Appendix 2: Relevance and Reliability Issues paper

Introduction and Objective

1 The objective of this paper is for EFRAG TEG to discuss two sections: Relevance and Reliability that will form part of the IFRS 17 *Insurance Contracts* draft endorsement advice.

2 In providing its assessment on whether IFRS 17 results in relevant and reliable information, EFRAG has considered all the requirements of IFRS 17 including the December 2019 IASB tentative decisions relating to the amendments to IFRS 17. The EFRAG Secretariat notes that this paper does not cover annual cohorts nor topics that the IASB will re-deliberate in its future meetings. These topics will be brought to EFRAG IAWG and then EFRAG TEG once the IASB tentative decisions on these are known.

3 EFRAG has focused its assessment on the requirements it considered most significant in relation to each of the criteria. EFRAG has accordingly focused on guidance that:

(a) is fundamental to the accounting for insurance contracts;

(b) has been subject to substantial debate (evidenced by the comments EFRAG has received from constituents including participants in EFRAG's field-tests and the comment letter due process on the amendments to IFRS 17);

(c) may be problematic to apply evidenced by the results of EFRAG's field-tests; and

(d) relates to the issues raised by the European Commission in its request for endorsement advice.

4 EFRAG has assessed IFRS 17 requirements against each of the technical criteria for each of the following topics:

	Topic	Relevance	Reliability
1	Measurement of insurance contracts (including discount rates)	X	X
2A	Different insurance accounting models	X	
2B	Reinsurance contracts held	X	X
3	Level of aggregation (including identification of onerous contracts)	X	X
4	Treatment of investment component	X	X
5	Risk mitigation	X	X
6	Sharing of risks	X	X
7	Performance of the insurance business	X	X
8	Presentation on the statement of comprehensive income	X	
9	Presentation on the statement of financial position	X	
10	Contract boundaries	X	
11	Separating components from an insurance contract	X	X

12	Accounting policy options		
13	Recognition of liabilities arising from insurance contracts		
14	Disclosures	X	X[1]
15	Transition requirements	X	X
16	Restatement of comparatives		
17	Business combinations	X	X

5 Issues that have been submitted to the IASB Transition Resource Group:

	Topic	**Relevance**	**Reliability**
A	Separation of insurance components of a single insurance contract	X	
B	Boundary of contracts with annual repricing mechanisms	X topic 10	
C	Boundary of reinsurance contracts held	X topic 10	X topic 10
D	Insurance acquisition cash flows paid on an initially written contract	X topic 1	
E	Determining quantity of benefits for identifying coverage units	X topic 7	X topic 7
F	Insurance acquisition cash flows when using fair value transition	X topic 1	
G	Cash flows within the contract boundary	X topic 10	
H	Presentation of groups of insurance contracts in the statement of financial position	X topic 9	

6 Topics related to the Amendments to IFRS 17:

	Topic	**Relevance**	**Reliability**
18	Scope exclusions – credit card contracts and loan contracts that meet the definition of an insurance contract	X	
19	Expected recovery of insurance acquisition cash flows	X topic 1	X topic 1
20	Contractual service margin attributable to investment-return service and investment-related service	X topic 7	X topic 7
21	Reinsurance contracts held — recovery of losses on underlying insurance contracts	X topic 2B	X topic 2B
22	Presentation in the statement of financial position	X topic 9	
23	Applicability of the risk mitigation option	X topic 5	X topic 5
24	Transition modifications and reliefs	X topic 15[2]	X topic 15
25	Interim reporting	X	

7 Analysis has been made in this paper for the December 2019 IASB tentative decisions relating to:

[1] Disclosures relating to the contractual service margin release.

[2] This excludes business combinations as the topic relates to cost/benefit challenges to distinguish between claims from contracts acquired and claims from contracts issued as these are managed together.

(a) insurance acquisition cash flows;

(b) reinsurance contracts held – recovery of losses;

(c) a scope exclusion for loans;

(d) the contractual service margin attributable to investment services - coverage units for insurance contracts with direct participation features;

(e) presentation in the statement of financial position - by portfolio instead of group level;

(f) the applicability of the risk mitigation option - for reinsurance contracts held;

(g) transition reliefs for business combinations; and

(h) transition relief for the risk mitigation option - the option to apply the fair value approach.

8 Placeholders have been inserted for topics that the IASB will discuss at future meetings. Analysis will be done on these once the IASB tentative decisions on these topics are known.

Relevance

9 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.

10 EFRAG considered whether IFRS 17 would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information. In its assessment of relevance, EFRAG has identified the following topics as being the most significant to this assessment:

(a) Scope exclusions;

(b) Measurement of insurance contracts;

(c) Separation of insurance components;

(d) Different insurance accounting models;

(e) Reinsurance contracts held;

(f) Level of aggregation;

(g) Sharing of risks;

(h) Treatment of investment component;

(i) Risk mitigation;

(j) Performance of the insurance business;

(k) Contract boundaries;

(l) Presentation on the statement of comprehensive income;

(m) Presentation on the statement of financial position;

(n) Disclosures;

(o) Transition requirements;

(p) Business combinations; and

(q) Interim reporting.

Scope exclusions

Scope exclusion for loans

11 IFRS 17 provides a choice at portfolio level which is irrevocable, to apply IFRS 17 or IFRS 9 to contracts that meet the definition of an insurance contract but limit the compensation for insured events to the amount required to settle the policyholder's obligation created by the contract (for example, loans).

12 EFRAG considers that this choice provides useful information because an entity would apply the same Standard to those contracts as it applies to other similar contracts it issues. For example, an entity that mainly issues insurance contracts would apply IFRS 17 to these loans while an entity that mainly issues financial instruments would apply IFRS 9.

13 [CREDIT CARDS TO BE COMPLETED AFTER FUTURE IASB TENTATIVE DECISIONS]

Measurement of insurance contracts

14 EFRAG discusses issues relating to contract boundaries in the paragraphs 87 to 92 below.

Measurement components

15 The distinction between contracts with and without direct participation features is discussed in paragraphs 41 to 45 below.

16 The general measurement model for an insurance contract comprises:

(a) the fulfilment cash flows which consist of (i) current expected future cash inflows and outflows, (ii) adjustment to reflect the time value of money and financial risks related to the future cash flows (discount rate) and (iii) a risk adjustment to reflect the uncertainty about the amount and timing of future cash flows for non-financial risk; and

(b) the contractual service margin which represents the expected unearned profit that the entity will recognise as it provides services in the future.

Future cash flows

17 IFRS 17 requires an entity to make an unbiased probability-weighted estimate of the future cash flows. Since the cash flows generated by insurance contracts are uncertain, entities will assess and capture a full range of foreseeable outcomes and their probabilities. As a result, EFRAG is of the view that this estimate will result in relevant information.

18 EFRAG considers that estimating only those cash inflows and outflows within the contract boundary (see paragraphs 87 to 92) will provide relevant information because it reflects the rights and obligations that arise from the contract, law or regulation.

Embedded options and guarantees in insurance contracts

19 Many insurance contracts contain significant embedded options and guarantees. The cash flow estimates will incorporate the intrinsic value of embedded options and guarantees as IFRS 17 requires the entity to look at a full range of possible scenarios in estimating the options and guarantees. In addition, the time value of options and guarantees, which reflects the uncertainty about the amount and timing of the options and guarantees occurring, is considered in the measurement. Therefore, incorporating options and guarantees in the cash flows will provide relevant information about when the options and guarantees will be 'in the money' and their corresponding value.

