounts before allocation to profit and loss	414	167	581
Allocation to profit and loss 1 / 4 for group 1 and 1 / 5 for group 2	(103)	(33)	(137)
CSM at the end of year Y+1	310	134	444

197 The financial statements are as follows :

Balance sheet	Year Y+1
Bonds	26 175
Liability for remaining coverage	-26 854
Contractual service margin	- 444
Net income	-137
Retained earnings	-103
Other comprehensive income	1 363

Profit and loss statement	Year Y+1
Insurance revenue	137
Finance income	675
Insurance finance expense	(675)
Net income	137

4.4 *At the end of year Y+2 and Y+3*

198 The bonds are accounted for at amortised costs, the entity therefore records the interest rate for the period that is:

- In Y+2: 11 025 x 5% + 15 150 x 1% = 703 ;
- In Y+3: 11 576 x 5% + 15 302 x 1% = 732.

199 The current market interest rate is flat at 1%. The fair value of the bonds held by the entity amounts to :

- In Y+2: 10 000 x 1.05 ^ 5 / 1.01 ^ 2 + 15 000 x 1.01 ^ 5 / 1.01 ^ 3 = 12 511 + 15 301 = 27 812;
- In Y+3: 10 000 x 1.05 ^ 5 / 1.01 + 15 000 x 1.01 ^ 5 / 1.01 ^ 2 = 28 091.

200 The fair value changes of the bonds are therefore:

- In Y+2: 27 812 – 27 537 = 275;
- In Y+3: 28 091 – 27 812 = 278.

201 The entity computes the liability for remaining coverage:

202 For group 1, the liability is :

- In Y+2: 12 225 / 1.01 ^ 2 = 11 984 with an increase of 11 984 – 11 866 = 119
- In Y+3: 12 225 / 1.01 = 12 104 with an increase of 12 104 – 11 984 = 120

203 For group 2, the liability is:

- In Y+2: 15 597 / 1.01 ^ 3 = 15 138 with an increase of 15 138 – 14 988 = 150
- In Y+3: 15 597 / 1.01 ^ 2 = 15 290 with an increase of 15 290 – 15 138 = 151

204 Then the entity unlocks the CSM to record its share in the changes in the fair value of the underlying item that is:

- In Y+2 : 275 - 119 – 150 = 7;
- In Y+3: 278 – 120 – 151 = 7.

205 Consistent with the entity's accounting policy, the changes in the variable fee are assigned to group 2.

206 Then the entity applies IFRS 17.B134 and disaggregates its insurance finance expenses between profit and loss and OCI. The amount booked to OCI is therefore:

- In Y+2: 119 + 150 + 7 – 703 = (427);
- In Y+3: 120 + 151 + 7 – 732 = (454).

207 Then the entity allocates the CSM to profit and loss according to IFRS 17.B119

	Group 1	**Group 2**	**Total**
Opening balance Y+1	310	134	444
Change in the entity's share of the underlying items		7	7
Allocation to profit and loss 1 / 3 for group 1 and 1 / 4 for group 2	(103)	(35)	(138)
CSM at the end of year Y+2	207	105	312
Change in the entity's share of the underlying items		7	7
Allocation to profit and loss 1 / 2 for group 1 and 1 / 3 for group 2	(103)	(37)	(141)
CSM at the end of year Y+3	103	75	178

208 The financial statements are as follows :

Balance sheet	Y+2	Y+3
Bonds	26 878	27 610
Liability for remaining coverage	(27 122)	(27 394)[1]
Contractual service margin	(312)	(178)
Net income	(138)	(141)
Retained earnings	(240)	(378)
Other comprehensive income	935	481

Profit and loss	Y+2	Y+3
Insurance revenue	138	141
Finance income	703	732
Insurance finance expense	(703)	(732)
Net income	138	141

4.5 At the end of year Y+4

209 Underlying assets:

- The bonds are accounted for at amortised costs, the entity therefore records the interest rate for the period that is 12 155 x 5% + 15 455 x 1% = 762.
- The bonds subscribed in year Y reach their maturity and the entity receives the final inflow of 12 763.
- The fair value of the remaining bonds held by the entity amounts to 15 000 x 1.01^5 / 1.01^1 = 15 609.
- The change in fair value of the underlying assets is therefore (15 609 + 12 763) - 28 091 = 281.

210 The entity computes the liability for remaining coverage:

211 The contracts of group 1 reach their maturity. The entity assigns the 2% returns to the policyholders' accounts and makes its expected final payment of 10 000 x 1.04 x 1.02^4 = 11 257. With regards to the legal obligation, this payment corresponds to the G 1 share in 80% of the yearly interest income on assets.

212 At the end of year Y+4, the company has cash at hand up to 12 763 – 11 257 = 1 506

213 The opening balance of the liability for remaining coverage of group 1 was 12 104 = 12 225 / 1.01.

214 The measurement of group 1 still includes 968 of future discretionary benefits allocated to policyholders of group 2.

215 The change in the liability for remaining coverage for group 1 is therefore :

Opening balance	**12 104**
Unwind of the discount rate (1%)	121
Terminal payment to policyholders of group 1	-11 257
Closing balance – Residual amount allocated to group 2	**968**

216 The entity applies IFRS 17.B71 and recognises a liability for the fulfilment cash flows allocated to group 2 up to 968.

All the CSM attributable to G 1 FCF has actually been allocated. The remaining 968 FCF have been transferred to G 2 thanks to IFRS 17.B 68 and IFRS 17.B 71 provisions.

[1] 27 394=15 290+12 104

217 For group 2, the liability is 15 597 / 1.01^1 = 15 443 with an increase of 15 443 - 15 290 = 153.

218 Then the entity unlocks the CSM to record its share in the changes in the fair value of the underlying item that is 281– 153 – 121 = 7. Consistent with the previously applied accounting policy, the change in the variable fee is assigned to group 2.

219 Then the entity applies IFRS 17 B134 and disaggregates its insurance finance expenses between profit and loss and OCI. The amount booked to OCI is therefore 274 + 7 – 762 = (481)

	Debit	Credit
Other comprehensive income		481
Insurance finance expense	481	
To record the disaggregation of finance expenses according to IFRS 17.B134.		

220 Then the entity allocates the CSM to profit and loss according to IFRS 17.B119.

	Group 1	Group 2	Total
Opening balance	103	75	178
Change in the entity's share of the underlying items		7	7
Allocation to profit and loss 1 / 1 for group 1 and 1 / 2 for group 2	- 103	-41	-144
CSM at the end of Y+4	0	41	41

221 The financial statements are as follows :

Balance sheet	Y+4
Cash at hand	1 506
Bonds	15 609
Liability for remaining coverage	-16 410
Contractual service margin	- 41
Net income	-144
Retained earnings	-519
Other comprehensive income	0

Profit and loss statement	Y+4
Insurance revenue	144
Finance income (bonds)	762
Insurance finance expense	-762
Net income	144

4.6 At the end of year Y+5

222 The bonds are accounted for at amortised costs, the entity therefore records the interest rate for the period that is 15 609 x 1% = 156. The change in the fair value of the bonds is also 156.

223 The bonds subscribed in year Y+1 reach their maturity and the entity receives the final inflow of 15 765.

224 The contracts of group 2 reach their maturity. The entity assigns an additional 2% discretionary bonus to the policyholders' accounts and makes its expected final payment of 15 000 x 1.02 ^ 5 = 16 561.

225 The balance of cash in hands amounts to 1 506 + 15 765 – 16 561 = 709

226 The changes in the liability for remaining coverage is the following :

	Residual amount from group 1	Group 2
Opening balance	**968**	**15 443**
Unwind of the discount rate (1%)		154
Transfer of fulfilment cash flows	-968	968
Terminal payment		-16 561
Closing balance	**0**	**4**

227 The entity re-measures the contractual service margin to take into account the entity's share of the changes in the fair value of the underlying assets 156 – 154 = 2.

	Group 1	Group 2	Total
CSM at the end of Y+4	0	41	41
Change in the entity's share of the underlying items		2	2
Allocation to profit and loss		-43	-43
CSM at the end of Y+4	0	0	0

228 The financial statements are as follows:

Balance sheet	Y+5
Cash at hand	709
Bonds	0
Liability for remaining coverage	(4)
Contractual service margin	0
Net income	(43)
Retained earnings	(663)
Other comprehensive income	0

Profit and loss statement	Y+5
Insurance revenue	43
Finance income (bonds)	156
Insurance finance expense	(156)
Net income	43

4.7 Conclusion on the objectives of annual cohorts requirement

<u>Recognising onerous contracts on a timely basis (IFRS 17.BC119)</u>

Without considering transfers from one group to the other, the annual cohort approach may lead to conclude that a group is onerous (from an accounting point of view) whereas it is actually not and still positively contributes to increasing the shareholders' value (see § 184).

In order to take into account the intergenerational nature of the underlying pool of assets and in order to avoid a misstatement of performance, a transfer has to be organised. Such a transfer is a significant complexity leading to an unnecessary administrative burden.

The example shows that as long as a sufficient amount of unallocated past return to past generations is available to serve, together with future return of the underlying portfolio of assets, the expected return to future generations there is no need for a cohort approach and the administrative overburden can be avoided.

Recognising expected profit over the lifetime of the group (IFRS 17.BC136)

Both the general model (IFRS 17.B98) and the VFA (IFRS 17.B112) allow the insurer to reassess the discretionary cash-flows allocated to a contract after the initial recognition and to adjust the CSM.

The example confirms that transfers of discretionary cash-flows from one group to another (applying IFRS 17.B68) also adjust the CSM in each group separately, thus also change the time-allocation of the CSM:

- G 1, without transfer, would have recognised an increase in CSM by 930 (see § 181);

- G 2 recognises an initial CSM amounting to 160 whereas, without transfer (of 917), it would have recognised a negative CSM e.g. a loss of 757 at inception (see § 189).

Transfers however do not materially adjust the total CSM (930-757-160=13), since they actually do not materially change the shareholder's part in the underlying items. The residual amount (13) however mainly stems from the deferral of cash flows by one year. The case demonstrates that transfers allow to defer CSM from one group to the other e.g. from one period to another (similar to what would happen in an open portfolio).

The example illustrates transfers of financial returns between groups sharing financial risks, regardless of the existence of minimum guaranteed returns (See § 189).

As mentioned in § 172 the same reasoning is applicable to groups that transfer insurance/technical returns because such groups share insurance/technical risks.

Accordingly contracts/groups that share risks on underlying items (assets and liabilities/insurance) may transfer financial and technical returns from one group to the other in order to achieve the same result as "a single combined risk-sharing portfolio" (IFRS 17.BC138).

4.8 Additional observation: profit sharing obligation in the annual FS

Even though the profit sharing obligation relates to annual financial statement under local GAAP and not IFRS FS, it is useful to analyse such impact since it eventually sets the binding legal obligation.

For instance, the way the 80% allocation rule is applied demonstrates that such an obligation relates to the interest income regardless of the changes in the fair value of the underlying assets.

Year Y

229 In the annual account, the entity decides to allocate a bonus of 4% to the individual policyholders' accounts. The policyholders' accounts are therefore credited by 400. The legal amount of profit sharing is 80% of the interest income that is 500 x 80% = 400. The collective reserve is therefore not credited. The total policyholders' account s balance is 10 400.

Year Y+1

230 In the annual account, the entity decides to allocate a bonus of 2% to the individual policyholders' accounts. The policyholders accounts are therefore credited by 508 (10 400 x 2% + 15 000 x 2% = 508). The legal amount of profit sharing is 80% of the interest income that is 675 x 80% = 540. The collective reserve is therefore credited for 32 with an overall balance of 32 at the end of year Y+1. The total policyholders' accounts balance is 10 400 + 15 000 + 508 = 25 908.

Years Y+2 and Y+3

231 In the annual account, **for both years** the entity allocate a bonus of 2% to the individual policyholders' accounts.

	Y+2	Y+3
Policyholders' accounts at opening	**25 908**	**26 426**
Interests credited (2%)	518	529
Policyholders' account at closing	**26 426**	**26 955**
Amount of financial income from bonds	703	732
x 80% (profit sharing obligation	562	585
Difference with credited interests	44	57
Collective reserve on opening balance	32	76
Collective reserve on closing balance	**76**	**133**

Year Y+4

232 In the annual account, the entity decides to allocate a bonus of 2% to the individual policyholders' accounts and makes the terminal payments to policyholders of group 1 up to 11 257. The policyholders accounts are therefore credited by 539 (26 954 x 2% = 539). The legal amount of profit sharing is 80% of the interest income that is 762 x 80% = 610.

233 The collective reserve is therefore credited for 71 with an overall balance of 204 at the end of year Y+1.

234 The accumulated policyholders' accounts balance is 26 954 + 539 – 11 257 = 16 236.

Year Y+5

	Y+5
Policyholders' accounts at opening	**16 236**
Interests credited (2%)	325
Terminal payment to group 2	-16 561
Policyholders' account at closing	**0**
Amount of financial income from bonds	156
x 80% (profit sharing obligation	125
Difference with credited interests	-200
Collective reserve on opening balance	204
Collective reserve on closing balance	**4**

5 Appendix 2: Example 2

5.1 Problem statement

235 An insurance company issues the following participating contracts:

- In year Y: 10 contracts with an individual premium of 1 000
- In year Y+1: 15 contracts with an individual premium of 1 000

236 The contracts share the returns of a common pool of assets segregated in a dedicated fund and are contractually entitled to a minimum of 80 % of the returns (determined based on the historical cost of the investments) from the pool, yet with the insurer's discretion as to the timing and allocation of the payments to individual policyholders. The contract duration is five years. Upon the contractual terms, policyholders are entitled to the account balance including the accumulated premiums and discretionary bonuses. Discretionary bonuses are set by management on a yearly basis and credited to policyholders' account. Afterwards, policyholders have an enforceable right to the payment of the bonus. For commercial reasons, management credits all policyholders' accounts using a single crediting rate (no distinction by year of subscription). Expected payment may exceed the contractual minimum of 80 % depending on market conditions and competitive pressure.

237 The contracts are investment contracts with discretionary participation features that fall under IFRS 17. The example assumes that they meet the criteria for the variable fee approach (IFRS 17.B 101).

238 The premiums are assumed to be paid on January 1st and immediately invested in zero-coupon bonds:

- in year Y: 10 000 in bonds with a 5 year maturity and an interest rate of 5 % capitalised until maturity;
- in year Y+1: 15 000 in bonds with a 5 year maturity and an interest rate of 3 % capitalised until maturity.

239 At the end of year Y, the market interest rate for bonds goes down to 3 %. For simplicity reason, yield curves are assumed to be flat.

240 At the end of year Y+1, the market interest rate for bonds goes down to 1 % and remains flat afterwards.

241 In future periods, notwithstanding the drop of market interest rate, everything happens as expected at inception.

242 The credit risk of the bonds is assumed to be negligible. The bonds are accounted for at amortised costs. Applying IFRS 17.B81 the entity determines the discount rate based on the yield curve implicit in the fair value measurement of the dedicated fund.

243 For simplicity reason, it is assumed that the company starts its activity in Y and has no other portfolios. Furthermore, the CSM is allocated to profit and loss based on the passage of time and no risk adjustment for non-financial risk is considered.

5.2 In year Y:

Recognition of the first group of contracts

244 Upon the receipt of the premium, the entity recognises the group of contracts issued in year Y.

245 The investment in bonds will provide a cash inflow of 10 000 x1.05^5 =12 763 in year 5 (Y+4).

246 Because of market competition, the insurance company expects to make a final pay-out upon year Y+4 with an implicit yearly yield rate of 4.5 % for the policyholders. The final expected payment is therefore 10 000 x1.045^5 =12 462. The participation of the policyholders is therefore 2 462 /2 763 =89 %, above the contractually guaranteed minimum, and the insurer's fee amounts to 301.

247 The dedicated portfolio of assets is considered as the reference portfolio for the determination of the discount rate. The bonds bear no credit risk and the entity decides to apply the option in IFRS 17.B81 not to adjust the reference portfolio's rate for differences in the liquidity characteristics. Therefore, the discount rate equals the rate of return implicit in the fair value of the dedicated portfolio of assets (top-down approach). At initial recognition the discounted value of the payment is 12 462 /1.05^5 =9 764.

248 The initial CSM is therefore 10 000 -9 764 =236.

At the end of year Y:

249 At the end of year Y the company's management decides to credit policyholders' account with a return of 4.5 %. The policyholders' account balance therefore becomes 10 000 x1.045 =10 450.

250 The bonds are accounted for at amortised cost, the entity records the interests earned over the period: 500.

251 As interest rate have fallen to 3 %, the fair value of the bonds purchased in year Y has increased to 10 000 x1.05^5 /1.03^4 =11 340.

252 The discount rate for the determination of the liability for remaining coverage is updated to reflect the current market rate of returns implicit in the fair value measurement of the reference portfolio, which is 3 %.

253 Because of the drop in market interest rate, the entity now does not expect to pay back 88 % of the pool's expected yield anymore and thus reduces its estimates of discretionary benefits from 4.5 % to 4.1 %. The expected final payment is 10 000 x1.045 x1.041^4 =12 272. The expected participation of policyholders is 82 % of the yield from the pool of assets.

254 The liability for remaining coverage under IFRS 17 is the discounted value of the expected terminal payment which is 10 000 x1.045 x1.041^4 /1.03^4 =10 904. The increase is 10 904 -9 764 =1 140.

255 Furthermore, as contracts are accounted for under the variable fee approach, the entity also updates the CSM by 200 up to the difference between:

- the change in the fair value of the underlying assets: 11 340 -10 000 =1 340.
- the change in the liability for remaining coverage: 9 764 -10 904 = -1 140.

256 In addition, as the entity holds the underlying items, it chooses to disaggregate the insurance finance income between profit and loss and OCI so as to eliminate the

mismatch with the assets carried at amortised costs. The difference is 1 140 +200 -500 =840.