Treatment of acquisition costs

20 IFRS 17 requires an entity to allocate, on a systematic and rational basis, insurance acquisition cash flows that are directly attributable to a group of insurance contracts to that group and to any groups that include contracts that are expected to arise from renewals of the contracts in that group. An asset is recognised before the group of insurance contracts to which they are allocated is recognised and the recoverability of this asset is assessed if facts and circumstances indicate the asset may be impaired.

21 EFRAG notes insurers use the following main distribution channels to sell insurance contracts:

(a) Insurance agents: these represent the insurance company and have an interest to bind the policyholder to the insurance company for a longer time, even when the contractual period is only for one year. As a result, the renewal rate for insurance contracts sold through insurance agents is expected to be high;

(b) Insurance brokers: these represent the policyholder and as a result can choose more freely the insurance company they recommend to the policyholder. As a result, the renewal rate for insurance contracts sold through insurance agents is expected to be less high; and

(c) Direct (e.g. online) selling points: here the policyholder interacts directly with the insurance company, without the intervention of any intermediate. In this channel the renewal rate for insurance contracts is expected to be the lowest but may still exist because of the overall "stickiness" of policyholders to their insurance contract.

22 EFRAG considers that entities may incur substantial acquisition costs to obtain a contract, in the expectation that the contract will be renewed and that the acquisition costs will be recovered over the life of the contract and its renewals. Therefore, the allocation of insurance acquisition cash flows to expected renewals will provide relevant information to users of financial statements by better reflecting the economic substance and general understanding of these transactions. Based on EFRAG's extensive case study, generally, renewals are not considered relevant for the life business but for property and casualty business.

23 In addition, the impairment test will also provide relevant information to users for their decision-making because they will be provided with information to what extent the entities consider that the acquisition cash flow asset would be recoverable.

Discounting

24 IFRS 17 requires entities to discount cash flows using market-consistent discount rates. The discount rates should include only relevant factors relating to the liability, i.e., factors that reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts.

25 As insurance contracts can run over many years, EFRAG considers that discounting the future cash flows reflects the impact of the passage of time, thus providing relevant information for users of financial statements on an entity's financial position.

26 EFRAG assesses that the reflection of the time value of money provides relevant information. Incorporating liquidity characteristics is also considered to provide relevant information because an entity generally is unable to sell the contract liability quickly. In addition, EFRAG considers that the discount rate chosen by entities will provide useful information on the characteristics of the cash flows because it will be focussed on the nature of the liability, for example, cash flows that vary based on returns from underlying items would use rates that reflect that variability.

Risk adjustment

27 Incorporating an explicit risk adjustment will provide relevant information to users of financial statements because the users will be able to evaluate the entity's view of the economic impact imposed by the non-financial risk associated with the entity's insurance contracts. In addition, any subsequent changes in estimates of the risk adjustment will provide users with useful information relating to any change in the entity's views relating to non-financial risk.

28 In addition, EFRAG considers that the risk adjustment includes the degree of diversification benefit when determining the compensation, the entity requires for bearing the risk.

29 Furthermore, the risk adjustment is estimated at current value. Some have argued that a small change in interest rates can affect the amount of risk adjustment that would be recognised in profit or loss and therefore, the statement of comprehensive income would not provide relevant information on performance of the entity. EFRAG assesses that because of the long duration[3] of many insurance contracts, there would be some uncertainty about both the timing and cash flows to and from policyholders. Therefore, the time value of money aspect of the risk adjustment would be relevant information because it reflects the present value of the risks associated with that uncertainty, which would assist a user in assessing the overall obligation of the entity.

Use of current rates

30 EFRAG is of the view that the use of current updated estimates at the end of each reporting period for the fulfilment cash flows provides relevant information about the entity's contractual obligations and rights by reflecting information about the amounts, timing and uncertainty of the cash flows generated by those obligations and rights. Updated estimates also provide relevant information because these take into consideration current developments which may impact the fulfilment cash flows. Therefore, the analysts of financial statements can assess the predictability of cash flows and can also assess the adequacy of the liability.

Contractual service margin

31 The contractual service margin is determined on initial recognition of a group of insurance contracts as the amount that eliminates any gains arising at that time.

32 EFRAG is of the view that the contractual service margin provides relevant information because it provides a transparent view of the expected but unearned profit that the entity considers that it will make from the insurance contracts over the coverage period. If entities need to update their estimates of the fulfilment cash flows which relate to future periods, the contractual service margin is adjusted to reflect this change. This updating to reflect the current conditions provides relevant information.

33 In addition, the contractual service margin provides relevant information because it enables users to consider the allocation of the unearned profit over the reporting periods included in the coverage period.

34 EFRAG's analysis on the release pattern of the contractual service margin to profit or loss is explained in paragraphs 84 to 86 below.

Questions for EFRAG TEG

[3] Duration is defined as weighted average maturity of cash flows within the contract boundary.

35	Do you have any comments from paragraph 11 to 34? Please explain.
36	Are there additional topics that EFRAG TEG considers should be included in these sections? Please explain.

Separation of insurance components

37 Insurance contracts may combine different types of insurance coverage, thereby grouping different insurance risks into one legal insurance contract. It is argued by some that the Standard should permit the separation of different insurance risks contained in a single insurance contract.

38 EFRAG disagrees with this view, except in cases where two or more insurance contracts are combined for administrative convenience, as the cost and complexity of the separation of a single insurance contract into its component is expected to outweigh any resulting increase of relevance of the information.

39 It is noted that the IASB TRG discussed this issue and noted the following:

(a) The lowest unit of account that is used in IFRS 17 is the contract that includes all insurance components;

(b) Entities would usually design contracts in a way that reflects their substance;

(c) Combining different types of products or coverages that have different risks into one legal insurance contract is not, in itself, sufficient to conclude that the legal form of the contract does not reflect the substance of its contractual rights and obligations; and

(d) The fact that a reinsurance contract held provides cover for underlying contracts that are included in different groups is not, in itself, sufficient to conclude that accounting for the reinsurance contract held as a single contract does not reflect the substance of its contractual rights and obligations.

Different insurance accounting models

40 IFRS 17 defines the principles for the measurement of insurance contracts as assessed above. Those principles are modified or simplified for:

(a) contracts with direct participation features;

(b) reinsurance contracts held;

(c) investment contracts with discretionary participation features; and

(d) contracts where the premium allocation approach is applied.

Contracts with direct participation features

<u>Distinction between contracts with and without direct participation features</u>

41 IFRS 17 distinguishes between insurance contracts with and without direct participation features.

42 Contracts with direct participation features are substantially investment-related contracts. EFRAG assesses that a specific treatment is justified for these contracts because:

(a) the entity is constrained in its ability to make decisions on the notional underlying items as a result of the direct link with the underlying items because (i) the entity is expected to manage the policyholder's invested premiums for the benefit of the policyholder; (ii) the entity must generally follow the investment strategy specified in the contract; and (iii) the entity is usually required to act in a fiduciary capacity for the policyholder. Even if the entity does not hold the underlying items, the entity would still be bound by the investment strategy specified in the enforceable contractual terms;

(b) there is a direct link between the fair value returns from the underlying items and the amount to be paid to the policyholder based on contractual terms. Therefore, the entity can be viewed as managing the underlying items on behalf of the policyholder; and

(c) the gains relating to the contractual underlying items are substantially for the policyholder (which is not the case for contracts without direct participating features) and the policyholder pays a fee to the entity, which would vary with the fair value of the underlying items.

43 EFRAG is of the view that this fee is the compensation that the entity will receive from the policyholder for the investment service provided under an insurance contract with direct participation features. Any changes in the fair value of the underlying items will cause a change in the amount of the fee that the entity will receive. EFRAG considers that this change in amount of the fee relates to the future because the entity continues to manage the investments for the benefit of the policyholder over the coverage period. Therefore, EFRAG considers it relevant that any changes to the fee should adjust the contractual service margin and be recognised in profit or loss as the investment services are provided over the coverage period.

44 For contracts without direct participation features, at least one of the criteria is not met to be classified as contracts with direct participation features. EFRAG assesses that for contracts without direct participation features, the entity is not expected to manage the policyholder's invested premiums entirely for the benefit of the policyholder, which is the case for contracts with direct participation features. In addition, for contracts without direct participation features, there is a no direct link between the fair value returns from the underlying items and the amount to be paid to the policyholder based on contractual terms. Therefore, the income that the entity receives is not restricted to a fee as for contracts with direct participation features.

45 Based on the above, EFRAG considers that the different measurement requirements between contracts with and without direct participation features provide relevant information about the differences in the nature of the entity's income or rewards from the contracts.

Scope of contracts with direct participation features

46 EFRAG assesses the relevance of the conditions that determine the scope of the approach available to contracts with direct participation features in the following paragraphs. Reinsurance contracts not eligible for the variable fee approach are discussed in paragraphs 62 to 64.

Participation in a clearly identified pool of assets

47 The requirement that contracts with direct participation features relates to a clearly identified pool of underlying items ensures that the link between the insurance contract liability and the associated assets is contractually determined and enforceable. This provides relevant information as the entity's fee can be determinable. This also provides relevant information as economic mismatches should not arise where the entity elects to hold those underlying items.

Payment to the policyholder a substantial share of the fair value returns from the underlying items

48 EFRAG assesses that this criterion leads to relevant information because it distinguishes situations in which the investment returns are viewed as belonging substantially to the policyholders rather than the entity. In other situations, the investment returns belong to the entity and are allocated by the entity to the policyholder. Therefore, since the entity can be viewed as managing the underlying items on behalf of the policyholder, and receiving a fee in exchange for that service,

EFRAG considers that this modification to the general measurement requirements portrays this special relationship by requiring that the policyholder receives a substantial part of the fair value returns on the underlying items.

Amounts to be paid to the policyholder vary with the change in fair value of the underlying items

49 This criterion ensures that the return provided to the policyholder encompasses not only interest or dividends accrued but also (un)realised value increases on the principal amounts invested. This provides relevant information as it fully reflects the entity's provision of investment services.

Contracts that contain a constructive instead of a contractual obligation

50 Based on EFRAG's extensive case study, some have argued that contracts with a constructive obligation rather than a contractual obligation should also be able to apply the variable fee approach. EFRAG does not agree with this view because under a constructive obligation, the share of returns on the underlying items that the entity retains would be entirely at the discretion of the entity and so this would not be consistent with that amount being equivalent to a fee. EFRAG considers that contractual terms that are enforceable would specify a determinable fee. Therefore, EFRAG does not consider that contracts with a constructive obligation would not hinder relevance.

Reinsurance contracts held

51 Reinsurance contracts held are discussed separately in paragraphs 56 to 70 below.

Investment contracts with discretionary participation features

52 Investment contracts with discretionary participation features are not insurance contracts as they do not transfer significant insurance risk. These contracts are scoped into IFRS 17 and treated as if they are insurance contracts only to the extent they are issued by an entity that also issues insurance contracts. The general requirements for measuring insurance contracts are modified for investment contracts with discretionary participation features.

53 EFRAG assesses that the changes to the general measurement requirements provides relevant and useful information for users as these contracts and insurance contracts, that specify a link to returns on underlying items, are sometimes linked to the same underlying pool of assets. Also, there are some characteristics in these contracts which are similar to insurance contracts, e.g., long maturities, recurring premiums.

Premium allocation approach

54 The premium allocation approach is a simplification of the IFRS 17 principles and can be applied in circumstances where the entity expects such a simplification would produce a measurement that is not materially different than a measurement following the general requirements or when the coverage period is one-year or less.

55 EFRAG assesses that the eligibility criteria ensure that the relevance of the information is not materially reduced compared to the general measurement requirements.

Reinsurance contracts held

General assessment

56 IFRS 17 modifies the requirements of the general model for reinsurance contracts held. The "contractual service margin" on initial recognition does not represent unearned profit but instead a net cost or net gain on the purchase of the reinsurance.

57 IFRS 17 treats insurance contracts issued and reinsurance contracts held as separate contracts with different counterparties. Based on the EFRAG user outreach in 2018, some specialist users indicated that reinsurance and insurance were not considered as separate businesses and the net effect was considered. However, EFRAG assesses that the separate treatment under IFRS 17 reflects the contractual positions. Also, 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.

58 It is argued by some that, from an economic perspective, reinsurance contracts held are highly dependent on the underlying insurance contracts. Those holding this view argue in favour of the same accounting treatment for both initial and subsequent measurement of the insurance liability and the reinsurance asset to avoid any accounting mismatches.

59 EFRAG acknowledges the high interdependence between a reinsurance contract held and the underlying insurance contract(s). Nevertheless, EFRAG only partly agrees with the view that measurement for both types of contracts in accordance with IFRS 17 results solely in accounting mismatches.

60 In EFRAG's view, the following mismatches may arise, and these mismatches reflect the economic mismatches between the underlying insurance contracts and the reinsurance contract:

(a) Reinsurance contracts come in many forms. For example, proportional contracts (which reinsure a proportion of the underlying risks) can be divided between those providing coverage for a quota share (for example, an entity reinsuring 50% of all underlying risks) or providing coverage up to certain fixed limit (so called surplus treaties). As a result, some of the risk in the underlying contracts is not reinsured;

(b) The terms of the reinsurance contract held and the underlying insurance contracts may differ. For example, the reinsurer may exclude particular risks from coverage such as terrorist attacks or natural disasters or the duration of the reinsurance contract may differ from the underlying insurance contracts; and

(c) Even when the insurance conditions between the two contract types are fully aligned, there may be a timing difference between any changes in contract conditions by the reinsurer and similar changes in the underlying insurance contracts.

61 In contrast, when the contractual characteristics and the timing of the reinsurance contract are fully aligned with the contractual characteristics and timing of the underlying insurance contracts, accounting mismatches may occur in applying IFRS 17. Examples of such accounting mismatches are described in paragraphs 62 to 64 below.

Reinsurance contracts do not qualify as contracts with direct participation features

62 In accordance with paragraph B109 of IFRS 17, reinsurance contracts issued and held do not qualify as contracts with direct participation features. For reinsurance contracts held this creates a mismatch with the underlying insurance contracts, when these are measured as contracts with direct participation features. EFRAG notes that determination of the nature of the mismatch is more complex for contracts with direct participation features. For example, an economic mismatch may occur when the underlying investment returns are better than initially expected. As reinsurance covers the downside risk, a better than expected investment return of

the underlying items would not necessarily result in an increased premium to the reinsurer.