257 Finally, the entity allocates the contractual service margin to P&L:

New contracts issued (§ 248)	236
Change in the entity's share of the underlying items (§ 255)	200
Amounts before allocation to profit and loss	436
Allocation to profit and loss 1/5	-87
CSM at year end	349

Balance sheet	Year Y
Bonds (§ 250)	10 500
Liability for remaining coverage (§ 254)	(10 904)
Contractual service margin (§ 257)	(349)
Net income (§ 257)	(87)
Other comprehensive income (§ 256)	840

Profit and loss statement	Year Y
Insurance revenue (§ 257)	87
Finance income (Bonds) (§ 250)	500
Insurance finance expenses: -1 140 -200 +840	(500)
Net income	87

5.3 In year Y + 1:

<u>Recognition of the second group of contracts</u>

258 The implicit rate of return in the fair value measurement of the reference portfolio of assets is 3 %.

259 The expected returns from the overall portfolios of investments in bonds amounts to: 10 000 x(1.05^5 -1) +15 000 x(1.03^5 -1) =5 152.

260 Considering the market conditions, the entity expects to credit policyholders' accounts with a single rate of 3 %.

- The expected terminal payment to group 1 (G 1) is therefore expected to be 10 450 x(1.03)^4 =11 762
- The expected terminal payment to group 2 (G 2) is thus expected to be 15 000 x(1.03)^5 =17 389
- Thus the expected returns to be passed to the policyholders amount to 1 762 +2 389 =4 151, that is 81 % of the total expected returns from the pool of assets.

261 Applying IFRS 17.B68 (b), the fulfilment cash flows included in the measurement of G 2 reflect the extent to which the contracts in the group cause the entity to be affected by expected cash flows.

262 In this example, the entity expects to pay 17 389 in year 5 to the policyholders of G 2, however, the measurement of G 1 already includes a 12 272 -11 762 =510 of payment allocated to G 2.

263 Applying IFRS 17.B68, the discounted fulfilment cash flows allocated to G 2 therefore amount to (17 389 -510) /1.03^5 =14 560. The CSM amounts to 440.

264 The calculation of the CSM of G 2 upon initial recognition (440) reflects the fact that a payment of 510, which was previously allocated to the policyholders of G 1, is expected to be paid in year Y+5 to the policyholders of G 2. However, applying IFRS 17.B68, this amount is allocated to G 1 and included in its discounted FCF up to

510 /1.03^4 =453. As a consequence, the discounting effect due to the time lag between the expected payments to G 1 and G 2 (453 -440 =13) adjusts the CSM of G 2.

The CSM of G 2 depends on the assumptions made on the whole mutualised population that (i) the crediting rate is 3 % and (ii) G 1 transfers 510 thanks to the pooling of assets' returns and applying IFRS 17.B 68. It is noteworthy that the amount of the CSM allocated to G 2 depends to a large extent on the discretionary assumptions made in past periods. This is illustrated in § 299-300 thereafter highlighting that whenever the discretionary benefits allocated to a group exceed the minimum contractual participation, the determination of the CSM of future groups is affected by the timing of the changes in discretionary assumptions.

<u>At the end of year Y+1</u>

265 The bonds are accounted for at amortised costs, the entity therefore records the interest rate for the period that is 10 500 x5 % +15 000 x3 % =975.

266 The current market interest rate falls to 1 %. The fair value of the bonds held by the entity amounts to 10 000 x1.05^5 /1.01^3 +15 000 x1.03^5 /1.01^4 =12 388 +16 710 =29 098. The fair value change is therefore 29 098 -15 000 -11 339 =2 759.

267 The entity computes the discounted fulfilment cash flows:

- For G 1, the liability is (11 762 +510) /1.01^3 =11 911 with an increase of 11 911 -10 903 =1 008
- For G 2, the liability is (17 389 -510) /1.01^4 =16 220 with an increase of 16 220 -14 560 =1 660.

The total increase in the discounted fulfilment cash flows is therefore 2 668.

268 Then the entity unlocks the CSM to record its share in the changes in the fair value of the underlying item that is 2 759 -2 668 =91.

IFRS 17 does not provide guidance in applying paragraphs B104 (b) (i) and B112 to groups of contracts that share in the same pool of underlying assets.

In this fact pattern, the changes in the fair value of the bonds cannot be specifically attributed to a cohort because policyholders do not have an individual right to the assets of the pool. Actually, the entity has not allocated discretionary bonuses to policyholders' accounts. As a consequence the fair value gain from the assets of the pool still belongs to the community of policyholders as a whole.

The entity therefore needs to determine an accounting policy to perform the allocation. In this example, it is *assumed* that the entity's share of the fair value of the underlying items is allocated proportionally to the increase in the discounted fulfilment cash flows allocated to each group.

269 According to its accounting policy, the entity thus allocates the entity's share of the fair value of the underlying items as follows:

- The amount allocated to G 1 is therefore 91 x1 008 /2 668 =34
- The amount allocated to G 2 is therefore 91 x1 660 /2 668 =57

The allocation policy applied affects the CSM of the cohorts. Given the lack of guidance in the standard, this challenges whether the information provided by the cohorts can lead to relevant and comparable information on profitability trends.

Actually, in the absence of a direct contractual relationship between the payments to individual policyholders and the returns on the underlying items, the annual cohort leads to an arbitrary allocation of mutualised discretionary benefits.

270 Then the entity applies IFRS 17.B134 and disaggregates its insurance finance expenses between profit and loss and OCI. The amount booked to OCI is therefore 2 668 +91 -975 =1 783.

271 Then the entity allocates CSM to P&L according to IFRS 17.B119

	G 1	G 2	Total
Opening balance	349		349
New contracts issued		440	440
Change in the entity's share of the underlying items	34	57	91
Amounts before allocation to profit and loss	383	497	880
Allocation to profit and loss 1 / 4 for G 1 and 1 / 5 for G 2	(96)	(99)	(195)
CSM at the end of year Y+1	287	398	685

272 The financial statements are as follows:

Balance sheet	Year Y+1
Bonds	26 475
Liability for remaining coverage	(28 131)
Contractual service margin	(685)
Net income	(195)
Retained earnings	(87)
Other comprehensive income	2 623

Profit and loss statement	Year Y+1
Insurance revenue	195
Finance income	975
Insurance finance expense	(975)
Net income	195

<u>In years Y+2 and Y+3</u>

273 The bonds are accounted for at amortised costs, the entity therefore records the interest rate for the period that is:

- In Y+2: 11 025 x5 % +15 450 x3 % =1 015 ;
- In Y+3: 11 576 x5 % +15 914 x3 % =1 056.

274 The current market interest rate is flat at 1 %. The fair value of the bonds held by the entity amounts to:

- In Y+2: 10 000 x1.05^5 /1.01^2 +15 000 x1.03^5 /1.01^3 =12 511 +16 878 =29 389;
- In Y+3: 10 000 x1.05^5 /1.01 +15 000 x1.03^5 /1.01^2 =29 683.

275 The fair value changes of the bonds are therefore:

- In Y+2: 29 389 -29 098 =291;
- In Y+3: 29 683 -29 389 =294.

276 The entity computes the discounted fulfilment cash flows

For G 1, the liability is:

- In Y+2: (11 762 +510) /1.01^2 =12 030 with an increase of 12 030 -11 911 =119
- In Y+3: (11 762 +510) /1.01 =12 150 with an increase of 12 150 -12 030 =120

For G 2, the liability is:

- In Y+2: (17 389 -510) /1.01^3 =16 382 with an increase of 16 382 -16 220 =162
- In Y+3: (17 389 -510) /1.01^2 =16 546 with an increase of 16 546 -16 382 =164.

277 Then the entity unlocks the CSM to record its share in the changes in the fair value of the underlying item that is:

- In Y+2: 291 -119 -162 =10
  Of which: 10 x119 /(119 +162) =4 allocated to G 1
  Of which: 10 x162 /(119 +162) =6 allocated to G 2
- In Y+3: 294 -120 -164 =10.
  Of which: 10 x120 /(120 +164) =4 allocated to G 1
  Of which: 10 x164 /(120 +164) =6 allocated to G 2

278 Then the entity applies IFRS 17.B134 and disaggregates its insurance finance expenses between profit and loss and OCI. The amount booked to OCI is therefore:

- In Y+2: 119 +162 +10 -1 015 =(724);
- In Y+3: 120 +164 +10 -1 056 =(762).

279 Then the entity allocates the CSM to profit and loss according to IFRS 17.B119

	G 1	G 2	Total
Opening balance Y+1	287	397	685
Change in the entity's share of the underlying items	4	6	10
Allocation to profit and loss 1/3 for G 1 and 1/4 for G 2	(97)	(101)	(198)
CSM at the end of year Y+2	194	302	496
Change in the entity's share of the underlying items	4	6	10
Allocation to profit and loss 1/2 for G 1 and 1/3 for G 2	(99)	(103)	(202)
CSM at the end of year Y+3	99	205	304

280 The financial statements are as follows:

Balance sheet	Y+2	Y+3
Bonds	27 490	28 546
Liability for remaining coverage	(28 412)	(28 697)
Contractual service margin	(496)	(304)
Net income	(198)	(202)
Retained earnings	(282)	(480)
Other comprehensive income	1 899	1 137

Profit and loss	Y+2	Y+3
Insurance revenue	198	202
Finance income	1 015	1 056
Insurance finance expense	(1015)	(1 056)
Net income	198	202

<u>In years Y+4</u>

281 Underlying assets:

- The bonds are accounted for at amortised costs, the entity therefore records the interest rate for the period that is 12 155 x5 % +16 391 x3 % =1 099.
- The bonds subscribed in year Y reach their maturity and the entity receives the final inflow of 12 763.

- The fair value of the remaining bonds held by the entity amounts to 15 000 x1.03^5 /1.01^1 =17 217.
- The change in fair value of the underlying assets is therefore (17 217 +12 763) -29 683 =297.

282 The contracts of G 1 reach their maturity. The entity makes its expected final payment of 10 000 x 1.045 x 1.03^4 =11 762. The change in the liability for remaining coverage for G 1 is therefore:

Opening balance	**12 151**
Unwind of the discount rate (1 %)	121
Terminal payment to policyholders of G 1	-11 762
Closing balance – Residual amount allocated to G 2	**510**

283 The entity applies IFRS 17.B71 and recognises a liability for the fulfilment cash flows allocated to G 2 up to 510.

284 At the end of year Y+5, the company has cash at hand up to 12 763 -11 762 =1 001

285 The discounted fulfilment cash flow to G 2 amounts to (15 000 x1.03^5 -510) /1.01 =16 712. The change amounts to 16 712 -16 546 =(165).

286 Then the entity unlocks the CSM to record its share in the changes in the fair value of the underlying item that is 297 -121 -165 =10, which is fully allocated to G 2.

287 Then the entity applies IFRS 17.B 134 and disaggregates its insurance finance expenses between profit and loss and OCI. The amount booked to OCI is therefore 287 +10 -1 099 =(803).

288 Then the entity allocates the CSM to profit and loss according to IFRS 17.B119:

	G 1	G 2	Total
Opening balance	99	205	304
Change in the entity's share of the underlying items	0	10	10
Allocation to profit and loss 1 / 1 for G 1 and 1 / 2 for G 2	- 99	-108	-207
CSM at the end of Y+4	0	108	108

289 The financial statements are as follows:

Balance sheet	Y+4
Cash at hand	1 001
Bonds	16 883
Liability for remaining coverage	-17 222
Contractual service margin	- 108
Net income	-207
Retained earnings	-682
Other comprehensive income	334

Profit and loss statement	Y+4
Insurance revenue	207
Finance income (bonds)	1 099
Insurance finance expense	-1 099
Net income	207

5.4 At the end of year Y+5

290 The bonds are accounted for at amortised costs, the entity therefore records the interest rate for the period that is 16 883 x3 % =506.

291 The bonds subscribed in year Y+1 reach their maturity and the entity receives the final inflow of 17 389. The change in the fair value of the bonds is 17 389 -17 217 =172.

292 The contracts of G 2 reach their maturity. The entity makes its expected final payment of 15 000 x1.03^5 =17 389.

293 The balance of cash in hands amounts is therefore unchanged and amounts to 1 001.

294 The changes in the liability for remaining coverage amounts to 17 389 -16 712 -511 =167.

295 The CSM is adjusted by 172 -167 =5 to recorded the entity's share of the fair value changes.

296 The entity releases the contractual service margin to profit and loss: 108 +5 =113.

297 Then the entity applies IFRS 17.B 134 and disaggregates its insurance finance expenses between profit and loss and OCI. The amount booked to OCI is therefore 167 +5 -506 =(334), which settles the balance of OCI.

298 The financial statements are as follows:

Balance sheet	Y+5
Cash at hand	1 001
Bonds	0
Liability for remaining coverage	0
Contractual service margin	0
Net income	(113)
Retained earnings	(888)
Other comprehensive income	0

Profit and loss statement	Y+5
Insurance revenue	113
Finance income (bonds)	506
Insurance finance expense	(506)
Net income	113

5.5 Alternative case

299 § 253 indicates that, because of the drop in market interest rate, the entity discretionary changes its estimates of the crediting rate from 4.5 % to 4.1 % at the end of year Y. Accordingly, the expected participation of G 1 policyholders in the yield of the pool of assets decreases from 88 % down to 82 %. The expected final payment thus decreases from 12 462 to 10 000 x1.045 x1.041^4=12 272.

300 Had that change in assumption not taken place at the end of Y, the expected final payment to G 1 would have remained at 10 000 x1.045^5 =12 462.

301 In that case, § 254-255 is changed as follows:

- At the end of year Y, the liability for remaining coverage under IFRS 17 is the discounted value of the expected terminal payment which is 10 000 x1.045^5 /1.03^4 =11 072. The increase is 11 072 -9 764 =1 308.

- Furthermore, as the contracts are accounted for under the variable fee approach, the entity also updates the CSM by **32** up to the difference between:
  - the change in the fair value of the underlying assets: 11 340 -10 000 =1 340.
  - the change in the liability for remaining coverage: 9 764 -11 072 = -1 308.

302 Furthermore § 262-264 are changed as follows

- In year Y+1 upon the initial recognition of G 2, the entity expects to pay 17 389 in year 5 to the policyholders of G 2, however, the measurement of G 1 already includes a 12 462 -11 762 =**700** of payment allocated to G 2.

- Applying IFRS 17.B68, the discounted fulfilment cash flows allocated to G 2 therefore amount to (17 389 -700) /1.03^5 =14 396. The CSM amounts to **604**.

- The FCF allocated to G 1 include a payment of 700 to G 2 which results in discounted FCF of 700 /1.03^4 =622 allocated to G 1 whereas for the calculation of the CSM of G 2, this amount is discounted over 5 years: 700 /1.03^5 =604 with a difference of 18. This amount impacts the CSM of G 2.

303 Consequently § 267-269 are amended as follows:

- The entity computes the discounted fulfilment cash flows:
  - For G 1, the liability is (11 762 +700) /1.01^3 =12 095 with an increase of 12 095 -11 072 =1 023
  - For G 2, the liability is (17 389 -700) /1.01^4 =16 038 with an increase of 16 038 -14 396 =1 642.

  The total increase in the discounted fulfilment cash flows is therefore 2 665.

- Then the entity unlocks the CSM to record its share in the changes in the fair value of the underlying item that is 2 759 -2 665 =94.

- According to its accounting policy, the entity thus allocates the entity's share of the fair value of the underlying items as follows:
  - The amount allocated to G 1 is therefore 94 x1 023 /2 665 =36
  - The amount allocated to G 2 is therefore 94 x1 642 /2 665 =58

304 The cumulative CSM of G 1 and G 2 has not significantly changed:

	Transfer: 510			Transfer: 700		
	G 1	**G 2**	**Total**	**G 1**	**G 2**	**Total**
New contracts issued in year Y	236		236	236		236
Change in the entity's share of the underlying items	200		200	32		32
Release to profit and loss (1/5)	-87		-87	-54		-54
Balance carried forward to year Y+1	349		349	214		214
Change in the entity's share of the underlying items	34	56	200	36	58	94
New contract issued in Y+1		440	440		604	604
CSM at the end of Y+1	383	497	**880**	250	662	**912**

By and large, the cumulative amount of CSM remains the same disregarding the discretionary *assumptions made on the mutualised population in-Force (G 1) before the new business (G 2) has been issued*. The difference in amount mainly results from the CSM released to profit and loss in year Y.

IFRS 17 issues – Reinsurance

Amended draft for discussion

1 Current IASB requirements and TRG conclusions

1.1 IFRS 17 requirements

1 IFRS 17.47: An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, any previously recognised acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow. Applying paragraph 16(a), an entity shall group such contracts separately from contracts that are not onerous. To the extent that paragraph 17 applies, an entity may identify the group of onerous contracts by measuring a set of contracts rather than individual contracts. An entity shall recognise a loss in profit or loss for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for the group being equal to the fulfilment cash flows and the contractual service margin of the group being zero.

2 IFRS 17.60: The requirements in IFRS 17 are modified for reinsurance contracts held, as set out in paragraphs 61–70.

3 IFRS 17.61: An entity shall divide portfolios of reinsurance contracts held applying paragraphs 14–24, except that the references to onerous contracts in those paragraphs shall be replaced with a reference to contracts on which there is a net gain on initial recognition. For some reinsurance contracts held, applying paragraphs 14–24 will result in a group that comprises a single contract.

4 IFRS 17.62: Instead of applying paragraph 25, an entity shall recognise a group of reinsurance contracts held:

(a) if the reinsurance contracts held provide proportionate coverage—at the beginning of the coverage period of the group of reinsurance contracts held or at the initial recognition of any underlying contract, whichever is the later; and

(b) in all other cases—from the beginning of the coverage period of the group of reinsurance contracts held.

5 IFRS 17.63: In applying the measurement requirements of paragraphs 32–36 to reinsurance contracts held, to the extent that the underlying contracts are also measured applying those paragraphs, the entity shall use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurance contracts held and the estimates of the present value of the future cash flows for the group(s) of underlying insurance contracts. In addition, the entity shall include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

6 IFRS 17.64: Instead of applying paragraph 37, an entity shall determine the risk adjustment for non-financial risk so that it represents the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts.