63 In EFRAG's simplified case study, it was mentioned that the scope of the variable fee approach should be extended to reinsurance contracts. From the results of the extensive case study, some of the respondents indicated that some reinsurance contracts would be eligible for the variable fee approach. These respondents mentioned that if volatility would arise in the ceding insurer's financial statements when the variable fee approach contracts are reinsured.

64 As explained in paragraphs 62 and 64 above, EFRAG considers that this mismatch and volatility as a result of the mismatch does not result in relevant information.

Intragroup reinsurance

65 Intragroup reinsurance is discussed in the prudence section.

Reinsurance contracts held — recovery of losses on underlying insurance contracts

66 When the entity recognises a loss on initial recognition of an onerous group of underlying insurance contracts, or on addition of onerous contracts to that group, the entity will determine the amount of a loss recovered from a reinsurance contract held and recognise it as income.

67 EFRAG considers that this requirement aims at reducing accounting mismatches between all reinsurance contracts held and the related underlying contracts as the entity has the right to recover some or all the claims that contribute to these losses.

68 Furthermore, the loss-recovery calculation based on total expected reinsurance recoveries would be consistent with the general measurement requirements of IFRS 17 that are comprehensively based on expectations about future cash flows.

69 Therefore, for the reasons explained above, EFRAG considers that this requirement provides useful and relevant information.

70 Under IFRS 17, a corresponding income is recognised for reinsurance contracts held to compensate the loss from the underlying contracts even if the reinsurance contract held is in a net cost position. It is argued by some that this would not reflect the economics of a reinsurance contract that is in a net cost position and would be open to abuse in order to achieve an accounting outcome. EFRAG considers that even in a net cost position, the entity has a right to recover claims from the reinsurer that the entity will receive service from the reinsurer over time. In addition, there are disclosures on the loss component of the underlying contracts and the loss-recovery component for the reinsurance contracts held to limit the possibility of abuse.

Questions for EFRAG TEG

71 Do you have any comments from paragraph 37 to 70? Please explain.

72 Are there additional topics that EFRAG TEG considers should be included in these sections? Please explain.

Level of aggregation

73 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

Sharing of risks

74 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

Treatment of investment component

75 IFRS 17 requires any differences between expected and actual amounts of the investment component payable in the period to be recognised in the contractual

service margin. A detailed description of this issue is provided in the Reliability section in paragraphs 182 to 186 below.

76 EFRAG has been made aware that the application of this requirement is complex. EFRAG acknowledges the complexity of the requirement but notes that accelerations or delays in payment of investment components are inherent to insurance business models. EFRAG does not consider as useful information, for example, the recognition of a gain for a delay in repaying an investment component accompanied by a loss that adjusts the contractual service margin for the expected later repayment. EFRAG assesses that accounting for the net effect of expected and actual amounts of the investment component in the contractual service margin brings relevant information as it smooths the effect over time and consequently avoids an immediately impact in profit or loss leading to volatility. EFRAG concludes that the complexity is balanced by the relevance of the resulting information in line with the insurance business models.

Risk mitigation

77 IFRS 17 provides a risk mitigation approach for contracts with direct participation features. In order to apply this approach an entity must have a previously documented risk-management objective and strategy for using derivatives and reinsurance contracts held to mitigate financial risk arising from insurance contracts. In the absence of this specific risk mitigation, the changes in the effect of financial risk on the entity's share of the underlying items would be recognised in the contractual service margin. However, the change in the fair value of the derivative or change in the financial risk of the reinsurance contracts held used to mitigate this financial risk would be recognised in profit or loss or loss giving rise to an accounting mismatch. Therefore, EFRAG assesses that the risk mitigation approach for contracts with direct participation features addresses a particular set of accounting mismatches.

78 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

79 Risk mitigation at transition is discussed in paragraphs 125 to 128 below.

Performance of the insurance business

Current rate versus locked-in rate to accrete the contractual service margin

80 IFRS 17 requires that, for insurance contracts without direct participation features, the contractual service margin is accreted using the discount rate that was determined at initial recognition of a group of contracts. In contrast, for contracts with direct participation features, IFRS 17 requires that the contractual service margin is adjusted based on current discount rates.

81 EFRAG supports the use of a locked-in rate for contracts without direct participation features because, at inception, the contractual service margin is a residual that represents unearned profit. As a result:

(a) the amount recognised in the statement of comprehensive income provides insight into the pricing and cost policies for a group of contracts; and

(b) when allocating the accretion of the contractual service margin to insurance revenue at a locked-in rate, a trend emerges over time that reveals an increase or decrease in the impact of pricing and/or cost policies of the entity.

82 For contracts with direct participation features, the effect of changes in the entity's share of underlying items, which comprises both the effect of the passage of time and the change in the value of the underlying items, is recognised in the contractual service margin. As a result, the contractual service margin is updated and consequently based on current discount rates. EFRAG considers that using current rates for these types of contracts provides relevant information because of the

different economics of these contracts compared to the contracts without direct participation features.

83 Some argue that insurance contracts without direct participation features should also use current rates to accrete the contractual service margin as this would better reflect the estimate of unearned profit. In addition, some propose that the difference between the current rate and the rate at inception could be recognised in other comprehensive income. EFRAG does not agree with this view as the contractual service margin would no longer present the profit trend expected at the inception of the contract.

Pattern of release of the contractual service margin

84 IFRS 17 requires an entity to systematically recognise the contractual service margin in profit or loss over the coverage period thereby reflecting the provision of coverage as required by the contract. In order to determine the provision of coverage, an entity identifies the number of coverage units in a group which are determined as the quantity of benefits provided by the contracts in the group and its expected coverage duration. This is applicable for both contracts with and without direct participation features.

Contracts without direct participation features

85 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

Contracts with direct participation features

86 For insurance contracts with direct participation features, the coverage units consider quantity of benefits and expected period of both insurance coverage and investment-related service. EFRAG considers that this represents the mixture of services provided under these contracts as these contracts are substantially investment-related service contracts and hence agrees that the allocation of the contractual service in accordance with the coverage period results in relevant information.

Contract boundaries

87 Cash flows are within the boundary of an insurance contract 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 premium or in which the entity has a substantive obligation to provide the policyholder with services.

Contract boundary of contracts with annual repricing mechanisms

88 The contract boundary ends when the insurer has the practical ability to reassess the risks of the underlying insurance contract or the portfolio that contains that insurance contract and as a result can set a price or level of benefits that fully reflects the risk of that portfolio. As a consequence, when an insurer uses annual repricing mechanisms that are closely related to the underlying risks, the cash flows resulting from the renewal terms are not part of the boundary of the existing insurance contract but belong to a new insurance contract instead. EFRAG assesses that accounting for this change as a new contract leads to relevant information because it reflects the changed economics of the contracts.

Contract boundary of reinsurance contracts held

89 IFRS 17 requires insurance and reinsurance contracts held to be treated as separate contracts. This implies that, in contrast to current practices, the contract boundary of reinsurance contracts held is determined independently of the underlying insurance contracts. As a result, the contract boundary of reinsurance contracts held may be shorter or longer than the underlying insurance contracts.

90 EFRAG notes that entities need to use consistent assumptions for measuring reinsurance contracts held and related underlying insurance contracts. Nevertheless, situations may occur where contract boundaries differ between reinsurance contracts held and the underlying insurance contracts. For example, reinsurance contracts held may be repriced on a more frequent basis than the underlying insurance contracts. EFRAG acknowledges the IASB TRG noted that both rights and obligations need to be considered when assessing the boundary of a contract but adds that in the fact pattern discussed the direct insurer had the right to terminate the contract when the reinsurer decided to reprice. EFRAG assesses that determining the contract boundary of insurance and related reinsurance contracts separately provides relevant information as it reflects the different conditions of insurance contracts issued and reinsurance contracts held.

Cash flows within the contract boundary

91 The contract boundary ends when the insurer has the practical ability to reassess the risks of the underlying insurance contract or the portfolio that contains that insurance contract and as a result can set a price or level of benefits that fully reflects the risk of that portfolio. When the contract includes an option to add insurance coverage at a future date, the IASB TRG noted that if that option is not a separate contract and the terms are not guaranteed by the entity, the cash flows arising from the option might be either within or outside of the contract boundary, depending on whether the insurer has the practical ability to set a price that fully reflects the reassessed risks.

92 EFRAG assesses that an entity is no longer bound by the existing contract at the point at which the contract confers on the entity the practical ability to reassess the risk presented by a policyholder. Therefore, only including cash flows in the contract boundary if they arise from substantive rights and obligations that exist during a reporting period provides relevant information.

Questions for EFRAG TEG

93 Do you have any comments from paragraph 73 to 92? Please explain.

94 Are there additional topics that EFRAG TEG considers should be included in these sections? Please explain.

Presentation on the statement of comprehensive income

95 IFRS 17 distinguishes two ways that entities earn profits from insurance contracts:

(a) the insurance service result, which comprises insurance revenue and incurred claims and depicts the profit earned from providing insurance coverage; and

(b) the financial result, which captures (i) investment income from managing financial assets and (ii) insurance finance expenses which are the effects of discount rates and other financial variables on the value of insurance obligations.

96 EFRAG is of the view that the insurance service result will provide useful information for users. This is because it will reflect insurance services that have already been provided and therefore will reflect profit on an earned basis for each reporting period. The insurance revenue and incurred claims excludes any investment components because this represents amounts payable to the policyholder regardless of an insured event occurring. EFRAG considers that, since the insurance revenue and incurred claims relates to insurance services, presenting the investment component separately provides relevant information.

97 IFRS 17 requires a gross presentation of the insurance service result, i.e. insurance revenue and insurance service expenses are presented separately. EFRAG

assesses this as adding relevant information as it provides users of financial statements more granular information about the insurance service result.

98 EFRAG considers that the financial result will provide useful information because it depicts the effects of investments and of market interest rates.

99 Similarly, as for the insurance service result, a separate presentation of investment income and insurance finance expenses is assessed as adding relevant information as it provides users of financial statements more granular information about the net financial result.

100 When applying IFRS 17, an entity will recognise the effect of changes in financial assumptions in the period in which the changes occur. However, the entity can choose where to present this effect - either in profit or loss (under financial result) or disaggregated between profit or loss (under financial result) and other comprehensive income.

101 EFRAG expects that entities will choose the presentation that better reflects the economics of their business. This choice provides relevant information because entities can align the accounting treatment of insurance contract liabilities with that of assets, thereby aligning investment income and investment finance expense.

102 As per EFRAG's 2018 user outreach, specialist users indicated that the requirement to split the presentation between underwriting and investing activities, in the statement of comprehensive income, would provide useful information. In addition, most of the specialist and generalist users did not see volatility in profit or loss as a problem as long as it reflects real economic substance and the underlying causes were communicated clearly.

103 Based on the reasons above, EFRAG assesses that, overall, the statement of comprehensive income will provide relevant information on the performance of the insurance business and also provide relevant information on the extent to which profit arises from underwriting and from financial activities.

104 As described in paragraph 100, IFRS 17 permits that entities can recognise the effect of changes in financial assumptions either in profit or loss or disaggregated between profit or loss and other comprehensive income. Some reject this and propose that the entire release of the contractual service margin should be recognised in profit or loss to avoid the complexities of permitting the option to recognise the release of the contractual service margin in other comprehensive income as permitted in IFRS 17.

105 EFRAG does not agree with this view. EFRAG supports both accounting options to present finance income or expenses either in profit or loss or disaggregated between profit or loss and other comprehensive income because they represent two business approaches of European insurers. Hence, EFRAG disagrees with the argument that complexity is created by introducing the option to use the other comprehensive income option without providing any compensating benefits. In addition, as per EFRAG's extensive case study, respondents mentioned that the accounting option would reflect the different business models of insurers and help eliminate some accounting mismatches, thus providing relevant information.

106 The pattern of release of the CSM is analysed in paragraphs 84 to 86.

Presentation on the statement of financial position

Separate presentation of portfolios that are assets and that are liabilities

107 IFRS 17 requires an entity to present separately in the statement of financial position portfolios of insurance contracts issued that are assets and those that are liabilities.

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

109 As per EFRAG's user outreach, most users agreed with this separate presentation as the portfolio level would not reduce the loss of useful information. EFRAG agrees with the remarks provided in the EFRAG user outreach and assesses that these requirements would not hinder relevance.

Non-separation of receivables and payables

110 Based on the requirement in paragraph 107 above, there is no separate presentation in the financial position of receivables or payables.

111 Some preparers argue that the principle of IFRS 17 to disclose a portfolio of insurance contracts as a bundle of rights and obligations resulting in one balance rather than separating out on the balance sheet its components such as premiums receivable or claims payable. They are concerned that the disclosure requirements under IFRS 17 would lead to a loss of credit risk information that users currently have.

112 From EFRAG's user outreach, there were mixed views. Some users did not consider that there should be a separation of receivables/payables as it would not have a big impact on their estimates when building their models. Fewer users were concerned about the less information in the statement of financial position or wanted the separation of receivables/payables.

113 EFRAG acknowledges that users will have less information unless preparers present such information. However, the presentation requirements are consistent with its measurement principle, i.e. a current estimate of all expected cash flows within the contract boundary. Therefore, EFRAG considers that the statement of financial position would reflect the combination of rights and obligations created by the contract as a whole.

114 EFRAG noted that there are currently differing definitions of premiums receivable used. It was also accepted that for primary insurance the credit risk period is short, e.g. a month or so (it could be six months for reinsurance contracts) and is overall not material. This is supported by the current disclosures of large European insurers which do not include policyholder credit risk in the discussion of their maximum exposure to credit risk as required by IFRS 7 or the amounts disclosed in the notes for premiums receivable in the context of the statement of financial position for these entities.

115 Therefore, based on the above reasons, on balance, EFRAG considers that non-separation of receivables and payables provides relevant information.

Disclosures

116 The objective of the disclosure requirements is to provide a basis for the users of financial statements to assess the effect of applying IFRS 17 on the entity's financial position, financial performance and cash flows. To meet this objective, IFRS 17 contains a range of qualitative and quantitative disclosure requirements. EFRAG considers that these disclosures would provide information that is most relevant for the circumstances of entities and would emphasise the importance of communication to users of financial statements rather than compliance with detailed and prescriptive disclosure requirements. Disclosures are also assessed under the Understandability section.