7 IFRS 17.65: The requirements of paragraph 38 that relate to determining the contractual service margin on initial recognition are modified to reflect the fact that for a group of reinsurance contracts held there is no unearned profit but instead a net cost or net gain on purchasing the reinsurance. Hence, on initial recognition:

(a) the entity shall recognise any net cost or net gain on purchasing the group of reinsurance contracts held as a contractual service margin measured at an amount equal to the sum of the fulfilment cash flows, the amount derecognised at that date of any asset or liability previously recognised for cash flows related to the group of reinsurance contracts held, and any cash flows arising at that date; unless

(b) the net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the group of reinsurance contracts, in which case, notwithstanding the requirements of paragraph B5, the entity shall recognise such a cost immediately in profit or loss as an expense.

8 IFRS 17.66: Instead of applying paragraph 44, an entity shall measure the contractual service margin at the end of the reporting period for a group of reinsurance contracts held as the carrying amount determined at the start of the reporting period, adjusted for:

(a) the effect of any new contracts added to the group (see paragraph 28);

(b) interest accreted on the carrying amount of the contractual service margin, measured at the discount rates specified in paragraph B72(b);

(c) changes in the fulfilment cash flows to the extent that the change:

(i) relates to future service; unless

(ii) the change results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for the group of underlying insurance contracts.

(d) the effect of any currency exchange differences arising on the contractual service margin; and

(e) the amount recognised in profit or loss because of services received in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period of the group of reinsurance contracts held, applying paragraph B119.

9 IFRS 17.67: Changes in the fulfilment cash flows that result from changes in the risk of non-performance by the issuer of a reinsurance contract held do not relate to future service and shall not adjust the contractual service margin.

10 IFRS 17.68: Reinsurance contracts held cannot be onerous. Accordingly, the requirements of paragraphs 47–52 do not apply.

11 IFRS 17.69: An entity may use the premium allocation approach set out in paragraphs 55–56 and 59 (adapted to reflect the features of

reinsurance contracts held that differ from insurance contracts issued, for example the generation of expenses or reduction in expenses rather than revenue) to simplify the measurement of a group of reinsurance contracts held, if at the inception of the group:

(a) the entity reasonably expects the resulting measurement would not differ materially from the result of applying the requirements in paragraphs 63–68; or

(b) the coverage period of each contract in the group of reinsurance contracts held (including coverage from all premiums within the contract boundary determined at that date applying paragraph 34) is one year or less.

12 IFRS 17.70: An entity cannot meet the condition in paragraph 69(a) if, at the inception of the group, an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the asset for remaining coverage during the period before a claim is incurred. Variability in the fulfilment cash flows increases with, for example:

(a) the extent of future cash flows relating to any derivatives embedded in the contracts; and

(b) the length of the coverage period of the group of reinsurance contracts held.

13 IFRS 17.82: An entity shall present income or expenses from reinsurance contracts held separately from the expenses or income from insurance contracts issued.

14 IFRS 17.86: An entity may present the income or expenses from a group of reinsurance contracts held (see paragraphs 60–70), other than insurance finance income or expenses, as a single amount; or the entity may present separately the amounts recovered from the reinsurer and an allocation of the premiums paid that together give a net amount equal to that single amount. If an entity presents separately the amounts recovered from the reinsurer and an allocation of the premiums paid, it shall:

(a) treat reinsurance cash flows that are contingent on claims on the underlying contracts as part of the claims that are expected to be reimbursed under the reinsurance contract held;

(b) treat amounts from the reinsurer that it expects to receive that are not contingent on claims of the underlying contracts (for example, some types of ceding commissions) as a reduction in the premiums to be paid to the reinsurer; and

(c) not present the allocation of premiums paid as a reduction in revenue.

15 IFRS 17.98: An entity shall disclose reconciliations that show how the net carrying amounts of contracts within the scope of IFRS 17 changed during the period because of cash flows and income and expenses recognised in the statement(s) of financial performance. Separate reconciliations shall be disclosed for insurance contracts issued and reinsurance contracts held. An entity shall adapt the requirements of paragraphs 100–109 to reflect the features of reinsurance contracts held that differ from insurance contracts

issued; for example, the generation of expenses or reduction in expenses rather than revenue.

16	IFRS 17.107:	For insurance contracts other than those to which the premium allocation approach described in paragraphs 53–59 or 69–70 has been applied, an entity shall disclose the effect on the statement of financial position separately for insurance contracts issued and reinsurance contracts held that are initially recognised in the period, showing their effect at initial recognition on: (a) the estimates of the present value of future cash outflows, showing separately the amount of the insurance acquisition cash flows; (b) the estimates of the present value of future cash inflows; (c) the risk adjustment for non-financial risk; and (d) the contractual service margin.
17	IFRS 17.App.A:	reinsurance contract: An insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity (underlying contracts).
18	IFRS 17.App.A:	investment component: The amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.
19	IFRS 17.B 101:	Insurance contracts with direct participation features are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items. Hence, they are defined as insurance contracts for which: (a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items (see paragraphs B105–B106); (b) the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items (see paragraph B107); and (c) the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items (see paragraph B107).
20	IFRS 17.B 109:	Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purposes of IFRS 17.
21	IFRS 17.B 115:	To the extent that an entity meets the conditions in paragraph B116, it may choose not to recognise a change in the contractual service margin to reflect some or all of the changes in the effect of financial risk on the entity’s share of the underlying items (see paragraph B112) or the fulfilment cash flows set out in paragraph B113(b).
22	IFRS 17.B 116:	To apply paragraph B115, an entity must have a previously documented risk-management objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts and, in applying that objective and strategy:

(a) the entity uses a derivative to mitigate the financial risk arising from the insurance contracts.

(b) an economic offset exists between the insurance contracts and the derivative, ie the values of the insurance contracts and the derivative generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated. An entity shall not consider accounting measurement differences in assessing the economic offset.

(c) credit risk does not dominate the economic offset.

23 IFRS 17.C 3: An entity shall apply IFRS 17 retrospectively unless impracticable, except that:

(a) an entity is not required to present the quantitative information required by paragraph 28(f) of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors; and

(b) an entity shall not apply the option in paragraph B115 for periods before the date of initial application of IFRS 17.

24 IFRS 17.BC 241: The Board decided that these differences are necessary to give a faithful representation of the different nature of the fee in these contracts. As explained in paragraphs BC228–BC231, the Board concluded that for many insurance contracts it is appropriate to depict the gains and losses on any investment portfolio related to the contracts in the same way as gains and losses on an investment portfolio unrelated to insurance contracts. However, the Board also considered a contrasting view that, for some contracts, the returns to the entity from a pool of underlying items should be viewed as the compensation that the entity charges the policyholder for service provided by the insurance contract, rather than as a share of returns from an unrelated investment. Under this contrasting view, changes in the estimate of the entity's share of returns are regarded as a change in the entity's compensation for the contract. Such changes in the entity's compensation should be recognised over the periods in which the entity provides the service promised in the contract, in the same way that changes in the estimates of the costs of providing the contract are recognised.

25 IFRS 17.BC 248: For reinsurance contracts an entity holds, the entity and the reinsurer do not share in the returns on underlying items, and so the criteria in paragraph BC238 are not met, even if the underlying insurance contracts issued are insurance contracts with direct participation features. The Board considered whether it should modify the scope of the variable fee approach to include reinsurance contracts held, if the underlying insurance contracts issued are insurance contracts with direct participation features. But such an approach would be inconsistent with the Board's view that a reinsurance contract held should be accounted for separately from the underlying contracts issued.

26 IFRS 17.BC 249: Although some types of reinsurance contracts issued might meet the criteria in paragraph BC238, the Board decided that reinsurance contracts issued are not eligible for the variable fee approach. This is because the view that the returns to the entity from a pool of underlying items should be viewed as part of the compensation that the entity charges the policyholder for the

service provided by the insurance contract (see paragraph BC241) does not apply to reinsurance contracts issued.

Reinsurance contracts (paragraphs 60–70 of IFRS 17)

27 IFRS 17.BC 296: A reinsurance contract is a type of insurance contract. The Board identified no reason to apply different requirements to reinsurance contracts from those applied to other insurance contracts an entity issues. Consequently, IFRS 17 requires entities that issue reinsurance contracts to use the same recognition and measurement approach as they use for other insurance contracts.

28 IFRS 17.BC 297: Although both an issuer of direct insurance contracts and a reinsurer of those contracts will measure their contractual rights and obligations on the same basis, in practice they will not necessarily arrive at the same amount. Differences between the estimates for the reinsurance contract and the underlying contracts may arise because the issuer of the underlying insurance contracts and the reinsurer may base estimates on access to different information; they may also make different adjustments for diversification effects.

29 IFRS 17.BC 298: IFRS 17 also applies to reinsurance contracts held by an entity (ie in which the entity is the policyholder). IFRS 17 requires a reinsurance contract held to be accounted for separately from the underlying insurance contracts to which it relates. This is because an entity that holds a reinsurance contract does not normally have a right to reduce the amounts it owes to the underlying policyholder by amounts it expects to receive from the reinsurer. The Board acknowledged that separate accounting for the reinsurance contracts and their underlying insurance contracts might create mismatches that some regard as purely accounting, for example on the timing of recognition (see paragraphs BC304–BC305), the measurement of the reinsurance contracts (see paragraphs BC310–BC312) and the recognition of profit (see paragraph BC313). However, the Board concluded that accounting for a reinsurance contract held separately from the underlying insurance contracts gives a faithful representation of the entity's rights and obligations and the related income and expenses from both contracts.

30 IFRS 17.BC 299: The amount an entity pays for reinsurance coverage consists of premiums the entity pays minus any amounts paid by the reinsurer to the entity to compensate the entity for expenses it incurs, such as underwriting or acquisition expenses (often referred to as 'ceding commissions'). The amount paid for reinsurance coverage by the entity can be viewed as payment for the following:

(a) the reinsurer's share of the expected present value of the cash flows generated by the underlying insurance contract(s). That amount includes an adjustment for the risk that the reinsurer may dispute coverage or fail to satisfy its obligations under the reinsurance contract held.

(b) a contractual service margin that makes the initial measurement of the reinsurance asset equal to the premium paid. This margin depends on the pricing of the reinsurance contract held and, consequently, may differ from the contractual service margin arising for the underlying insurance contract(s).

31 IFRS 17.BC 300: When estimating cash flows and the associated adjustments for the financial risk and the time value of money arising from reinsurance contracts held, the entity would use assumptions consistent with those it uses for the underlying contracts. As a result, the cash flows used to measure the reinsurance contracts held would reflect the extent to which those cash flows depend on the cash flows of the contracts they cover.

32 IFRS 17.BC 301: Consistent with the requirements for the measurement of insurance contracts an entity issues, the entity also may apply the premium allocation approach to simplify the measurement of reinsurance contracts held, provided that the resulting measurement is a reasonable approximation of the results that would be obtained by applying the general requirements of IFRS 17. The entity may also apply the premium allocation approach if the coverage period of each reinsurance contract held in the group is one year or less. Because groups of reinsurance contracts are separate from the groups of underlying insurance contracts, the assessment of whether a group of reinsurance contracts meets conditions for applying the premium allocation approach may differ from the assessment of whether the group(s) of underlying insurance contracts meet(s) those conditions.

33 IFRS 17.BC 302: IFRS 17 modifies the requirements for reinsurance contracts held to reflect the fact that:

(a) groups of reinsurance contracts held are generally assets, rather than liabilities; and

(b) entities holding reinsurance contracts generally pay a margin to the reinsurer as an implicit part of the premium, rather than making profits from the reinsurance contracts.

34 IFRS 17.BC 303: The following paragraphs discuss aspects of the general principles in IFRS 17 in relation to groups of reinsurance contracts held:

(a) recognition for groups of reinsurance contracts held (see paragraphs BC304–BC305);

(b) derecognition (see paragraph BC306);

(c) cash flows (see paragraphs BC307–BC309); and

(d) contractual service margin (see paragraphs BC310–BC315).

Recognition for groups of reinsurance contracts held (paragraph 62 of IFRS 17)

35 IFRS 17.BC 304: Many reinsurance arrangements are designed to cover the claims incurred under underlying insurance contracts written during a specified period. In some cases, the reinsurance contract held covers the losses of separate contracts on a proportionate basis. In other cases, the reinsurance contract held covers aggregate losses from a group of underlying contracts that exceed a specified amount.

36 IFRS 17.BC 305: The Board decided to simplify the application of the principle that a contract should be recognised from the date the entity is exposed to risk for reinsurance contracts as follows:

(a) when the group of reinsurance contracts held covers the loss of a group of insurance contracts on a proportionate basis, the group of reinsurance contracts held is recognised at the later of the beginning of the coverage period of the group of reinsurance contracts held or the initial recognition of any underlying contracts. This means that the entity will not recognise the group of reinsurance contracts until it has recognised at least one of the underlying contracts.

(b) when the group of reinsurance contracts held covers aggregate losses arising from a group of insurance contracts over a specified amount, the group of reinsurance contracts held is recognised when the coverage period of the group of reinsurance contracts begins. In these contracts the entity benefits from coverage—in case the underlying losses exceed the threshold—from the beginning of the group of reinsurance contracts held because such losses accumulate throughout the coverage period.

Derecognition of underlying contracts (paragraphs 74–75 of IFRS 17)

37 IFRS 17.BC 306: An entity does not derecognise an insurance contract until the contractual obligations are extinguished by discharge, cancellation or expiry (or on specified modifications of the contract). A reinsurance contract held typically protects the entity from the effects of some defined losses on the underlying group of insurance contracts, but does not eliminate the entity's responsibility for fulfilling its obligations under those contracts. It follows that the entity typically would not derecognise the related underlying insurance contracts upon entering into a reinsurance contract.

Cash flows in reinsurance contracts held (paragraph 63 of IFRS 17)

38 IFRS 17.BC 307: As required by paragraph 63 of IFRS 17, cash flows for a group of reinsurance contracts held should be estimated using assumptions that are consistent with those used for the group(s) of underlying insurance contracts. In addition, IFRS 17 requires entities to reflect expected credit losses in the measurement of the fulfilment cash flows. This is discussed in paragraphs BC308–BC309.

39 IFRS 17.BC 308: An entity holding reinsurance contracts faces the risk that the reinsurer may default, or may dispute whether a valid claim exists for an insured event. IFRS 17 requires the estimates of expected credit losses to be based on expected values. Hence, estimates of the amounts and timing of cash flows are probability-weighted outcomes after calculating the effect of credit losses.

40 IFRS 17.BC 309: IFRS 17 prohibits changes in expected credit losses adjusting the contractual service margin. In the Board's view, differences in expected credit losses do not relate to future service. Accordingly, any changes in expected credit losses are economic events that the Board decided should be reflected as gains and losses in profit or loss when they occur. This would result in consistent accounting for expected credit losses between reinsurance contracts held and purchased, and originated credit-impaired financial assets accounted for in accordance with IFRS 9.

Gains and losses on buying reinsurance (paragraph 65 of IFRS 17)

41 IFRS 17.BC 310: The amount paid by the entity to buy reinsurance contracts would typically exceed the expected present value of cash flows generated by the reinsurance contracts held, plus the risk adjustment for non-financial risk. Thus, a debit contractual service margin, which represents the net expense of purchasing

reinsurance, would typically be recognised on the initial recognition of a group of reinsurance contracts held. The Board considered whether the contractual service margin of the group of reinsurance contracts held could be a credit if, as happens in rare cases, the amount paid by the entity is less than the expected present value of cash flows plus the risk adjustment for non-financial risk. Such a credit contractual service margin would represent a net gain on purchasing reinsurance. The most likely causes of such a net gain would be either of the following:

(a) an overstatement of the underlying insurance contract(s). An entity would evaluate this by reviewing the measurement of the underlying insurance contract(s).

(b) favourable pricing by the reinsurer; for example, as a result of diversification benefits that are not available to the entity.

42 IFRS 17.BC 311: The Board originally proposed that entities should recognise a gain when such a negative difference arose. The Board proposed this for symmetry with the model for the underlying group of insurance contracts and for consistency with the Board's conclusion that the contractual service margin for the underlying group of insurance contracts should not be negative. However, IFRS 17 requires entities to instead recognise the negative difference over the coverage period of the group of reinsurance contracts held. The Board was persuaded by the view that the apparent gain at initial recognition represents a reduction in the cost of purchasing reinsurance, and that it would be appropriate for an entity to recognise that reduction in cost over the coverage period as services are received.

43 IFRS 17.BC 312: The Board also decided that the net expense of purchasing reinsurance should be recognised over the coverage period as services are received unless the reinsurance covers events that have already occurred. For such reinsurance contracts held, the Board concluded that entities should recognise the whole of the net expense at initial recognition, to be consistent with the treatment of the net expense of purchasing reinsurance before an insured event has occurred. The Board acknowledged that this approach does not treat the coverage period of the reinsurance contract consistently with the view that for some insurance contracts the insured event is the discovery of a loss during the term of the contract, if that loss arises from an event that had occurred before the inception of the contract. However, the Board concluded that consistency of the treatment of the net expense across all reinsurance contracts held would result in more relevant information.

44 IFRS 17.BC 313: The Board considered the view that the amount of the contractual service margin included in the measurement of the group of reinsurance contracts held should be proportional to the contractual service margin on the group of underlying contracts instead of being measured separately by reference to the reinsurance premium. Under this approach, any difference between the amount recognised for the group of underlying insurance contracts and the reinsurance premium would be recognised in profit or loss when the group of reinsurance contracts held is initially recognised. This approach would depict a

gain or loss equal to the shortfall or excess of the reinsurance premium the entity pays to the reinsurer above or below the premium that the entity receives from the policyholder. Thereafter, unearned profit from the group of underlying contracts would be offset by an equal and opposite expense for the reinsurance premium. However, in the Board's view, measuring the group of reinsurance contracts held on the basis of the premium the entity receives for the underlying contracts when that premium does not directly affect the cash flows arising from the group of reinsurance contracts held would be contrary to viewing the group of reinsurance contracts held and the underlying contracts as separate contracts. Such a measurement approach would also not reflect the economics of the group of reinsurance contracts the entity holds—that the expense of purchasing the group of reinsurance contracts (that should be recognised over the coverage period) equals the whole of the consideration paid for the group of reinsurance contracts.