Questions for EFRAG TEG

117 Do you have any comments from paragraph 95 to 116? Please explain.

118 Are there additional topics that EFRAG TEG considers should be included in these sections? Please explain.

Transition requirements

Existence of three transition approaches

119 At transition, entities are required to apply IFRS 17 retrospectively unless impracticable. The full retrospective approach recognises and measures insurance contracts as if IFRS 17 had always been applied. When impracticable, entities can choose between applying either the modified retrospective approach or the fair value approach using IFRS 13 *Fair Value Measurement*.

120 As per EFRAG's user outreach in 2018, some specialist users were not sure of the impact of the different transition approaches, e.g., concerns that people would choose the option they want in terms of opening balances and window dressing, not necessarily choosing what is most appropriate. In EFRAG's 2019 user outreach, some users indicated that it was unclear how transition was managed and therefore when the numbers will normalise going forward. Some users also preferred the use of only one transition approach and not three.

121 EFRAG considers that each of the above transition approaches can provide relevant information depending on the information available because entities are implementing IFRS 17 from different starting points and users will be informed of the effect of the transition method chosen and the movement of the figures going forward as each transition method is disclosed separately. Whenever practicable, entities would use the full retrospective approach that provides the most complete and consistent information. The EFRAG extensive case study showed that all three approaches would be used in practice.

122 Some argue that when applying the fair value approach, the resulting contractual service margin is too low. Under the fair value approach, the fair value of liabilities at the date of transition is defined (in accordance with IFRS 13). The fair value is therefore driven by the relationship between two willing market participants and is determined by reference to the rate of return required by such market participants. As a result, when calculating the fair value, it would include a compensation that the market participant would require for taking on the obligation. Therefore, EFRAG considers that the contractual service margin applying the fair value approach would have a range of contractual service margin amounts rather than being too low.

123 Overall, taking the above reasons into consideration, on balance, EFRAG is of the view that the existence of three transition requirements does not result in a lack of relevant information.

Modified retrospective approach

Additional specific transition modification and reliefs (including transition requirements for insurance acquisition cash flows)

124 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

Applying the risk mitigation option

Option to apply the fair value approach

125 Under IFRS 17, on transition, an entity may choose to apply the fair value approach, for contracts with direct participation features, if it meets specified criteria relating to risk mitigation.

126 An entity that uses the fair value transition approach avoids the situation in which changes in the fair value of derivatives being used for risk mitigation are reflected in

opening retained earnings or equity but the corresponding changes in the insurance contracts are reflected in the contractual service margin resulting in an accounting mismatch. At the transition date, the fair value of derivatives will include only expectations about future cash flows. In the fair value approach, the fair value of insurance contracts at transition would also include only expectations about future cash flows.

127 As a result, this option would address the accounting mismatch issue and therefore provide relevant information.

Applying the risk mitigation option retrospectively/ at transition date

128 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

Business combinations

129 For insurance contracts issued and reinsurance contracts held acquired in a business combination, the consideration paid or received (i.e. the fair value of the contracts at the date of the acquisition) is used as a proxy for the premiums received.

130 Based on the results of its case study, EFRAG understands that the fair value of a portfolio of insurance contracts typically ranges between 70%-90% of the present value of future shareholder transfers. That is, the fair value at transaction day would create an immediate gain in profit or loss and a lower future contractual service margin and thus future profits.

131 EFRAG notes that the consideration paid can either be lower (in which case it results in a bargain purchase), higher (in which case goodwill is created) or equal than the present value of future shareholder transfers.

132 In those cases where the acquirer makes a bargain purchase, EFRAG assesses that the acquirer continues the obligation of the acquiree to provide services to the policyholders, but not to the same extent as the acquiree. This may be due different expectations from the acquirers' perspective in insurance and/or financial variables that affect the insurance business, compared to the acquiree's perspectives for those same variables. As a result, EFRAG considers that accounting for an immediate gain in profit or loss for a bargain purchase and a lower future contractual service margin result in relevant information.

Contracts acquired in their settlement period

133 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

Interim reporting

134 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

Questions for EFRAG TEG

135 Do you have any comments from paragraph 119 to 134? Please explain.

136 Are there additional topics that EFRAG TEG considers should be included in these sections? Please explain.

Conclusion about the relevance of information resulting from IFRS 17

137 The choice to apply IFRS 17 or IFRS 9 to loans that meet the definition of insurance contracts provides relevant information because entities would apply the same Standard to similar contracts that it issues.

138 The general measurement requirements are assessed to lead to relevant information as the rights and obligations that arise from insurance contracts are considered. Also, the measurement captures a full range of foreseeable outcomes and their probabilities. Finally, time value of money is being considered through the

use of discounting. The treatment of acquisition costs in cases where renewals of insurance contracts are considered by the insurer is assessed to lead to relevant information.

139 The general measurement requirements are modified or simplified for:

(a) Contracts with direct participation features: These contracts are assessed to be of an economical different nature and the conditions to apply the approach for contracts with direct participation features are assessed to lead to relevant information as they permit the aim of reducing or eliminating accounting mismatches between the insurance liability and the underlying items of the contracts within the scope;

(b) Investment contracts with discretionary participation features: the measurement is assessed to provide relevant information as these are accounted for under IFRS 17 if the entity also issues insurance contracts. These investment contracts often have similar characteristics to insurance contracts; and

(c) Premium allocation approach: the reduction in relevance is considered not to be material and is balanced by the simplification it represents for preparers.

140 For reinsurance contracts held that are used to recover losses from the underlying contracts, EFRAG considers that this provides relevant information as it aims at reducing accounting mismatches. The fact that reinsurance contracts do not qualify as contracts with direct participation features does not result in relevant information, although EFRAG understands that currently very few insurance contracts containing investment risk are reinsured.

141 The level of aggregation requirements [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS].

142 The treatment of investment components is considered to be complex, but that complexity is balanced by the relevance of the resulting information in line with the insurance business models.

143 The risk mitigation approach of IFRS 17 addresses adequately particular accounting mismatches for contracts with direct participation features when derivatives and reinsurance contracts held are used. [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

144 On measuring the performance of an insurance entity, the contractual service margin is treated as a residual. For contracts without direct participation features accreting this residual at a locked in rate provides relevant information about the pricing power and cost control of an entity for a group of insurance contracts. In contrast, contracts with direct participation features essentially act as a 'pass-through' of all the benefits (minus a fee for the insurer) to the policyholder. For such more investment-like contracts, a treatment similar to the use of current discount rates is assessed to be appropriate.

145 The release pattern of the contractual service margin for contracts without direct participation features [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]. When an insurer provides both insurance coverage and investment services for direct participation contracts, EFRAG assesses the release of the contractual service margin should reflect this thus providing relevant information.

146 The issues that EFRAG is aware of in relation to the contract boundary do not limit the relevance of the resulting information as cash flows within a contract boundary reflect the substantive rights and obligations that exist.

147 The statement of comprehensive income is expected to provide relevant information on the performance of the insurance business and distinguishes performance between underwriting activities and financial activities.

148 The requirement for separate presentation of contracts in an asset position and contracts in a liability position on the statement of financial position is assessed not to hinder relevant information. Regarding non-separate presentation of receivables/payables, the combination of rights and obligations should be reflected as a whole. EFRAG is also aware that currently there are differing definitions of receivables. Therefore, on balance, EFRAG assesses that this non-separation provides relevant information.

149 The disclosure requirements would provide information that is most relevant for the circumstances of entities.

150 The transition requirements consider the situation where an insurer has all, partly or an insufficient amount of information available to apply the Standard retrospectively. In addressing each of these situations, the transition requirements are assessed to lead to relevant information, considering the extent of the information available for each particular group of insurance contracts at transition. The option to apply the fair value approach when using risk mitigation and full retrospective approach is assessed to provide relevant information as it would address accounting mismatches. [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS - MODIFIED RETRSOPECTIVE APPROACH AND RISK MITIGATION]

151 The treatment of business combinations - [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

152 Interim reporting - [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

153 EFRAG's overall assessment is to be finalised.

Questions for EFRAG TEG

154 Do you have any comments on the conclusion section from paragraph 137 to153? Please explain.

Reliability

155 EFRAG also considered the reliability of the information that will be provided by applying IFRS 17. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

156 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

157 In its assessment of reliability, many of the aspects addressed in the relevance section also affect reliability. These issues are not repeated. As a result, EFRAG has identified the following topics as being the most significant to the assessment of reliability:

(a) Measurement of insurance contracts;

(b) Reinsurance contracts held;

(c) Level of aggregation;

(d) Risk mitigation;

(e) Separating components from an insurance contract;

(f) Treatment of investment component;

(g) Sharing of risks;

(h) Business combinations;

(i) Performance of the insurance business;

(j) Transition requirements; and

(k) Disclosures on the release of the contractual service margin.

Measurement of insurance contracts

158 Measurement of insurance liabilities in IFRS 17 requires judgement in estimating the fulfilment value of an insurance contract. Judgement and interpretation may be required including accounting policy choices which may affect the reliability of information. EFRAG acknowledges that judgement is inherent in the insurance business and in the complexity of the products and as a result, it is inherent in the measurement of insurance contracts. Therefore, EFRAG considers that estimating future cash flows would not lead to reduced reliability.

159 In addition, EFRAG considers that reliability would not be reduced because entities have experience in applying judgement when applying other IFRS Standards and in managing their business.

160 Also, IFRS 17 is a new standard and as a certain market practice will develop over time, this would increase the reliability of information.

Discount rates

161 IFRS 17 requires entities to discount cash flows. Under IFRS 17, discount rates include only relevant factors, i.e. factors that arise from the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts. When such discount rates are not directly observable in the market, an entity uses estimates.

162 IFRS 17 does not require a particular estimation technique for determining discount rates. However, in applying an estimation technique, an entity (i) maximises the use of observable inputs, (ii) reflects current market conditions from the perspective of

a market participant, and (iii) uses judgement in assessing the degree of similarity between the features of the insurance contracts being measured and the features of the instrument for which observable market prices are available and adjust those prices to reflect the differences between them.

163 In assessing the reliability of the use of discount rates, EFRAG notes that:

(a) observable rates may not be available for particular markets or very long durations, requiring the use of particular estimation techniques;

(b) dealing with estimates and uncertainty is inherent to the insurance business and the use of professional judgement is inherent to that; and

(c) an entity is required to disclose information about significant judgements and changes in judgements, including the approach used in determining the discount rates. Also, the yield curve(s) used to discount cash flows that do not vary based on the return on underlying items are to be disclosed.

Treatment of acquisition costs

164 EFRAG notes that entities are required to allocate, on a systematic and rational basis, insurance acquisition cash flows that are directly attributable to a group of insurance contracts to that group and to any groups that include contracts that are expected to arise from renewals of the contracts in that group. EFRAG also notes that entities should assess the recoverability of an asset for insurance acquisition cash flows if facts and circumstances indicate the asset may be impaired.

165 EFRAG acknowledges that such allocation and recoverability assessment require the use of judgement to be exercised especially the expectation with regards to the renewals of contracts. Under IFRS 17, the allocation of directly attributable overheads is allocated based on a systematic and rational basis and so EFRAG assesses that the allocation of the acquisition costs in the same way provides a reliable measurement of directly attributable costs.

166 An entity has to make expectations about the expected renewals of contracts and EFRAG assesses that this judgement is inherent in the insurance business because the entity pays the acquisition cost, e.g. commissions, in the expectation of it being recovered via renewals. Therefore, EFRAG considers that the entity has taken into considerations the extent of the renewals and this information would also be used when assessing recoverability of the acquisition cash flow asset.

167 EFRAG also notes that in order to help users of financial statements assess such judgement exercised, extensive disclosure is required for the asset recognised which arise from the expected renewals and for the recognition and reversal of impairment losses.

168 Therefore, EFRAG considers that such judgement would not reduce reliability.

Premium allocation approach

169 EFRAG considers that the measurement under the premium allocation approach provides information that is reliable because the information is expected to provide a reasonable approximation of the general requirements.

170 Under IFRS 17, the carrying amount of the liability at initial recognition under the premium allocation approach includes premiums received, if any, at initial recognition. In addition, for subsequent periods, the carrying amount of the liability includes premiums received in the period. However, IFRS 17 does not mention whether future premiums already invoiced but not yet paid and future premiums not yet invoiced should also be included in the liability measurement. EFRAG considers that the premium allocation approach was created to balance operational complexity and cost with information that users can faithfully use for their analysis. Therefore,

EFRAG considers that since the premium allocation approach is a simplification, only including premiums received only in the liability calculation provides complete information within the bounds of materiality and cost.

Reinsurance contracts held

Recovery of losses on underlying insurance contracts

171 An entity is required to determine the amount of a loss recovered from a reinsurance contract held by multiplying the loss recognised on underlying contracts by the percentage of claims on underlying insurance contracts the entity expects to recover from the reinsurance contract held.

172 EFRAG acknowledges that the expected loss-recovery calculation requires judgement and the extent of judgement may depend on the type of reinsurance contracts held. More judgement may be required for reinsurance contracts where there is no one-to-one relationship between the underlying contract and the reinsurance contract held, e.g. where an excess of loss reinsurance contract held covers multiple underlying contracts. However, EFRAG considers this is required, anyway, for the purpose of determining the cash flows in the measurement of the reinsurance contract held. Therefore, EFRAG considers that the judgement used faithfully represents the entity's recovery expectations.

Contract boundary of reinsurance contracts held

173 EFRAG understands that the cash flows within the boundary of the reinsurance contract held arise from the substantive rights and obligations of the primary insurer. The substantive right is to receive services from the reinsurer. The substantive obligation is to pay amounts to the reinsurer. Therefore, a substantive right to receive services from the reinsurer ends when the reinsurer has the practical ability to reassess the risks transferred to the reinsurer and can set a price or level of benefits for the contract to fully reflect the reassessed risk.

174 EFRAG understands that one implication of this is that the boundary of a reinsurance contract held could include cash flows from underlying contracts covered by the reinsurance contract that are expected to be issued in the future. Under IFRS 17, the direct insurance contracts and the reinsurance contracts held of a primary insurer are measured separately.

175 EFRAG considers that there may be a reduction in reliability in estimating contracts expected to be written in the future. However, EFRAG:

(a) expects entities to have a budget or forecast which includes expected new business and to have past information on new business acquired even if at portfolio level or higher to provide a basis for estimation of the future cash flows; and

(b) notes that the estimation of these contracts would follow the same measurement principles as IFRS 17, i.e., probability-weighted estimate of the present value of cash flows.