45 IFRS 17.BC 314: For the measurement of the group of insurance contracts the entity issues, IFRS 17 specifies that the contractual service margin can never be negative. IFRS 17 does not include a limit on the amount by which the contractual service margin of a group of reinsurance contracts held could be adjusted as a result of changes in estimates of cash flows. In the Board's view, the contractual service margin for a group of reinsurance contracts held is different from that for a group of insurance contracts issued—the contractual service margin for the group of reinsurance contracts held depicts the expense the entity incurs when purchasing reinsurance coverage rather than the profit it will make by providing services under the insurance contract. Accordingly, the Board placed no limit on the amount of the adjustment to the contractual service margin for the group of reinsurance contracts held, subject to the amount of premium paid to the reinsurer.

46 IFRS 17.BC 315: The Board considered the situation that arises when the underlying group of insurance contracts becomes onerous after initial recognition because of adverse changes in estimates of fulfilment cash flows relating to future service. In such a situation, the entity recognises a loss on the group of underlying insurance contracts. The Board concluded that corresponding changes in cash inflows from a group of reinsurance contracts held should not adjust the contractual service margin of the group of reinsurance contracts held, with the result that the entity recognises no net effect of the loss and gain in the profit or loss for the period. This means that, to the extent that the change in the fulfilment cash flows of the group of underlying contracts is matched with a change in fulfilment cash flows on the group of reinsurance contracts held, there is no net effect on profit or loss.

1.2 TRG

<u>TRG 2018-02 AP 03: reinsurance contract's boundaries</u>

47 TRG 2018-02 Summary. §16: […] A Board member observed that those existing accounting practices are inconsistent with accounting for

reinsurance contracts held separately to the underlying insurance contracts and using measurement principles for reinsurance contracts held that are consistent with the measurement of the insurance contracts issued.

TRG 2018-09 AP 03: presentation in the reinsurer's statement of performance

48 TRG 2018-09 Summary. §14: TRG members discussed the analysis in Agenda Paper 3 and observed that:

(a) the requirements set out in paragraph 86 of IFRS 17 for the presentation of income or expenses from reinsurance contracts held are based on the economic effect of exchanges between the reinsurer and the cedant, and it would be appropriate to apply an assessment of the economic effect of such exchanges to reinsurance contracts issued as well.

(b) the economic effect of amounts exchanged between a reinsurer and a cedant that are not contingent on claims is equivalent to the effect of charging a different premium. Therefore, those amounts would be recognised as part of insurance revenue applying paragraph B123 or B126 of IFRS 17.

(c) the economic effect of amounts exchanged between a reinsurer and a cedant that are contingent on claims is equivalent to reimbursing a different amount of claims than expected. Therefore, those amounts would be recognised as part of insurance service expenses applying paragraph 42(a) of IFRS 17.

(d) unless the cedant provides a distinct service to the reinsurer that results in a cost to the reinsurer for selling, underwriting and starting a group of reinsurance contracts that it issues, a ceding commission is not an insurance acquisition cash flow of the reinsurer.

(e) amounts exchanged between the reinsurer and the cedant that are not contingent on claims may meet the definition of an investment component if they are repaid to the cedant in all circumstances (including on cancellation of the contract).

2018-09 AP 09: reinsurance vs. co-insurance or transfer of insurance contracts

49 TRG 2018-09 Summary. §33: TRG members discussed the analysis in Agenda Paper 9 and observed that:

(a) in some cases, the parties to the contract are clear from the legal form of the contract. In other cases, the terms of the contract require analysis to identify the substance of the rights and obligations—including who is the issuer of the contract. For insurance contracts in an industry pool the issuer could be:

(i) the individual member entity that writes the contracts;

(ii) each member entity for its respective share of each contract in the pool; or

(iii) the collective comprised of all member entities.

(b) IFRS 17 applies to insurance contracts issued by an entity and does not have specific requirements for insurance contracts issued by more than one entity. Entities should assess whether an arrangement under which an insurance contract is issued by more than one entity is also within the scope of another IFRS Standard, for example IFRS 11 Joint Arrangements. IAS 8 includes requirements for an entity to apply in the absence of a Standard that specifically applies to a transaction, other event or condition.

(c) in some cases, an individual member entity may write an insurance contract and then subsequently transfer the contract to the industry pool. If that member entity is the issuer of the contract applying IFRS 17, the entity should consider whether the transfer:

(i) is a contract that meets the definition of a reinsurance contract applying IFRS 17; or

(ii) extinguishes the individual member's obligations to the policyholder applying paragraph 74 of IFRS 17.

1.3 Tentative Board's decisions

<u>December 2018 meeting</u>

50 IASB 2018-12.AP 2E §25: The staff also observe that the purpose of the amendment proposed in paragraph 17(a)is to achieve 'mirror' accounting between the reinsurance contract held and the underlying insurance contracts issued. This approach was considered and rejected by the Board during the development of IFRS 17 because such an approach is contradictory to the **fundamental principle that a reinsurance contract held should be accounted for in the same manner as insurance contracts issued, including reinsurance contracts issued**.

<u>January 2019 meeting</u>

51 IASB 2019-01.AP 2B §68: The staff recommend the Board amend IFRS 17 to: (a) expand the scope of the exception in paragraph 66(c)(ii) of IFRS 17 to require an entity to recognise a gain in profit or loss when the entity recognises losses on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis; and

(b) require an entity to apply the expanded exception when the entity measures contracts applying the PAA.

52 IASB 2019-01.AP 2B §43: The staff agree with stakeholder concerns that if an amendment was to apply also to reinsurance contracts entered into *after* the underlying contracts are issued, an entity might enter into a reinsurance contract after the underlying contracts are issued to achieve a particular accounting outcome. Therefore, this paper does not consider any amendments that would apply in those circumstances.

53 IASB 2019-01.AP 2D §2: The staff recommend the International Accounting Standards Board (Board) amend IFRS 17 to expand the scope of the risk mitigation exception for insurance contracts with direct participation features in paragraph B115 of IFRS 17 Insurance Contracts so that it applies when an entity uses a derivative or a reinsurance contract held to mitigate financial risk, to the extent that the entity meets the conditions in paragraph B116 of IFRS 17.

54 IASB 2019-01.AP 2D §8: For reinsurance contracts an entity holds, the entity and the reinsurer do not share in the returns on underlying items, and so the criteria for the scope of the variable fee approach are not met. This is the case regardless of whether the underlying insurance contracts issued are insurance contracts with direct participation features.

55 IASB 2019-01.AP 2D §11: The Board also considered stakeholder feedback that some reinsurance contracts *issued* might meet the criteria for the scope of the variable fee approach. The Board decided that, although some types of reinsurance contracts issued might meet the criteria for the scope of the variable fee approach, reinsurance contracts issued are not eligible for the variable fee approach. This is because the Board developed the variable fee approach for contracts for which, in the Board's view, the returns to the entity from a pool of underlying items should be viewed as part of the compensation that the entity charges the policyholder for the services provided by the insurance contract. That view does not apply to reinsurance contracts issued.

56 IASB 2019-01.AP 2D §17: The staff observe that some reinsurance contracts held do not mitigate the financial risks of variable fee approach insurance contracts. However, stakeholders have noted that some reinsurance contracts held may do so. For those reinsurance contracts, there may be an accounting mismatch similar to the accounting mismatch created when an entity uses derivatives to mitigate financial risks of underlying variable fee approach contracts. Therefore, the staff think an amendment to IFRS 17 that would resolve that accounting mismatch could be justified.

<u>March 2019 meeting</u>

57 IASB 2019-03.AP 2 §A6: The Board tentatively decided [in January 2019] to amend IFRS 17 to:

(a) expand the scope of the exception in paragraph 66(c)(ii) of IFRS 17 to require an entity to recognise a gain in profit or loss when the entity recognises losses on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis; and

(b) require an entity to apply the expanded exception when the entity measures contracts applying the PAA.

58 IASB 2019-03.AP 2 §A7: The Board also tentatively decided [in January 2019] to amend IFRS 17 to expand the scope of the risk mitigation exception for insurance contracts with direct participation features in paragraph B115 of IFRS 17 so that the exception applies when an entity uses a derivative or a reinsurance contract held to mitigate financial risk, to the extent that the entity meets the conditions in paragraph B116 of IFRS 17.

1.4 Current understanding of the accounting treatment

<u>Issue 1: Prohibition of VFA to reinsurance contracts</u>

59 The standard does not address separately reinsurance contracts issued: they are treated similarly to insurance contracts (IFRS 17.BC 296) except for IFRS 17.B 109 that explicitly prohibits applying the VFA.

60 The standard prohibits the application of the VFA to reinsurance contracts issued even when meeting the VFA criteria (IFRS 17.BC 249). The reason provided is that a reinsurer cannot receive a "fee" depicted in IFRS 17.BC 241 as the returns on a pool of underlying items being part of a compensation that it charges for the service provided to policyholders.

61 IFRS 17.B 109 also prohibits the application of VFA to reinsurance contracts held.

62 IASB staff however acknowledged (IASB 2019-01.AP 2D §17) that for some reinsurance contracts there may be an accounting mismatch similar to the accounting mismatch created when an entity uses derivatives to mitigate financial risks of underlying variable fee approach contracts. In January 2019, the board then tentatively decided to amend IFRS 17 to expand the scope of the risk mitigation exception for insurance contracts with direct participation features in paragraph B115 of IFRS 17 so that it applies when an entity use a derivative or a reinsurance contract held to mitigate financial risk, to the extent that the entity meets the conditions in paragraph B116 of IFRS 17.

Reinsurance vs. co-insurance or transfer of insurance contracts

63 According to the definition in appendix A, a reinsurance contract is an insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity (underlying contracts).

64 Co-insurance contracts are not defined in the standard but have been addressed by the TRG (TRG 2018-09.AP 09.18 and 2018-09 Summary § 33(b)) when dealing with "insurance contracts issued by more than one entity". Such contracts are either in the scope of IFRS 11 or, as no other standard applies, a specific accounting policy may be developed according to IAS 8.10.

65 The TRG also contemplated the case when an entity writes a contract and then subsequently transfers it. The transfer may then either (i) meet the definition of a reinsurance contract or (ii) extinguish the entity's obligation to the policyholder, applying IFRS 17.74. (TRG 2018-09.AP 09.22 and 2018-09 Summary § 33(c))

<u>Issue 2: Reinsurance of onerous contracts</u>

66 The net gain on reinsurance contracts held on initial recognition has to be spread over the duration of the reinsurance contract, even if it efficiently covers onerous insurance contracts issued, which losses have been immediately recognised; [IFRS 17.61 and IFRS 17.65(a)].

67 Since reinsurance initially covers all future cash flows, a reinsurance contract is *recognised* (IFRS 17.65) as soon as underwritten, even at a net "nil" value. Any future underlying contract issued induces a change in the *measurement* (IFRS 17.66(e)) of the reinsurance contract but not in its recognition.

<u>Issue 3: Contract's boundaries of reinsurance contracts held</u>

68 The board has recalled (IASB 2018-12 AP 2E §25) that the measurement of reinsurance contracts held includes future cash-flows in order to be symmetrical to

the reinsurance contract issued, rather than promoting symmetry with the underlying contracts.

Issue 4: presentation of reinsurance contracts issued

69 In the statement of financial performance of a reinsurer, the presentation of amounts exchanged with the primary insurer is not addressed by the standard. TRG suggests presentation rules (rather than principles requiring judgement) that are based on the relation to the amount of claim rather than on the nature of the service received or provided.

Issue 5: Accounting treatment of reinsurance contracts held

70 According to IFRS 17, reinsurance contracts have to be accounted for as separate contracts, i.e. not as an element of the cash-flows of the underlying insurance contracts. As a consequence, even if reinsurance contracts may have an impact of the profitability of underlying insurance contracts, they have no impact on the level of aggregation applied on the underlying contracts. Reinsurance contracts held are subject to the general standard's provisions with some adjustment expressed in IFRS 17.60-70.

71 A "bouquet" of reinsurance treaties combines a set of reinsurance contracts between the same primary insurer and the same reinsurer, as addressed in principle by IFRS 17.9. The standard acknowledges that it may be necessary to treat the series of contracts as a whole. In order to apply the provisions on the level of aggregation in IFRS 17.14, the entity would apply IFRS 17.24 and allocate the fulfilment cash-flows of the bouquet to each separate portfolio. Such a bouquet may raise application issues (but no standard-setting issue) regarding the level of aggregation of reinsurance contracts held and the allocation of the CSM to the portfolios and groups.

2 Issue

2.1 Reinsurance contracts

72 From the perspective of the (ceding) primary insurer, reinsurance held (ceded/purchased) is an efficient risk mitigating tool because reinsurers benefit from higher diversification effects, i.e. a lower risk adjustment.

73 Reinsurance on an annual or multi-year basis may be:

- Proportional treaties (including "surplus-share" or "quota-share", covering losses on a proportional basis); or
- Non-proportional treaties ("excess of loss", covering aggregate losses in excess of a specified amount).

74 The proper accounting treatment of reinsurance held from the perspective of the primary insurer should, in principle:

- be driven by the economic link between the reinsured business and the reinsurance transaction, rather than by the form of the reinsurance transaction.
- present the risk mitigation effects of reinsurance held in symmetry with the accounting performance of the reinsured business.

Reported issues

75 Several issues have been reported:

- 1. Reinsurance issued or held cannot be accounted for under the VFA model, even if the VFA model is applied to the underlying insurance contracts;
- 2. For a contract onerous on initial recognition an insurer has to recognise a loss component though P/L whereas the relief from a corresponding reinsurance contract held has to be deferred and recognised over the coverage period;
- 3. Contract boundaries for reinsurance may be inconsistent with those of the underlying insurance contracts; indeed reinsurance accounting results in including an estimate of underlying insurance business that is not yet written/recognised;
- 4. Specific presentation issues in the statement of financial performance of a reinsurer.
- 5. Standard's provisions on the level of aggregation applied to reinsurance held are not clear enough.

2.2 Issue 1: Prohibition of VFA to reinsurance contracts

76 As mentioned above (§ 60 and § 61), the dedicated accounting treatment ("VFA") for direct participating contracts cannot apply to reinsurance contracts issued or held. Stakeholders in certain jurisdictions have identified direct participating contracts (that can be managed in substance as co-insurance business) that would meet the specific VFA criteria in the standard and question the conceptual reasons for such a prohibition.

<u>Reinsurance contracts with direct participation features</u>

77 Non-proportional treaties generally do not cover financial risks. By contrast, some proportional (or "quota-share") treaties do actually "share the returns on the underlying items between the primary insurer and the reinsurer". Such reinsurance contracts are proportionally exposed to the same underlying risks and returns as the primary insurance contracts. Such treaties are generally set:

- for business purposes, e.g. exchanging reinsurance service against access to a broader distribution network. In order to provide a broader service but keeping the direct commercial relationship with the policyholder, an insurer may hold reinsurance contracts ;
- in order to provide a better performance to the policyholder when combining the performance of several insurers;
- to achieve prudential solvency capital requirements, such prudential ratio being computed net of reinsurance contracts.

78 "Quota-share" reinsurance contracts with direct participation features have in common that:

- a pool of underlying items is shared between the reinsurer and the primary insurer;
- the reinsurer's obligations towards the primary insurer replicate the primary insurer's obligations towards policyholders:
    - the reinsurer has to pay to the primary insurer a significant part of the returns of the share of the underlying items it holds so that the primary insurer may pay them to the primary policyholders;
    - a substantial proportion of the cash flows the reinsurer expects to pay to the primary insurer vary with the cash flows from its share of the underlying items, so that the final cash flows paid to the policyholders vary similarly.

79 "Quota-share" (less than 100%) reinsurance contracts with direct participation features may have different features:

- A share in the premium paid by policyholders is transferred from the primary insurer to the reinsurer, who then invests in its own assets. An additional mechanism pools then together a substantial share in the returns on assets of the insurer and the reinsurer in order to return it to policyholders (see also illustrative example in § 82-84); or
- The premium paid by policyholders and the control on / management of the underlying assets are retained by the primary insurer. Such a scheme is designed to avoid the complexity of reflecting exactly the evolution of the underlying items held by the insurer: by nature, all the underlying items, both the reinsurer's and the primary insurer's parts, are similar. However, the reinsurer retains the full ownership and responsibility of its share in the underlying items: the primary insurer acts as an asset manager for the ceded share of the underlying items (see also illustrative example in § 86-87).

80 In the first case the primary insurer and the reinsurer manage their own share of assets, and then pool the returns, whereas in the second case, the reinsurer and the primary insurer benefit from the same pool of underlying items (managed by the primary insurer).

81 VFA criteria (as defined in IFRS 17.B101) depend upon what the policyholder is expecting to receive rather than what the insurer and the reinsurer are expecting to receive from the underlying items. Actually, in both cases:

- Policyholders participate in a share of a clearly identified pool of underlying items;
- The expected amount to be paid to policyholders is equal to a substantial share of the fair value returns on the underlying items.
- A substantial proportion of any change in the amounts to be paid to the policyholder is expected to vary with the change in fair value of the underlying items.

Illustrative example 1 – "Préfon"

82 For 50 years, Préfon has been put in place in order to provide a voluntary additional life and protection insurance scheme to French civil servants. Préfon nowadays manages around 13 b€.

83 Préfon is managed through a regulated association which has contracted a group insurance contract with a large insurance company in charge of the administration of the contracts. The policy is reinsured by three other insurers (taking on 35%, 20% and 10% of the risk). The insurer and the three reinsurers are responsible for the financial management and performance of the life insurance contracts and bound together with the association through an agreement.

84 From a prudential, contractual and economic point of view, the service provided by the three reinsurers is proportional reinsurance because each reinsurer receives a share in the premiums and manages it in their respective assets. After deduction of a management fee, all the performance of the underlying items is returned to the primary insurer and then passed through to policyholders. The reinsurance management fee is calculated based on the reinsurer's liability against the primary insurer.

85 Regarding the application of the VFA criteria (IFRS 17.B 101) to this illustrative example:

- From the policyholders' point of view, the underlying items are clearly identified as the sum of the reinsurers-managed share and the primary-insurer managed share in the underlying items;

- A substantial proportion of the cash flows the reinsurers expect to pay to the primary insurer and then passed-through to policyholders vary with the changes in fair value of the underlying items;
- All returns on underlying items (less management fees paid to reinsurers and to the primary insurer) are returned to policyholders. As a result, a substantial proportion of any change in the amounts to be paid to the policyholder is expected to vary with the change in fair value of the underlying items.

Illustrative example 2 – "Quota-share treaty"

86 A quota-share (proportional) reinsurance treaty where the reinsurer accepts a fixed share in every risks covered by the primary insurer and where the primary insurer:

- does not necessarily pays upfront to the reinsurer an implicit part of the premium, but, in following periods:
    - pays to the reinsurer the same fixed share in the profits generated by the underlying insurance contracts; or
    - receives from the reinsurer the same fixed share in the losses generated by the underlying insurance contracts;
- in addition:
    - manages the administrative work on contracts, receiving as compensation a specific commission;
    - performs the financial management of the underlying assets over which it retains control. Conversely, the reinsurer does not have any control on assets and is therefore bound to the asset management performed by the insurer.

87 Regarding the application of the VFA criteria (IFRS 17.B 101) to this illustrative example:

- The underlying items are clearly identified and they are held by the primary insurer who has the primary responsibility towards the policyholders for managing them appropriately and a secondary responsibility towards the reinsurer for managing the ceded share of the underlying items in the same way as the retained share;
- The reinsurer expects to pay to the primary insurer an amount equal to a substantial share of the returns from the ceded share of the underlying items, as the contract between the reinsurer and the primary insurer specifies that these returns will be returned to policyholders;
- A substantial proportion of the cash flows the reinsurer expects to be finally paid to the primary insurer are expected to vary with cash flows from the ceded share of underlying items, because there is a replication of the contracts between the primary insurer and the policyholders.

Reinsurance contracts *issued* with direct participation features

88 The prohibition from applying the VFA to reinsurance contracts may stem from their specificities (change in value linked with underlying items) that could make them meet the VFA criteria (IFRS 17.B101) even when not being "in substance VFA". However, some reinsurance contracts issued actually include commitments against primary insurers and their policyholders and are genuine VFA / direct participating contract.

89 In contradiction with the view expressed in IFRS 17.BC 249, some reinsurance contracts issued actually provide an indirect compensation for the underlying insurance service rendered to policyholders. And for that service, the reinsurer does not only receive a fixed premium but rather a share of the returns in a pool of underlying items. Such reinsurance contracts, in addition to meeting the criteria for

VFA contracts (see also § 87 and § 85) also comply with the view depicted in IFRS 17.BC 241.

90 Absent a VFA treatment of such reinsurance contracts, co-insurance could be a way forward on the basis of substance.

<u>Reinsurance contracts *held* with direct participation features</u>

91 In contradiction with IFRS 17.BC 248, reinsurance contracts held may actually have direct participation features and meet the VFA criteria (the same way the related insurance contracts liabilities do).

92 However, because of IFRS 17.B109, accounting treatments of the VFA cannot apply: any change in the financial risk (e.g. a change in the discount rate) of reinsurance contracts held is immediately recognised in the current result or OCI (general model). Under the VFA, the same change in the financial risk is reflected in the CSM of the underlying participating insurance contracts and therefore spread over the coverage period. As a result, the combination of insurance and reinsurance contracts therefore creates an accounting mismatch in the statement of performance (and possibly OCI).

93 In its January 2019 meeting, IASB tentatively decided to expand the scope of the risk mitigation provisions for VFA contracts to also include reinsurance contracts held to mitigate financial risk.

94 In our view, assimilating reinsurance held to risk mitigation should not preclude a retrospective application (IFRS17.C3(b)) (see also the ANC IFRS 17 Issues Paper on Transition).

2.3 Issue 2: Accounting mismatch on reinsurance of an insurance contract being onerous at initial recognition

<u>Accounting mismatch</u>

95 According to IFRS 17.BC 310, a net gain on purchasing reinsurance is expected to be rare because the reinsurance premium paid by a ceding entity will typically exceed the expected present value of cash flows generated by the reinsurance contracts held, plus the risk adjustment for non-financial risks.

96 However, several factors may lead to situations where reinsurance contracts give rise to gains such as:

- Upfront reinsurance commissions to cover the initial acquisitions incurred in expectation of the future renewals;
- Additional mutualisation benefits arising from larger reinsurance portfolios, thus allowing to charge a lower reinsurance premium than the fulfilment cash outflows estimated by the ceding company;
- Additional diversification benefits available for the reinsurer, thus allowing to charge a lower reinsurance premium than the fulfilment cash outflows estimated by the ceding company.

97 On initial recognition, losses are recognised upfront for primary insurance contracts that are onerous at inception. By contrast, any net gain on related reinsurance contracts held is recognised over the life of the reinsurance contract held (except for covered events already occurred). This accounting treatment creates a mismatch and therefore does not reflect the mitigation expected from the reinsurance held.

98 If an insurance contract is not onerous at inception but becomes onerous later on, there is no such a mismatch. Indeed, IFRS 17.66(c)(ii) ensures that any change in

the fulfilment cash flows impacting the CSM of an insurance contract is also reflected in the fulfilment cash flows impacting the CSM of the corresponding reinsurance contract held.

99 In other words, IFRS 17 provides for a symmetrical accounting treatment of the reinsurance contracts held and the underlying insurance contracts *except* at initial recognition. Continuity in the accounting treatment would be achieved by immediately recognising net gains on reinsurance contracts covering onerous underlying contracts rather than by deferring the loss on the underlying contract. From an economical and conceptual point of view, there is no reason to distinguish those situations where, absent a reinsurance contract, no such onerous contract would have been accepted/issued.

<u>Scope of a reinsurance treaty and of its underlying contracts</u>

100 In order to prevent unduly deferring losses on onerous contracts, not all reinsurance results have to be addressed but only reinsurance gains. This excludes reinsurance treaties providing additional costs (i.e. a negative CSM) that have some similarities with “financial reengineering”.

101 The issue relates to primary insurance contracts issued *after* a reinsurance treaty has been underwritten. Accordingly only losses recognised in the period may trigger the recognition of a related gain on reinsurance.

102 The situation of insurance contracts issued in the period during which the reinsurance contract is being negotiated might create a partial retrospective application of the treaty. This very specific situation additionally requires applying judgment on a case by case basis.

<u>Distinction between proportionate and non-proportionate reinsurance</u>

103 In a proportional reinsurance a reinsurer takes a part of the cash flows of the individual underlying insurance contracts. IASB has been proposing an accounting treatment for the net gain on a proportionate reinsurance treaty covering onerous underlying contracts.

104 Gains on *non-proportionate* reinsurance treaty (e.g. on catastrophic risks or where an insurance company takes the first 20% of the losses and the reinsurer anything above that benchmark) have not yet been addressed by IASB.

105 There is no accounting issue with an *existing contract becoming onerous*: if an existing contract forces the entity to cross the aggregate, then it will show a loss on the underlying and a profit on the reinsurance. An issue first emerges on how to release the reinsurance gain when a *new onerous contract* is issued. This is because a non-proportionate reinsurance treaty does not relate to one contract but to all. When a new contract is added to a pool of existing contracts making the whole group going over the top of the reinsurance limit, is it because of the old contracts or of the new added one?

106 Addressing non-proportionate reinsurance may therefore additionally require assessing the existence of a “link” between the reinsured risk and the underlying contracts. Absent such a link it might not be possible to clearly identify which of many risks actually triggers the reinsurance gain (and to what extent). For instance, assuming the flood risk in a city is covered by different insurance policies (car, personal, public utility…), which one leads above the line?

107 Non-proportionate reinsurance could also be dealt by impacting the risk adjustment rather than the CSM. Generally, absent a better risk adjustment, no reinsurer would take certain (non-proportionate) risks.

108 Non-proportionate reinsurance could finally impact the FCF, the risk adjustment or even the P&L. One of these three possibilities might help avoiding a mismatch.

2.4 Issue 3: Contract boundaries of reinsurance contracts held differ from underlying liabilities boundaries

Reinsurance contracts include cash flows from contracts not yet written

109 The reinsurance contract's boundary stems from the substantive right and obligation of the primary insurer which includes receiving service from the reinsurer in exchange for the reinsurance premium. Thus the substantive right to receive services from the reinsurer ends when the reinsurer has the practical ability to reassess the risks transferred and to set a price accordingly. As a consequence, the fulfilment cash flows arising from the reinsurance contracts may include cash flows from contracts not yet written.

110 Hence, the definition of the boundary applicable to reinsurance contracts does not require consistency with the underlying insurance contracts and is rather assessed based on the contractual features of the reinsurance contract itself. Taking into account the expected future insurance contracts reflects the way reinsurers manage their business rather than the way primary insurers do. From an economic point of view, reinsurance held (being proportional or non-proportional, life or non-life) aims at mitigating the insurance risks recorded in the underlying liabilities.

Resulting risk of mismatch

111 Inconsistencies between reinsurance contracts held and related insurance contracts may crystallise in the following accounting treatments:

- Applying different discount rates result in mismatches in the financial result;
- Differences in the measurement of CSM and differences in allocation periods (coverage units) lead to mismatches in the insurance result (notably linked with the difference between the assessment of future contracts and the assessment of future cash flows when such contracts are eventually recognised, or changes in estimates in key assumptions).
- Including estimated underlying future new business within the reinsurance asset leads to disproportionately complex disclosures

112 Recognising reinsurance contracts cash flows relating to insurance contracts not yet written provides information of little relevance whereas it raises significant costs due to the operational complexity to deal with such temporary estimates in the IT systems and their possible discounting effect and subsequent changes. Based on a cost/benefit analysis, we therefore suggest limiting the reinsurance contracts' boundaries to the recognised underlying contracts.

Is a distinction between proportional and non-proportional reinsurance relevant for recognition and measurement purposes?

113 Recognition provisions set in IFRS 17.62 make a distinction between proportional and non-proportional reinsurance contracts. We analyse below whether such distinction is also relevant when setting contracts boundaries:

- Proportional reinsurance: is similar to a swap that generally provides a coverage with no value until the underlying contract is recognised. The value of the coverage thus depends on the recognised contracts. Premium to the reinsurer is generally not paid upfront but as insurance contracts are issued.

- Non proportional reinsurance: is similar to an option that provides no coverage until losses exceed the threshold. The value of the coverage depends on the cumulative exposition to all expected insurance contracts. Premium to the reinsurer is generally paid upfront.

114 In practice reinsurance contracts generally do not exceed one year and cover the calendar year. Questions about contract boundaries therefore mainly relate to intermediary financial statements. In our view, applying IAS 34 interim financial reporting, consistent with other situation (income tax, yearly step-up rebates,…) leads to consider the year-to-date cost of insurance (including any mitigating effect of reinsurance) and to allocate it when appropriate (IAS 34.40) to the reporting period. Accordingly, an entity would not wait until losses exceed the threshold for recognising the benefits of a non-proportional reinsurance which is expected to strike at year-end.

Illustrative example 3 – "Non proportional reinsurance"

115 In a non-proportional reinsurance treaty a reinsurer accepts to cover losses exceeding cumulatively 70 in a year. The primary insurer expects losses cumulating to 100 at year end. Losses are incurred on a steady basis so that cumulative losses incurred as of 30/6 amount to 50.

116 In its interim report as of 30/6, the entity should:

- View 1: present no gain from reinsurance since the threshold is not yet reached; or
- View 2: present a gain amounting to (100-70)/2=15 corresponding to the proportion of the year-end expected gain on the reinsurance?

117 We support view 2: the coverage should be accounted for in proportion of the underlying contracts <u>recognised as expected</u>. Accordingly the recognition criterion on non-proportional reinsurance benefits is similar to proportional reinsurance, even if the measurement appears more complex.

118 As a conclusion, the recognition of reinsurance contracts held and their related CSM is closely related to the recognition of the underlying contracts. There is no reason for differentiating proportional from non-proportional reinsurance held even if the measurement of the latter may prove more complex.

2.5 Issue 4: Presentation issues in the statement of financial performance of a reinsurer

119 IFRS 17 does not address the presentation of amounts exchanged between a reinsurer and the primary insurer. The TRG has suggested a presentation of common types of commissions due to the cedant and reinstatement premiums charged to the cedant following the occurrence of an insured event. TRG members have made suggestions based on whether such amounts are contingent on claims or not.

120 We find little basis in the standard (or even in the basis for conclusions) supporting these suggestions and therefore encourage IASB to add these provisions in the standard itself (as it was previously suggested in § 41(b) of ED/2013/7).

2.6 Issue 5: unclear provisions regarding reinsurance held

121 Reinsurance contracts held are subject to the general standard's provisions with some adjustment expressed in IFRS 17.60-70. Such adjustments have been reflected in Appendix 1: application of specific provisions on reinsurance contracts held (IFRS 17.60-.70). This simulation makes it clear that the specific provisions on reinsurance contracts held are not literally transposable into the general requirements of the standard on insurance contracts. Among others, we stress the point that:

- Level of aggregation requirements relating to onerous contracts (or contracts that may become onerous) are incompatible with IFRS 17.68 stating that reinsurance contracts cannot be onerous. In addition, the modifications to IFRS 17.14 to 24 required by IFRS 17.61 introducing the notion of “contracts on which there is a net gain on initial recognition” do not seem to create the conditions for an sdequate aggregation of reinsurance contracts held.
- General provisions on subsequent measurement (IFRS 17.40-43) refer to liabilities and unearned profits and therefore cannot apply without further adjustments to reinsurance contracts held.

3 Suggested solution (tentative)

3.1 Issue 1: Suggested modifications relating to the prohibition of applying the VFA to reinsurance contracts held or issued

122 The prohibition of the VFA for reinsurance contracts (IFRS 17.B109) is justified in IFRS 17.BC 248 for reinsurance contracts held and in IFRS 17.BC 249 for reinsurance contracts issued. However, contracts may have features that contradict the key assumptions retained in the basis for conclusions for prohibiting applying the VFA either to held or issued reinsurance contracts.

Solution 1: Suggested modifications

123 We therefore suggest removing the prohibition in IFRS 17.B109. Reinsurance contracts should be subject to the same VFA criteria as insurance contracts or, to amended ones if necessary in order to not unduly encompass reinsurance contracts issued that would not be “in-substance VFA”.

124 IFRS 17.B 109: ~~Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purposes of IFRS 17.~~

Solution 2: Alternative suggestions

125 An alternative solution would be to apply the proposed expansion of the risk mitigation provisions to reinsurance contracts *held* (provided that transition requirements are adequately changed).

126 Absent a standard-setting solution for reinsurance contracts *issued*, an analysis of such contracts possibly to be considered as co-insurance contracts could be a way forward on the basis of substance.

3.2 Issue 2: Suggested modifications relating to accounting mismatch on reinsurance of onerous insurance

127 In its January 2019 meeting, IASB has tentatively decided to amend the accounting treatment for net gains on proportionate reinsurance contracts covering onerous underlying contracts.

128 The Australian TRG[1] already had suggested a solution that extends “the subsequent measurement requirement set out in IFRS 17.66(c)(ii) […] to initial recognition so that, to the extent the reinsurance contract held on initial recognition covers onerous underlying contracts, the reinsurance benefit is recognised in the profit or loss instead of as a CSM on the balance sheet where they result from the losses on those underlying contracts”.

129 ANC supports any solution that achieves a continuous symmetry in the accounting treatment of reinsurance contract held and the underlying insurance contracts issued.

130 However, ANC’s view is that proportional and non-proportional reinsurance treaties are conceptually similar. They both are risk mitigation instruments comparable with derivatives, whereas proportional reinsurance could be assimilated to a swap (exchange of cash-flows) and non-proportional reinsurance could be assimilated to an option (no cash-flows until the strike is reached). Accordingly, there is no reason for not addressing both situations.

131 In practice, non-proportional reinsurance might require further estimates and thus raise more application difficulties than proportional reinsurance. Considering non-proportionate reinsurance in the risk adjustment would be relevant but possibly disruptive, since it would mix net and gross reinsurance data. It is an indirect solution whereas a direct one would be better.

132 Finally, we suggest amending the measurement requirement set in IFRS 17.66 in order to provide a continuous symmetry in the accounting treatment of reinsurance contract held and the underlying insurance contracts issued. We do not introduce any distinction between proportional and non-proportional reinsurance treaty.

Suggested modifications:

133 IFRS 17.66: Instead of applying paragraph 44, an entity shall measure the contractual service margin at the end of the reporting period for a group of reinsurance contracts held as the carrying amount determined at the start of the reporting period, adjusted for:

(a) the effect of any new contracts added to the group (see paragraph 28). Where newly issued insurance contracts are onerous, the entity shall recognise any net gain on purchasing the group of reinsurance held immediately in profit or loss to the extent the gain relates to losses on the group of underlying insurance contracts that are recognised in profit or loss;

(b) interest accreted on the carrying amount of the contractual service margin, measured at the discount rates specified in paragraph B72(b);

(c) changes in the fulfilment cash flows to the extent that the change:

(i) relates to future service; unless

(ii) the change results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for the group of underlying insurance contracts.

[1] Australian TRG 2018-07-20 § 2.8(2)

(d) the effect of any currency exchange differences arising on the contractual service margin; and

(e) the amount recognised in profit or loss because of services received in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period of the group of reinsurance contracts held, applying paragraph B119.

3.3 Issue 3: Suggested modifications relating to reinsurance contracts boundaries

134 IFRS 17.63 refers to IFRS 17.34 in order to set the boundaries of insurance contracts held. This boundaries end with those of reinsurance contracts issued rather than with those of underlying liabilities. We suggest amending IFRS 17.63 in order to align the boundaries of insurance contracts held with those of recognised underlying contracts.

Suggested modifications

135 IFRS 17.63: ~~In applying t~~The measurement requirements of paragraphs 32–36 to reinsurance contracts held apply~~,~~ to the extent that the underlying contracts are recognised. ~~also measured applying those paragraphs , t~~ The entity shall use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurance contracts held and the estimates of the present value of the future cash flows for the group(s) of underlying insurance contracts. In addition, the entity shall include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

3.4 Issue 4: Suggested modifications relating to presentation issues in the statement of financial performance of a reinsurer

136 In order to avoid standard-setting out of the standards, we encourage IASB to introduce into IFRS 17 the suggestions made by TRG members on the presentation of exchange amounts between reinsurer and primary insurer, that currently lack a conceptual basis.

3.5 Issue 5: unclear provisions regarding reinsurance held

137 According to IFRS 17, reinsurance contracts have to be accounted for as separate contracts, i.e. not as an element of the cash-flows of the underlying insurance contracts. As a consequence, reinsurance contracts held are subject to the general standard's provisions with some adjustment expressed in IFRS 17.60-70.

138 We refer to "Appendix 1: application of specific provisions on reinsurance contracts held (IFRS 17.60-.70)" presenting a simulation of the specific provisions relating to the accounting of reinsurance contracts held. It appears complex to amend these provisions that will eventually modify the general provisions in order to reflect a proper recognition and measurement of reinsurance contracts.

4 Appendix 1: application of specific provisions on reinsurance contracts held (IFRS 17.60-.70)

According to IFRS 17, reinsurance contracts have to be accounted for as separate contracts, i.e. not as an element of the cash-flows of the underlying insurance contracts. As a consequence, reinsurance contracts held are subject to the general standard's provisions with some adjustment expressed in IFRS 17.60-70.

Such adjustments have been reflected below (direct in red, indirect/contextual in blue)

Application of IFRS 17.61 on the level of aggregation

139 IFRS 17.14: An entity shall identify portfolios of **re**insurance contracts **held**. A portfolio comprises contracts subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together. Contracts in different product lines (for example single premium fixed annuities compared with regular term life assurance) would not be expected to have similar risks and hence would be expected to be in different portfolios.

~~140 IFRS 17.15: Paragraphs 16–24 apply to insurance contracts issued. The requirements for the level of aggregation of reinsurance contracts held are set out in paragraph 61.~~

141 IFRS 17.16: An entity shall divide a portfolio of ~~insurance contracts issued~~ **reinsurance contracts held** into a minimum of:

(a) a group of contracts ~~that are onerous~~ **on which there is a net gain on initial recognition**, if any;

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

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

142 IFRS 17.17: If an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group applying paragraph 16, it may measure the set of contracts to determine if there are contracts ~~are~~ **on which there is a net gain on initial recognition** (see paragraph 47) and assess the set of contracts to determine if the contracts have no significant possibility of ~~becoming onerous~~ generating a net gain subsequently (see paragraph 19). If the entity does not have reasonable and supportable information to conclude that a set of contracts will all be in the same group, it shall determine the group to which contracts belong by considering individual contracts.

143 IFRS 17.18: For ~~contracts issued~~ **reinsurance contracts held** to which an entity applies the premium allocation approach (see paragraphs 53–59), the entity shall assume there is no contracts in the portfolio ~~are~~ **on which there is a net gain on initial recognition**, unless facts and circumstances indicate otherwise. An entity shall assess whether contracts that ~~are not~~ **on which there is a net gain on initial recognition** at initial recognition have no significant possibility of ~~becoming onerous~~ generating a net

subsequently by assessing the likelihood of changes in applicable facts and circumstances.

144 IFRS 17.19: For ~~contracts issued~~ **reinsurance contracts held** to which an entity does not apply the premium allocation approach (see paragraphs 53–59), an entity shall assess whether contracts ~~that are not~~ **on which there is a net gain on initial recognition** have no significant possibility of ~~becoming onerous~~ generating a net gain:

(a) based on the likelihood of changes in assumptions which, if they occurred, would result in the contracts ~~becoming onerous~~ generating a net gain.

(b) using information about estimates provided by the entity's internal reporting. Hence, in assessing whether contracts ~~that are not~~ **on which there is ~~a~~** no **net gain on initial recognition** have no significant possibility of ~~becoming onerous~~ generating a net gain:

(i) an entity shall not disregard information provided by its internal reporting about the effect of changes in assumptions on different contracts on the possibility of their ~~becoming onerous~~ generating a net gain; but

(ii) an entity is not required to gather additional information beyond that provided by the entity's internal reporting about the effect of changes in assumptions on different contracts.

145 IFRS 17.20: If, applying paragraphs 14–19, contracts within a portfolio would fall into different groups only because law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, the entity may include those contracts in the same group. The entity shall not apply this paragraph by analogy to other items.

146 IFRS 17.21: An entity is permitted to subdivide the groups described in paragraph 16. For example, an entity may choose to divide the portfolios into:

(a) more groups ~~that are not~~ **on which there is ~~a~~** no **net gain on initial recognition**—if the entity's internal reporting provides information that distinguishes:

(i) different levels of profitability; or

(ii) different possibilities of contracts ~~becoming onerous~~ generating a net gain after initial recognition; and

(b) more than one group of contracts ~~that are~~ **on which there is a net gain on initial recognition**—if the entity's internal reporting provides information at a more detailed level about the extent to which **there is a net gain on initial recognition** of the contracts ~~are **on which**~~.

147 IFRS 17.22: An entity shall not include ~~contracts issued~~ **reinsurance contracts held** more than one year apart in the same group. To achieve this, the entity shall, if necessary, further divide the groups described in paragraphs 16–21.

148 IFRS 17.23: A group of **re**insurance contracts **held** shall comprise a single contract if that is the result of applying paragraphs 14–22.

149 IFRS 17.24: An entity shall apply the recognition and measurement requirements of IFRS 17 to the groups of ~~contracts issued~~ **reinsurance contracts held** determined by applying paragraphs 14-23. An entity shall establish the groups at initial recognition, and shall not reassess the composition of the groups subsequently. To measure a group of contracts, an entity may estimate the fulfilment cash flows at a higher level of aggregation than the group or portfolio, provided the entity is able to include the appropriate fulfilment cash flows in the measurement of the group, applying paragraphs 32(a), 40(a)(i) and 40(b), by allocating such estimates to groups of contracts.

Application of IFRS 17.62 on recognition

150 IFRS 17.62: ~~Instead of applying paragraph 25,~~ An entity shall recognise a group of reinsurance contracts held:

(a) if the reinsurance contracts held provide proportionate coverage—at the beginning of the coverage period of the group of reinsurance contracts held or at the initial recognition of any underlying contract, whichever is the later; and

(b) in all other cases—from the beginning of the coverage period of the group of reinsurance contracts held.

Application of IFRS 17.63 on measurement

151 IFRS 17.32 On initial recognition, an entity shall measure a group of **re**insurance contracts **held** at the total of:

(a) the fulfilment cash flows, which comprise:

(i) estimates of future cash flows (paragraphs 33–35);

(ii) an adjustment to reflect the time value of money and the financial risks related to the future cash flows, to the extent that the financial risks are not included in the estimates of the future cash flows (paragraph 36); and

(iii) a risk adjustment for non-financial risk (paragraph 37).

(b) the contractual service margin, measured applying paragraphs 38–39.

Estimates of future cash flows (paragraphs B36–B71)

152 IFRS 17.33: An entity shall include in the measurement of a group of **re**insurance contracts **held** all the future cash flows within the boundary of each contract in the group (see paragraph 34). Applying paragraph 24, an entity may estimate the future cash flows at a higher level of aggregation and then allocate the resulting fulfilment cash flows to individual groups of contracts. The estimates of future cash flows shall:

(a) incorporate, in an unbiased way, all reasonable and supportable information available without undue cost or effort about the amount, timing and uncertainty of those future cash flows (see paragraphs B37–B41). To do this, an entity shall estimate the expected value (ie the probability-weighted mean) of the full range of possible outcomes. **To the extent that the underlying contracts are also measured applying paragraphs**

32-36, the entity shall use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurance contracts held and the estimates of the present value of the future cash flows for the group(s) of underlying insurance contracts. In addition, the entity shall include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

(b) reflect the perspective of the entity, provided that the estimates of any relevant market variables are consistent with observable market prices for those variables (see paragraphs B42–B53).

(c) be current—the estimates shall reflect conditions existing at the measurement date, including assumptions at that date about the future (see paragraphs B54–B60).

(d) be explicit—the entity shall estimate the adjustment for non-financial risk separately from the other estimates (see paragraph B90). The entity also shall estimate the cash flows separately from the adjustment for the time value of money and financial risk, unless the most appropriate measurement technique combines these estimates (see paragraph B46).

153 IFRS 17.34: Cash flows are within the boundary of a~~n~~ **re**insurance contract **held** if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services (see paragraphs B61–B71). A substantive obligation to provide services ends when:

(a) the entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; or

(b) both of the following criteria are satisfied:

(i) the entity has the practical ability to reassess the risks of the portfolio of **re**insurance contracts **held** that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio; and

(ii) the pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date.

154 IFRS 17.35: An entity shall not recognise as a liability or as an asset any amounts relating to expected premiums or expected claims outside the boundary of the **re**insurance contract **held**. Such amounts relate to future **re**insurance contracts **held**.

Discount rates (paragraphs B72–B85)

155 IFRS 17.36: An entity shall adjust the estimates of future cash flows to reflect the time value of money and the financial risks related to those cash flows, to the extent that the financial risks are not included in the estimates of cash flows. The discount rates applied to the estimates of the future cash flows described in paragraph 33 shall:

(a) reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the **reinsurance** contracts **held**;

(b) be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the **re**insurance contracts **held**, in terms of, for example, timing, currency and liquidity; and

(c) exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the **re**insurance contracts **held**.

Application of IFRS 17.64 on risk adjustment

156 IFRS 17.64: ~~Instead of applying paragraph 37, a~~ **A**n entity shall determine the risk adjustment for non-financial risk so that it represents the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts.

Application of IFRS 17.65 on CSM on initial recognition

~~157~~ IFRS 17.38: The contractual service margin is a component of the asset or liability for the group of **re**insurance contracts **held** that represents the ~~unearned profit~~ **net cost or net gain on purchasing the reinsurance** the entity will recognise as it provides services in the future. ~~An entity shall measure the contractual service margin on initial recognition of a group of insurance contracts at an amount that, unless paragraph 47 (on onerous contracts) applies, results in no income or expenses arising from:~~

~~(a) the initial recognition of an amount for the fulfilment cash flows, measured by applying paragraphs 32–37;~~

~~(b) the derecognition at the date of initial recognition of any asset or liability recognised for insurance acquisition cash flows applying paragraph 27; and~~

~~(c) any cash flows arising from the contracts in the group at that date~~.

Hence, on initial recognition:

(a) the entity shall recognise any net cost or net gain on purchasing the group of reinsurance contracts held as a contractual service margin measured at an amount equal to the sum of the fulfilment cash flows, the amount derecognised at that date of any asset or liability previously recognised for cash flows related to the group of reinsurance contracts held, and any cash flows arising at that date; unless

(b) the net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the group of reinsurance contracts, in which case, notwithstanding the requirements of paragraph B5, the entity shall recognise such a cost immediately in profit or loss as an expense.

Application of IFRS 17.66 on CSM on subsequent measurement

Subsequent measurement

158 IFRS 17.40: The carrying amount of a group of **re**insurance contracts **held** at the end of each reporting period shall be the sum of:

(a) the liability for remaining coverage comprising:

(i) the fulfilment cash flows related to future service allocated to the group at that date, measured applying paragraphs 33–37 and B36–B92;

(ii) the contractual service margin of the group at that date, measured applying paragraphs 43–46; and

(b) the liability for incurred claims, comprising the fulfilment cash flows related to past service allocated to the group at that date, measured applying paragraphs 33–37 and B36–B92.

159 IFRS 17.41: An entity shall recognise income and expenses for the following changes in the carrying amount of the liability for remaining coverage:

(a) insurance revenue—for the reduction in the liability for remaining coverage because of services provided in the period, measured applying paragraphs B120–B124;

(b) insurance service expenses—~~for losses on groups of onerous contracts, and reversals of such losses (see paragraphs 47–52)~~; and

(c) insurance finance income or expenses—for the effect of the time value of money and the effect of financial risk as specified in paragraph 87.

160 IFRS 17.42: An entity shall recognise income and expenses for the following changes in the carrying amount of the liability for incurred claims:

(a) insurance service expenses—for the increase in the liability because of claims and expenses incurred in the period, excluding any investment components;

(b) insurance service expenses—for any subsequent changes in fulfilment cash flows relating to incurred claims and incurred expenses; and

(c) insurance finance income or expenses—for the effect of the time value of money and the effect of financial risk as specified in paragraph 87.

Contractual service margin (paragraphs B96—B119)

161 IFRS 17.43: The contractual service margin at the end of the reporting period represents the profit in the group of **re**insurance contracts **held** that has not yet been recognised in profit or loss because it relates to the future service to be provided under the contracts in the group.

~~162 IFRS 17.44: For insurance contracts without direct participation features, the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for:~~

~~(a) the effect of any new contracts added to the group (see paragraph 28);~~

~~(b) interest accreted on the carrying amount of the contractual service margin during the reporting period, measured at the discount rates specified in paragraph B72(b);~~

~~(c) the changes in fulfilment cash flows relating to future service as specified in paragraphs B96–B100, except to the extent that:~~

~~(i) such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48(a)); or~~

~~(ii) such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).~~

~~(d) the effect of any currency exchange differences on the contractual service margin; and~~

~~(e) the amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period applying paragraph B119.~~

163 IFRS 17.66: ~~Instead of applying paragraph 44, a~~ An entity shall measure the contractual service margin at the end of the reporting period for a group of reinsurance contracts held as the carrying amount determined at the start of the reporting period, adjusted for:

(a) the effect of any new contracts added to the group (see paragraph 28);

(b) interest accreted on the carrying amount of the contractual service margin, measured at the discount rates specified in paragraph B72(b);

(c) changes in the fulfilment cash flows to the extent that the change:

(i) relates to future service; unless

(ii) the change results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for the group of underlying insurance contracts.

(d) the effect of any currency exchange differences arising on the contractual service margin; and

(e) the amount recognised in profit or loss because of services received in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period of the group of reinsurance contracts held, applying paragraph B119.

164 IFRS 17.67: Changes in the fulfilment cash flows that result from changes in the risk of non-performance by the issuer of a reinsurance contract held do not relate to future service and shall not adjust the contractual service margin.

165 IFRS 17.68: Reinsurance contracts held cannot be onerous. Accordingly, the requirements of paragraphs 47–52 do not apply.

IFRS 17 issues – Transition

Amended draft for discussion

1 Current IASB requirements and TRG conclusions

1.1 IFRS 17 requirements

1	IFRS 17.88:	Unless paragraph 89 applies, an entity shall make an accounting policy choice between: (a) including insurance finance income or expenses for the period in profit or loss; or (b) disaggregating insurance finance income or expenses for the period to include in profit or loss an amount determined by a systematic allocation of the expected total insurance finance income or expenses over the duration of the group of contracts, applying paragraphs B130–B133.
2	IFRS 17.89:	For insurance contracts with direct participation features, for which the entity holds the underlying items, an entity shall make an accounting policy choice between: (a) including insurance finance income or expenses for the period in profit or loss; or (b) disaggregating insurance finance income or expenses for the period to include in profit or loss an amount that eliminates accounting mismatches with income or expenses included in profit or loss on the underlying items held, applying paragraphs B134-B136.
3	IFRS 17.90:	If an entity chooses the accounting policy set out in paragraph 88(b) or in paragraph 89(b), it shall include in other comprehensive income the difference between the insurance finance income or expenses measured on the basis set out in those paragraphs and the total insurance finance income or expenses for the period.
4	IFRS 17.91:	If an entity transfers a group of insurance contracts or derecognises an insurance contract applying paragraph 77: (a) it shall reclassify to profit or loss as a reclassification adjustment (see IAS 1 Presentation of Financial Statements) any remaining amounts for the group (or contract) that were previously recognised in other comprehensive income because the entity chose the accounting policy set out in paragraph 88(b). (b) it shall not reclassify to profit or loss as a reclassification adjustment (see IAS 1) any remaining amounts for the group (or contract) that were previously recognised in other comprehensive income because the entity chose the accounting policy set out in paragraph 89(b).
5	IFRS 17.116:	An entity that chooses to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income applies paragraphs C18(b), C19(b), C24(b) and C24(c) to determine the cumulative difference between the insurance finance income or expenses that would have been recognised in profit or loss and the total insurance finance income or expenses at the transition date for the groups of insurance contracts to

which the disaggregation applies. For all periods in which amounts determined applying these paragraphs exist, the entity shall disclose a reconciliation from the opening to the closing balance of the cumulative amounts included in other comprehensive income for financial assets measured at fair value through other comprehensive income related to the groups of insurance contracts. The reconciliation shall include, for example, gains or losses recognised in other comprehensive income in the period and gains or losses previously recognised in other comprehensive income in previous periods reclassified in the period to profit or loss.

6 IFRS 17.B93: When an entity acquires insurance contracts issued or reinsurance contracts held in a transfer of insurance contracts that do not form a business or in a business combination, the entity shall apply paragraphs 14–24 to identify the groups of contracts acquired, as if it had entered into the contracts on the date of the transaction.

7 IFRS 17.B101: Insurance contracts with direct participation features are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items. Hence, they are defined as insurance contracts for which:

(a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items (see paragraphs B105–B106);

(b) the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items (see paragraph B107); and

(c) the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items (see paragraph B107).

8 IFRS 17.B115: To the extent that an entity meets the conditions in paragraph B116, it may choose not to recognise a change in the contractual service margin to reflect some or all of the changes in the effect of financial risk on the entity's share of the underlying items (see paragraph B112) or the fulfilment cash flows set out in paragraph B113(b).

9 IFRS 17.B116: To apply paragraph B115, an entity must have a previously documented risk-management objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts and, in applying that objective and strategy:

(a) the entity uses a derivative to mitigate the financial risk arising from the insurance contracts.

(b) an economic offset exists between the insurance contracts and the derivative, ie the values of the insurance contracts and the derivative generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated. An entity shall not consider accounting measurement differences in assessing the economic offset.

(c) credit risk does not dominate the economic offset.

10 IFRS 17.B132: For groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholders:

(a) a systematic allocation for the finance income or expenses arising from the estimates of future cash flows can be determined in one of the following ways:

(i) using a rate that allocates the remaining revised expected finance income or expenses over the remaining duration of the group of contracts at a constant rate; or

(ii) for contracts that use a crediting rate to determine amounts due to the policyholders—using an allocation that is based on the amounts credited in the period and expected to be credited in future periods.

(b) a systematic allocation for the finance income or expenses arising from the risk adjustment for non-financial risk, if separately disaggregated from other changes in the risk adjustment for non-financial risk applying paragraph 81, is determined using an allocation consistent with that used for the allocation for the finance income or expenses arising from the future cash flows.

(c) a systematic allocation for the finance income or expenses arising from the contractual service margin is determined:

(i) for insurance contracts that do not have direct participation features, using the discount rates specified in paragraph B72(b); and

(ii) for insurance contracts with direct participation features, using an allocation consistent with that used for the allocation for the finance income or expenses arising from the future cash flows.

11 IFRS 17.B134: Paragraph 89 applies if an entity, either by choice or because it is required to, holds the underlying items for insurance contracts with direct participation features. If an entity chooses to disaggregate insurance finance income or expenses applying paragraph 89(b), it shall include in profit or loss expenses or income that exactly match the income or expenses included in profit or loss for the underlying items, resulting in the net of the two separately presented items being nil.

12 IFRS 17.C3: An entity shall apply IFRS 17 retrospectively unless impracticable, except that:

(a) an entity is not required to present the quantitative information required by paragraph 28(f) of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors; and

(b) an entity shall not apply the option in paragraph B115 for periods before the date of initial application of IFRS 17.

13 IFRS 17.C5: If, and only if, it is impracticable for an entity to apply paragraph C3 for a group of insurance contracts, an entity shall apply the following approaches instead of applying paragraph C4(a):

(a) the modified retrospective approach in paragraphs C6–C19, subject to paragraph C6(a); or

(b) the fair value approach in paragraphs C20–C24.

14 IFRS 17.C6: The objective of the modified retrospective approach is to achieve the closest outcome to retrospective application possible using reasonable and supportable information available without undue cost or effort. Accordingly, in applying this approach, an entity shall:

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

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

15 IFRS 17.C7: Paragraphs C9–C19 set out permitted modifications to retrospective application in the following areas:

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

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

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

(d) insurance finance income or expenses.

16 IFRS 17.C8: To achieve the objective of the modified retrospective approach, an entity is permitted to use each modification in paragraphs C9–C19 only to the extent that an entity does not have reasonable and supportable information to apply a retrospective approach

17 IFSR 17.C10: To the extent permitted by paragraph C8, an entity shall not apply paragraph 22 to divide groups into those that do not include contracts issued more than one year apart.

18 IFRS 17.C19: For groups of insurance contracts that do not include contracts issued more than one year apart:

(a) if an entity applies paragraph C13 to estimate the discount rates that applied at initial recognition (or subsequently), it shall also determine the discount rates specified in paragraphs B72(b)–B72(e) applying paragraph C13; and

(b) if an entity chooses to disaggregate insurance finance income or expenses between amounts included in profit or loss and amounts included in other comprehensive income, applying paragraphs 88(b) or 89(b), the entity needs to determine the cumulative amount of insurance finance income or expenses recognised in other comprehensive income at the transition date to apply paragraph 91(a) in future periods. The entity shall determine that cumulative difference:

(i) for insurance contracts for which an entity will apply the methods of systematic allocation set out in paragraph B131—if the entity applies paragraph C13 to estimate the discount rates at initial recognition—using the discount rates that applied at the date of initial recognition, also applying paragraph C13;

(ii) for insurance contracts for which an entity will apply the methods of systematic allocation set out in paragraph B132—on the basis that the assumptions that relate to financial risk that applied at the date of initial recognition are those that apply on the transition date, ie as nil;

(iii) for insurance contracts for which an entity will apply the methods of systematic allocation set out in paragraph B133—if the entity applies paragraph C13 to estimate the discount rates at initial recognition (or subsequently)—using the discount rates that applied at the date of the incurred claim, also applying paragraph C13; and

(iv) for insurance contracts with direct participation features to which paragraph B134 applies—as equal to the cumulative amount recognised in other comprehensive income on the underlying items.

19 IFRS 17.C20: To apply the fair value approach, an entity shall determine the contractual service margin or loss component of the liability for remaining coverage at the transition date as the difference between the fair value of a group of insurance contracts at that date and the fulfilment cash flows measured at that date. In determining that fair value, an entity shall not apply paragraph 47 of IFRS 13 Fair Value Measurement (relating to demand features).

20 IFRS 17.C25: Notwithstanding the reference to the annual reporting period immediately preceding the date of initial application in paragraph C2(b), an entity may also present adjusted comparative information applying IFRS 17 for any earlier periods presented, but is not required to do so. If an entity does present adjusted comparative information for any earlier periods, the reference to 'the beginning of the annual reporting period immediately preceding the date of initial application' in paragraph C2(b) shall be read as 'the beginning of the earliest adjusted comparative period presented'.

21 IFRS 17. C31: An entity that applies paragraph C29 is not required to restate prior periods to reflect such changes in designations or classifications. The entity may restate prior periods only if it is possible without the use of hindsight. If an entity restates prior periods, the restated financial statements must reflect all the requirements of IFRS 9 for those affected financial assets. If an entity does not restate prior periods, the entity shall recognise, in the opening retained earnings (or other component of equity, as appropriate) at the date of initial application, any difference between:

(a) the previous carrying amount of those financial assets; and

(b) the carrying amount of those financial assets at the date of initial application.

22 IFRS 17.BC388: The Board concluded that providing restated comparative information for at least one reporting period was necessary because of the diversity of previous accounting and the extent of the changes introduced by IFRS 17. Because IFRS 17 only

requires retrospective application on transition if practicable, and specifies simplified approaches when retrospective application is impracticable, the Board expects that determining the comparative amounts will not require significant incremental time and resources beyond those required to first apply IFRS 17. The Board set the effective date for IFRS 17 based on information given about the necessary time to prepare, in the knowledge that restated comparative information for one reporting period would be required.

23 IFRS 17.BC389: The requirement to restate comparative information for one reporting period is different from the transition requirements of IFRS 9, which did not require restatement of comparative amounts at transition to that Standard, including the fair value of financial instruments (and which did not allow restatement if doing so required the use of hindsight). However, the Board noted that different circumstances applied when it developed the transition requirements for IFRS 9, which were developed with the intention of minimising obstacles to voluntary application of IFRS 9 before its effective date. In addition, entities applying those transition requirements of IFRS 9 had all previously applied the same requirements, ie those in IAS 39. In contrast, the Board expects that most entities will apply IFRS 17 no earlier than the effective date and believes that the restatement of comparative amounts is particularly important, for the reasons given in paragraph BC388. Therefore, the Board decided not to provide relief from the restatement of comparative information to facilitate early application of IFRS 17.

24 IFRS 17.BC393: Paragraph B115 of IFRS 17 permits entities not to recognise a change in the contractual service margin for changes in fulfilment cash flows and the entity’s share in the fair value returns on underlying items for which an entity uses derivatives to mitigate their financial risk. However, an entity applying this option is required to document its risk management objective and the strategy for mitigating the risk before doing so. This documentation requirement is analogous to the documentation requirements for hedge accounting in IFRS 9. Consistent with the transition requirements for hedge accounting in IFRS 9, the Board concluded that retrospective application of the risk mitigation treatment would give rise to the risk of hindsight. In particular, the Board was concerned that documentation after the event could enable entities to choose the risk mitigation relationships to which it would apply this option, particularly because the application of this approach is optional. Consequently, IFRS 17, consistent with the transition requirements for hedge accounting in IFRS 9, requires prospective application of the risk mitigation option from the date of initial application of the Standard.

25 IFRS 9.7.2.1: An entity shall apply this Standard retrospectively, in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, except as specified in paragraphs 7.2.4–7.2.26 and 7.2.28. This Standard shall not be applied to items that have already been derecognised at the date of initial application.

1.2 Tentative Board's decisions

February 2019 meeting

26 IASB 2019-02 AP 2C §13: The staff think that applying the risk mitigation option retrospectively without using hindsight is challenging. The entity would have to determine what amounts it would have recognised in profit or loss for the mitigated risks. The staff also think that retrospectively applying an option that is prospective by nature gives rise to 'cherry picking' opportunities. Retrospective application of the risk mitigation option could also lead to unjustified inconsistency with the requirements for hedge accounting in IFRS 9 that prohibits the retrospective application of hedge accounting for the same reason.

27 IASB 2019-02 AP 2C §14: To illustrate, if the Board were to permit the risk mitigation option to be applied retrospectively, entities that have a previously documented risk-management objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts could, for example:

(a) choose retrospectively the risk mitigation relationships to which they apply the option based on the outcome known at the effective date;

(b) determine the fulfilment cash flows in a group to which the risk mitigation option applies retrospectively based on the outcome known at the effective date; and

(c) determine when to start applying the risk mitigation option based on the outcome known at the effective date, even if the derivative had the same risk mitigating effect in previous periods.

28 IASB 2019-02 AP 2C §20: When an entity chooses to disaggregate insurance finance income or expenses between profit or loss and OCI, it may be permitted or required to determine the cumulative amount of insurance finance income or expenses recognised in OCI at the transition date as nil in the following circumstances:[4]

(a) permitted when applying the fair value approach (paragraph C24(b) of IFRS 17);

(b) permitted when applying the modified retrospective approach for groups of insurance contracts that include contracts issued more than one year apart (paragraph C18(b) of IFRS 17); and

(c) required when applying the modified retrospective approach for groups of insurance contracts that do not include contracts issued more than one year apart for insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholders (paragraph C19(b)(ii) of IFRS 17).

29 IASB 2019-02 AP 2C §27: Some stakeholders have suggested the Board should amend the requirements of IFRS 17 or IFRS 9 to either:

(a) permit an entity to deem the accumulated amount of finance income in OCI related to related assets as nil at transition to IFRS 17; or

(b) permit an entity to deem the accumulated amount of insurance finance income or expenses in OCI for these insurance contracts at the same amount as the accumulated amount of finance income in OCI on the related assets at transition.

30 IASB 2019-02 AP 2D §18: The staff observe that, generally, an entity would be expected to use information that is reasonable and supportable in the preparation of financial statements to meet the objective of providing useful information to users of financial statements.

31 IASB 2019-02 AP 2D §36: The staff think that in the light of stakeholder feedback in paragraph 30 of this paper, if the Board decides not to permit entities to develop their own unspecified modifications, it may be helpful to stakeholders if the Board were to explain in the Basis for Conclusions on IFRS 17 that the existence of specified modifications in the modified retrospective approach does not prohibit an entity from:

(a) making estimates that are necessary in retrospectively applying an accounting policy as described in paragraph 51 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors; or

(b) similarly, making estimates when applying a specified modification in the modified retrospective approach.

<u>March 2019 meeting</u>

32 IASB 2019-03 AP 2E §16: The staff considered two possible ways, other than retrospective application of the risk mitigation option, to address stakeholders' concerns:

(a) permitting entities to apply a prospective application of the risk mitigation option from the IFRS 17 transition date; and

(b) permitting entities that have used derivatives or reinsurance contracts held to mitigate financial risk arising from insurance contracts with direct participating features before the transition date to apply the fair value approach to transition, even if they are able to apply IFRS 17 retrospectively.

<u>April 2019 meeting</u>

33 IASB 2019-04 AP 2C §34: The staff observe that proposing any changes to IFRS 9, particularly with respect to the transition requirements, may risk unintended consequences. Given that insurers can mitigate some of these concerns by applying IFRS 9 for the first time before they apply IFRS 17 for the first time, the staff think that a change to the requirements of IFRS 9 is not required.

1.3 Current understanding of the accounting treatment

<u>Selection of a transition methodology</u>

34 On transition, IFRS 17.C3 requires to apply the full retrospective approach (FRA) unless impracticable. In the latter case, the entity may apply either the fair value approach (FVA) or the modified retrospective approach (MRA).

35 No specific provision is given relating to the FRA. By contrast, the MRA is providing some relief absent reasonable and supportable information to apply the FRA (IFRS 17.C06-IFRS 17.C19). Guidance is also provided on how to apply the FVA (IFRS 17.C20-IFRS 17.C24).

36 Considering that the FVA can only be applied upon the date of transition (IFRS 17.C20) and not in prior periods, a chosen approach appears to apply to the entirety of a given group of insurance contracts, e.g. mixed approaches would not be possible.

37 When considering the issue at its February meeting, IASB considered that using information that is reasonable and supportable in the preparation of the FS would meet the objectives set in a retrospective approach. The Board noted the importance of the clarification in the paper that the existence of specified modifications does not preclude the normal use of estimation techniques.

OCI option

38 As summarised by the staff in an agenda paper to the board (IASB 2019-02 AP 2C §20), when an entity chooses to disaggregate insurance finance income or expenses between profit or loss and OCI (IFRS 17.88(b)) in non-VFA contracts, it may be permitted or required to determine the cumulative amount of insurance finance income or expenses recognised in OCI at the transition date as nil in the following circumstances:

- (a) permitted when applying the FVA (IFRS 17.C24(b));
- (b) permitted when applying the MRA for groups of insurance contracts that include contracts issued more than one year apart (IFRS 17.C18(b)); and
- (c) required when applying the MRA for groups of insurance contracts that do not include contracts issued more than one year apart for insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholders (IFRS 17.C19(b)(ii)).

39 In its February meeting, the board considered and discarded two scenarios:

- to amend IFRS 9 in order to also set to zero the OCI on assets;
- to deem the accumulated amount of OCI on assets at the same amount as on insurance contracts. This solution is exposed to subjectivity in allocating the assets to liabilities as well as setting the discount rate on transition.

Interaction with IFRS 9 – Risk mitigation

40 IFRS 17.C3(b) specifically prohibits a retrospective application of the risk mitigation option for direct participating contracts.

41 IFRS 17.BC 393 justifies that "consistent with the transition requirements for hedge accounting in IFRS 9, the Board concluded that retrospective application of the risk mitigation treatment would give rise to the risk of hindsight. In particular, the Board was concerned that documentation after the event could enable entities to choose the risk mitigation relationships to which it would apply this option, particularly because the application of this approach is optional".

42 In its analysis during the February 2019 meeting, the board confirmed the view that the risk of "cherry picking" was not acceptable.

43 In its March 2019 meeting, the board decided permitting entities to apply a prospective application of the risk mitigation option (to derivatives or reinsurance contracts held) from the IFRS 17 transition date.

Interaction with IFRS 9 – Comparative information in 2021

44 Insurers applying the IFRS 4 amendment may defer the IFRS 9 implementation until 1 January 2022.

45 On the first time application of IFRS 17 comparative year 2021 has to be restated (IFRS 17.C25, .BC388 and .BC389) except if IFRS 9 already applied (overlay approach) beforehand so that it may change its previous classification of ("redesignate") financial instruments without restating prior periods (IFRS 17.C31).

46 By contrast, on the first time application of IFRS 9 comparative year 2021 has not to be restated (IFRS 17.BC 389).

47 If an entity however decides to restate the comparative year 2021:

- financial items that have not been derecognised at the date of initial application would have to be accounted for according to IFRS 9 (IFRS 9.7.2.1);
- financial items that have been derecognised at the date of initial application would need to continue to follow IAS 39 until the date of sale.

48 IASB has addressed the issue raised by ANC in the sweep issues considered at the April's board meeting. The staff analysed that the issue had already been considered when developing the transition requirements in IFRS 9 and IFRS 17 and that changes to IFRS 9 in that regard may risk unintended consequences. It suggested an earlier FTA of IFRS 9 in order to mitigate such effect.

2 Issue

49 The EFRAG case study has been the unique opportunity at this stage to test on a large basis the practicability of the transition requirements.

50 It raised issues of different natures:

- Operational difficulties in complying with the criteria for applying the three methodologies offered and in gathering data;
- Possible accounting mismatches created by certain requirements.

2.1 Operational difficulties

Selection of a transition methodology

51 Case studies report that the proposed transition methodologies better fit to certain situation. Accordingly:

	The methodology is expected to apply to group of contracts:
FRA	– where data are available (i.e. from 2018 on); – for which reasonable proxies can be made for the missing data based on European embedded value (EEV) or Solvency II information.
MRA	– where no data is available or out of scope of EEV or solvency II
FVA	– data required to perform MRA is not available; – expected CSM at transition is nil or negative: undue complexity of applying a retrospective approach since the recognised insurance contracts on transition only correspond to fulfilment cash-flows; – PAA, since no CSM assessment required on transition

52 Mixed transition approaches appear not applicable. However, for long term contracts a mix transition approach such as an initial FVA and a MRA from this date onward,

would make the calculation of key data (CSM, LC, cumulative OCI on liabilities, acquisition cash to be recovered) on transition much easier and would also improve the relevance of the estimates.

53 On the other hand, users are concerned that depending on the transition methodology applied and assumptions retained upon transition, the measure of future performance could be significantly affected for a long period of time. Some are requesting a reduction of options.

54 We however support the view that different approaches allow for the most relevant and practicable solution to be applied in a context of major changes in the industry. In addition, many disclosures are required to provide information to users on estimates and judgments.

55 We support the application of retrospective approaches. In the insurance business, transactions are rarely performed on a quoted market so that fair value is difficult to gather and generally pertains to level 3 valuations that probably require as much judgment and assessments (and as few comparability) as applying a retrospective approach. We therefore do not consider that the fair value approach should take precedent on any retrospective approach.

56 Our understanding is that the FRA is very demanding. The concern has been raised that the simplifications introduced by the MRA may not result in much less efforts than the FRA. In order to facilitate a retrospective application rather than a prospective approach the MRA should therefore be as flexible as possible.

57 We concur with the principle set in IFRS 17.C6 that the MRA aims at achieving "the closest outcome to retrospective application possible using reasonable and supportable information available without undue cost or effort".

58 We expect the practice to develop in this area (and the reference to "supportable information" invites to such a development). However, we think that either in the FRA or in the MRA, it would be very useful that the standard more clearly states how estimates (which might relax a too strict application) may be used in FRA before being considered as a departure requiring applying the MRA or the FVA. Questions on how to use "reasonable and supportable" information under the FRA or MRA are key, for instance when determining the initial value or when applying annual cohort requirements.

<u>Contracts acquired through a business combination or a portfolio transfer before transition</u>

59 According to IFRS 17.B93, accounting classification (VFA, General Model/BBA, PAA) has not to be made according to initial conditions (e.g. when the contract was issued) but on the date of the transaction (e.g. business combination or portfolio transfer).

60 Furthermore, contracts acquired in their settlement period before transition are treated as contracts providing coverage for the adverse development of claims, and revenue reflects the entire expected claims.

61 On transition, since no specific relief has been provided in the MRA nor in the VFA, these treatments would lead to a:

- Complex assessment of the accounting classification (BBA vs. VFA; BBA vs. PAA) depending on:
  - the date of transfer of a contract (compared with the date of issuance);
  - when a claim arose (whether before or after the transfer);

- possible distortion in the presentation or calculation of KPI (i.e. revenue on claims acquired).

Other transition issues

62 There is a common expectation that IFRS 4 amendment on IFRS 9 exemption will be deferred in order to be aligned with the postponed implementation of IFRS 17.

2.2 Possible accounting mismatches

63 Following 3 issues have been identified for possibly creating accounting mismatches:

- On transition, when applying the OCI option, OCI on liabilities has to be set to nil for non-VFA participating contracts;
- Risk mitigation cannot be applied retrospectively.
- IFRS 9 provisions on financial instruments derecognised in prior year deter from restating comparative financial statement;

OCI option for non VFA participating contracts under the MRA

64 For an entity that chooses to disaggregate insurance finance income or expenses between P&L and OCI in accordance with IFRS 17.88 (b), the MRA requirements indicate that the cumulative OCI relating to non-VFA contracts at the transition date should be assessed as nil under the assumption that the discount rate retained is the current rate on transition (IFRS 17.C19(b)(ii)).

65 From an economic standpoint, there is an issue in considering that changes in discount rate have not yet been recognised on the asset side (measured at amortised cost of FVOCI), whereas the insurance liability would be recognised on transition at a current value, e.g. implicitly considering that past changes in discount rate have been recorded in the retained earnings.

66 Not considering any impact of the OCI carried forward on the liabilities could significantly impact the result of future periods and then undermine the credibility of the transition which is a higher risk than the risk of hindsight created by accepting to retrospectively calculate former FCF.

67 In our view, transition requirements should not only provide a solution to VFA contracts (as IFRS 17.C19(b)(iv) does) but more broadly to participating contracts (as defined in IFRS 17.B132) that are “directly” (i.e. with a clearly identified linkage) linked with assets without complying with all the VFA criteria set in IFRS 17.B101. This would allow for a more continuous accounting treatment of participating contracts preventing the “cliff effect” of VFA criteria.

68 We note that IFRS 17.116 assumes that there is such a link between OCI on assets and liabilities upon transition, even for non VFA contracts.

69 For instance that linkage could be based on a “constructive obligation” not meeting the IFRS 17.B101 criteria or a reinsurance contract issued (such as “Prefon”).

70 In our view reference to a general pool of assets is possible. A pool of assets that would be smaller than the liability is probably not usual; it would however not disqualify but limit to that extent the OCI referred to upon transition.

71 The adjustment would only take into consideration the share in the referred assets that belongs to the policyholders (without considering the entity’s share). Assessing that adjustment probably requires an estimation of historical flows / changes in the FCF in order to estimate the proper amount of OCI to be adjusted.

72 FCF could be discounted at the rate the entity is expecting to be committed to against its policyholders (the “*crediting rate*”). Accordingly, accretion of the liability would reflect the returns transferred to policyholders. From an economic standpoint, the difference between that rate (estimated at transition date) and the current date on

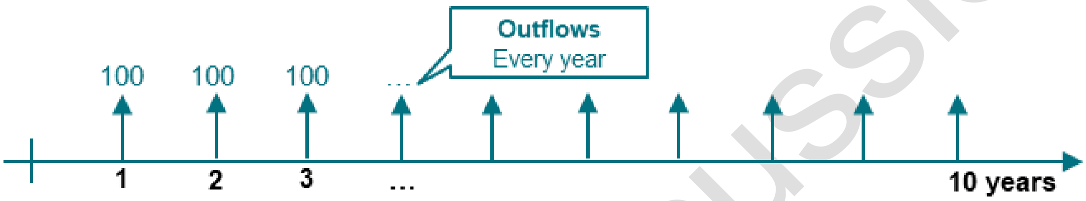
transition could be a proxy of what would have been put in OCI, be IFRS 17 applied from inception. The example below illustrates that alternative.

Illustrative example – Recalculating OCI on transition for non-VFA participating contracts

Assumptions

73 Assuming an indirect participating contract with :

- A fixed income portfolio backing liabilities with a book yield of 5 % (cumulative OCI on assets equal to 107)
- IFRS 17 current discount rate at transition date of 2.5 %
- Policyholders' participation rate of 80%
- Expected cash-outflows of 100 during 10 years (Inforce only, i.e. no New Business)



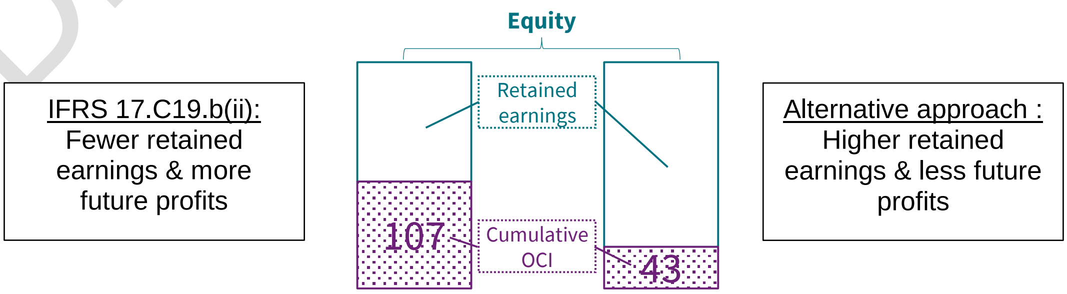
Amount of cumulative OCI at transition

74 Applying the simplification offered by the standard (IFRS 17.C19.b(ii)):

- Cumulative OCI on the asset side (107) results from the difference between the market value 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 amounts to 107-0=107

75 Alternative approach: OCI with a "crediting rate" (expected rate of return to policyholders according to IFRS 17.B 134) amounting to 4 % (i.e. 5 %*80%).

- Cumulative OCI on the asset side (107)
- Cumulative OCI on liability (64) results from the outflows at 2.5% current rate subject to a crediting rate of 4%
- Net cumulative OCI then amounts to 43 (107 – 64).

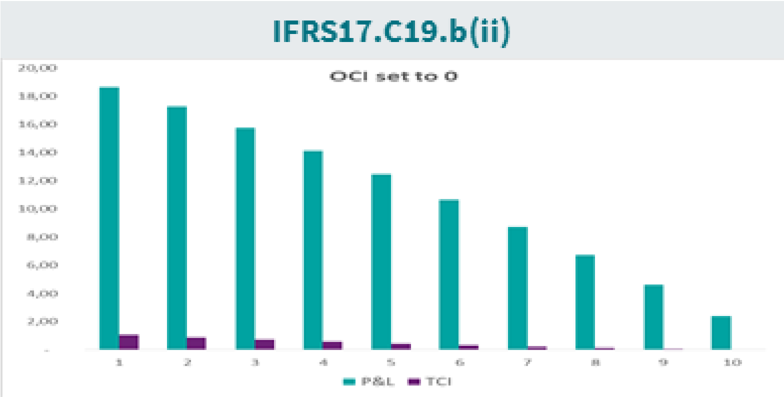


76 The amount of cumulative OCI at transition has:

- no impact on equity (but on the breakdown between OCI and retained earnings);
- a potential major impact on retained and future results.

Focus on the P&L

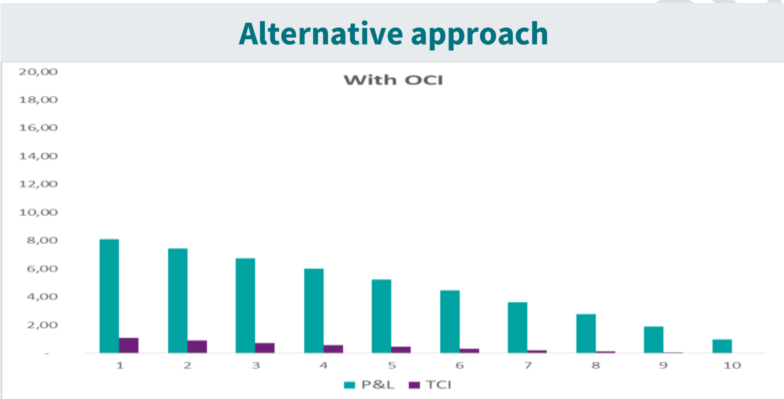
77 The comprehensive income (net result +OCI) remains unchanged.



78 The effective yield on the liability is the current discount rate (2.5 %). Since the effective yield is much lower than the book yield (5 %), the insurance finance expense will be low and the investment result high.

79 There is no allowance for past assets/liabilities interactions.

80 Future investment results are too high (above any economical vision)



81 The crediting rate amounts to 4 %. Since this effective yield is closer to the investment return (5 %), the insurance finance expense will be higher and the investment result lower.

82 The investment result is more in line with the expected financial margin (1 % in our example). In this example all the service provided is linked to investment return services (e.g. no insurance coverage).

83 In its February meeting (see also § 39), IASB discussed two possible solutions but not the one suggested above in this paper.

<u>Interaction with IFRS 9 – Risk mitigation</u>

84 Risk mitigation provisions in IFRS 17.B115 allows for recording in the P&L instead of in the CSM the financial risk's component of changes in the CSM, in order to match the corresponding changes in the derivatives. Retrospectively apply such risk mitigation on transition would accordingly impact the CSM and the retained earnings.

85 However IFRS 17.C3(b) specifically prohibits a retrospective application of risk mitigation that may "give rise to the risk of hindsight" (IFRS 17.BC 393).

86 Conversely, in our view, not reflecting it on transition could distort the historical CSM and significantly impact the insurance result for years.

87 In our view, the documentation on the risk-management objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts referred to in IFRS 17.B116 may already exist prior to the transition.

88 There is no conceptual reason for excluding the retrospective application of IFRS 17.B115 as long as the same documentation requirement applies. In our view, there is a higher risk to not provide a fair view in not considering any impact of risk mitigation carried forward than in accepting the risk of hindsight to carry forward existing risk mitigation instruments.

89 Moreover, risk mitigation is derived from a corporate strategy and does not result from a deliberate choice. An overall consistency with information provided in other parts of the previous reports could be additionally required: description of the hedging strategy and its major impact, clear distinction between instruments providing risk mitigation and the related contracts, and those that do not provide such a risk mitigation.

90 Moreover, the reference made in IFRS 17.C6 to “reasonable and supportable information available without undue cost or effort” should be a general principle ensuring an adequate financial information in the very specific and temporary situation of a transition.

91 In its March meeting, IASB tentatively decided that risk mitigation could apply prospectively from the transition date on. This may provide a solution limited to the effect of the risk mitigation during the comparative period, but not addressing the opening effect on CSM and retained earnings.

92 IASB has tentatively decided in its January 2019 meeting that the risk mitigation’s provisions would apply to proportionate reinsurance held. Accordingly, the risk mitigation issue on transition has been extending to proportionate reinsurance held.

<u>Interaction with IFRS 9 – Comparative information in 2021</u>

93 Applying IFRS 9 provisions, an entity deciding to restate the comparative year 2021 will have to apply both standards (i) IAS 39 on financial instrument derecognised before transition and (ii) IFRS 9 on financial instrument that *have not* been derecognised before transition.

94 Restating the comparative period provides more relevant information, but applying both standards would be operationally burdensome and conceptually inconsistent so that it would deter preparers from choosing that option.

95 There is no conceptual reason for providing a relief on the retrospective application of IFRS 9 to financial instrument that have been derecognised before transition. It is a practical expedient that aimed at facilitating the transition on a standalone basis i.e. where no further collateral impact would arise. By contrast, when applied at the same time as IFRS 17, this provision leads to undue complexity when restating comparative year 2021.

96 In its April meeting, IASB suggested that an application of IFRS 9 could mitigate the issue. Since the issue stems from the non-alignment of transition dates between IFRS 9 and IFRS 17 (which also justified the IFRS 4 amendment) we are not convinced that an earlier adoption of IFRS 9 would actually solve the issue.

3 Suggested solution (tentative)

3.1 Suggested modifications relating to operational complexities –MRA

General

97 There is no need for a detailed guidance on how to apply the principle set in IFRS 17.C8.

98 We are however very supportive of the suggestion made in February's board meeting (IASB 2019-02.AP 2D §36) to explain that a retrospective approach (either FRA or MRA) does not prohibit from making estimates and further to clarify to which extent an estimates stops and becomes a departure to the retrospective approach. This explanation would be better placed in the standard itself.

99 For instance, applying a mixed approach on transition: full retrospective as long as reasonable and supportable information is available (i.e. for the last 10 years) and a FVA as initial value for the period before.

Suggested modifications

100 IFRS 17.C8: To achieve the objective of the modified retrospective approach, an entity is permitted to use each modification in paragraphs C9–C19 only to the extent that an entity does not have reasonable and supportable information to apply a retrospective approach. In addition, the existence of specified modifications in the modified retrospective approach does not prohibit an entity from:

(a) making estimates that are necessary in retrospectively applying an accounting policy as described in paragraph 51 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors; or

(b) similarly, making estimates when applying a specified modification in the modified retrospective approach.

3.2 Suggested modifications relating to operational complexities – contracts acquired through a business combination or a portfolio transfer before transition

General

101 Introducing specific transition provisions (whatever the methodology retained) on the possibility to classify:

- groups of acquired contracts (BBA vs. VFA; BBA vs. PAA) as of the date of issuance instead of the date of transfer;
- as "liabilities for incurred claims" claims acquired in their settlement period before transition.

Suggested modifications

102 IFRS C5bis: On transition and regardless of the approach retained, an entity may depart from IFRS 17.B93 in applying the date when the contract was issued instead of the date of the transaction (e.g. business combination or portfolio transfer) to contracts acquired before transition.

3.3 *Suggested modifications relating to possible accounting mismatches – OCI option*

General

103 We suggest amending IFRS 17.C19(b) so that transition requirements address the cumulative amount of OCI carried forward on the liability for participating contracts (as defined in IFRS 17.B132) that are “directly” (i.e. with a clearly identified linkage) linked with assets without complying with all the VFA criteria set in IFRS 17.B101.

104 FCF should be discounted at the rate the entity is expecting to be committed to against its policyholders. Accordingly, accretion of the liability would reflect the returns transferred to policyholders. From an economic standpoint, the difference between that rate (estimated at transition date) and the current date on transition could be a proxy of what would have been put in OCI, be IFRS 17 applied from inception (as illustrated in the example in § 73-82).

Suggested modifications

105 IFRS 17.C19: For groups of insurance contracts that do not include contracts issued more than one year apart:

(a) if an entity applies paragraph C13 to estimate the discount rates that applied at initial recognition (or subsequently), it shall also determine the discount rates specified in paragraphs B72(b)–B72(e) applying paragraph C13; and

(b) if an entity chooses to disaggregate insurance finance income or expenses between amounts included in profit or loss and amounts included in other comprehensive income, applying paragraphs 88(b) or 89(b), the entity needs to determine the cumulative amount of insurance finance income or expenses recognised in other comprehensive income at the transition date to apply paragraph 91(a) in future periods. The entity shall determine that cumulative difference:

(i) for insurance contracts for which an entity will apply the methods of systematic allocation set out in paragraph B131—if the entity applies paragraph C13 to estimate the discount rates at initial recognition—using the discount rates that applied at the date of initial recognition, also applying paragraph C13;

(ii) for insurance contracts for which an entity will apply the methods of systematic allocation set out in paragraph B132 — on the basis of the difference at transition date between the current rate and the rate based on which the entity expects to determine its commitment under the contract (*crediting rate*); otherwise on the basis that the assumptions that relate to financial risk that applied at the date of initial recognition are those that apply on the transition date, ie as nil;

(iii) for insurance contracts for which an entity will apply the methods of systematic allocation set out in paragraph B133—if the entity applies paragraph C13 to estimate the discount rates at initial recognition (or subsequently)—using the discount rates that applied at the date of the incurred claim, also applying paragraph C13; and

(iv) for insurance contracts with direct participation features to which paragraph B134 applies—as equal to the cumulative amount recognised in other comprehensive income on the underlying items.

3.4 Suggested modifications relating to possible accounting mismatches – Interaction with IFRS 9 – Risk mitigation

General

106 We suggest removing the prohibition introduced in IFRS 17.C3(b) of a retrospective application of the risk mitigation provisions.

Suggested modifications

~~107~~ IFRS 17.C3: An entity shall apply IFRS 17 retrospectively unless impracticable, except that ~~:~~

~~(a)~~ an entity is not required to present the quantitative information required by paragraph 28(f) of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.~~; and~~

~~(b) an entity shall not apply the option in paragraph B115 for periods before the date of initial application of IFRS 17.~~

3.5 Suggested modifications relating to possible accounting mismatches – Interaction with IFRS 9 – Comparative information in 2021

General

108 We suggest making optional the exception introduced in IFRS 9.7.2.1 regarding financial instruments derecognised during the comparative period.

109 For consistency reasons, this should apply to all qualifying items and not on an item by item basis.

Suggested modifications

110 IFRS 9.7.2.1: An entity shall apply this Standard retrospectively, in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, except as specified in paragraphs 7.2.4–7.2.26 and 7.2.28. An entity opts whether t~~T~~his Standard ~~shall~~ ~~not be~~ applie~~d~~s or not to all items that have already been derecognised at the date of initial application.