Level of aggregation

176 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

Risk mitigation

177 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

Questions for EFRAG TEG

178 Do you have any comments from paragraphs 158 to 177? Please explain.

179 Are there additional topics that EFRAG TEG considers should be included in these sections? Please explain.

Separating components from an insurance contract

180 EFRAG assesses that there may be cases where the legal form of a single contract would not reflect the substance of its contractual rights and obligations. For example, an entity selling one legal contract which has several insurance components only for the convenience of the policyholder and the price is the total of the standalone prices for the different insurance components provided. Therefore, EFRAG considers that, in this case, separating the components would faithfully represent the economics of the transactions.

181 However, EFRAG considers that in assessing whether insurance components should be separated reliably, the entity would need to consider the interdependency among the insurance components. and whether the components can be priced and sold separately. Judgement may be required in determining the extent of the stand-alone pricing.

Treatment of investment component

182 IFRS 17 requires any differences between expected and actual amounts of the investment component payable in the period to be recognised in the contractual service margin.

183 EFRAG considers that there are cases where an investment component that becomes payable in a period may directly cause changes in estimates of the present value of other future cash flows. For example, an acceleration in the repayment of an investment component because of more deaths than expected causes a reduction in the investment component to be paid in the future.

184 The difference between the expected and actual cash flows of the investment component are recognised in the contractual service margin instead of profit or loss. Also, the changes in estimates relating to the future would adjust the contractual service margin. EFRAG considers that the combined effect of such events adjusting the contractual service margin provides a faithful representation of information because it avoids the recognition of a loss or gain in the current period and a consequential gain or loss in future periods. As a result, the net effect on the contractual service margin would be the effect of the change in timing of the payment of the investment component.

185 EFRAG notes that entities should identify coverage units for insurance contracts without direct participation features considering the quantity of benefits and expected period of investment-return service, if any, in addition to insurance coverage. EFRAG also notes that entities are required to identify coverage units for insurance contracts with direct participation features considering the quantity of benefits and expected period of both insurance coverage and investment-related service.

186 EFRAG acknowledges that the identification of such investment-return and investment-related services is a matter of judgement. However, EFRAG considers that such judgement is not additional to those already required in the insurance industry. Therefore, EFRAG considers that identification of these services would not lead to a reduction in reliability.

Sharing of risks

187 [TO BE COMPLETED AFTER THE IASB TENTATIVE DECISIONS ON ANNUAL COHORTS]

Business combinations

188 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

Performance of the insurance business

Use of coverage units for the contractual service margin

189 EFRAG acknowledges that the determination of the profit allocated in profit or loss based on the actual service provided over the expected duration and quantity of benefits of the contracts within a portfolio represents the use of significant estimates

190 In assessing the reliability of the information resulting from the application of coverage units in allocating the contractual service margin to profit or loss, EFRAG notes that:

(a) the estimation of coverage units is subject to professional judgement, the reliability of which is similar to other judgements used in applying IFRS 17; and

(b) the coverage units help an entity in reflecting its long-term business model over time as they allow unearned profit to be spread over the contract duration instead of recognising it entirely at day 1.

Coverage units for contracts without direct participation features

191 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

Coverage units for contracts with direct participation features

192 For insurance contracts with direct participation features, the coverage units consider quantity of benefits and expected period of both insurance coverage and investment-related service.

193 These contracts are substantially investment-related contracts, i.e. having more investment-related service compared to insurance service, therefore, EFRAG assesses that the weighting between insurance and investment would faithfully represent these types of contracts. Furthermore, the entity has to disclose the approach used in determining the weighting which would help users to assess the weighting.

Use of locked-in rate for the contractual service margin

194 IFRS 17 requires that for insurance contracts without direct participation features, the contractual service margin is accreted using the discount rate that was determined at initial recognition of a group of contracts.

195 Some argue that using current rates to accrete the contractual service margin would better reflect the best estimate of unearned profit. EFRAG has assessed the relevance of the use of the locked-in rate from paragraphs 80 to 83 above. The arguments used in that assessment are equally valid when assessing reliability.

196 In addition, for contracts without direct participation features, there can be a link between the liability and the market yield that is used to determine the discount rate. However, there is a no *direct* connection between the liability and the underlying items. Therefore, the argument that the use of a current rate is necessary to avoid accounting mismatches with the assets is not supported by EFRAG. Specifically, EFRAG notes that the relationship between the insurance liability and the assets held by the entity is not static. The variability arises from asset liability management techniques such as the following.

(a) An insurance contract may promise a share of some of the returns on particular assets, but the entity decides not to hold these assets. When the returns from the assets held do not move in line with the promised returns, the resulting economic mismatch will have an impact on the statement of comprehensive income.

(b) Entities hold different types of asset portfolios: (i) dedicated asset portfolios that support specific liability portfolios; (ii) a general fund, the assets of which support different insurance contract liabilities and (iii) surplus assets, which represent the overall excess of assets in relation to insurance liabilities. Individual assets can move between these asset portfolios at the discretion of the entity.

(c) An entity may want to achieve a targeted return on particular assets. When the assets in one of the portfolios described in (b) above do not achieve that return, assets from another portfolio described in (b) above with better prospects can be re-allocated to take their place without derecognition of the original assets.

197 Overall, EFRAG assesses that accreting the contractual service margin at a locked-rate for contracts without direct participation features leads to reliable information.

Questions for EFRAG TEG

198 Do you have any comments from paragraphs 180 to 197? Please explain.

199 Are there additional topics that EFRAG TEG considers should be included in these sections? Please explain.

Transition requirements

Transition approaches

200 On transition, entities are required to apply IFRS 17 retrospectively unless impracticable. In the latter case, entities can choose between applying either the modified retrospective approach or the fair value approach.

201 EFRAG assesses that applying the full retrospective approach would result in reliable information because insurance contracts would be identified, recognised and measured as if IFRS 17 had always been applied. It is likely that retrospective application will be practicable for short-term contracts and recently issued long-term contracts.

202 However, on transition it may be impracticable to apply the full retrospective approach. One of the transition approaches that can be applied is the modified retrospective approach.

203 [MODIFIED RETROSPECTIVE APPROACH - TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

204 When applying the fair value approach, the contractual service margin on transition will be the difference between the fair value of the group of insurance contracts at transition date and the fulfilment cash flows at that date.

205 In applying IFRS 13, entities will have to consider assumptions from a market participant perspective, together with the compensation that a market participant would require for taking on the obligation. This compensation will be part of the contractual service margin on transition and will be allocated to profit or loss consistently with IFRS 17.

206 It is argued by some that such an approach will not result in reliable information as the compensation that a market participant will require will differ in almost all cases

from the contractual service margin that an entity would calculate under the modified retrospective approach or the profit for future services reported under the entity's previous accounting policies.

207 EFRAG notes that transitioning to a new standard changes previous recognition and measurement requirements. Due to the impracticability to apply the full retrospective approach, e.g., because of lack of data, the fair value approach is more forward looking and allows entities to recognise the transition effect over the remaining duration of the contract portfolio. That is, the fair value approach (along with the other transition approaches) supports the notion of the entity's long-term business model.

208 In addition, when applying the fair value approach, IFRS 17 excludes insurance acquisition cash flows that occurred prior to the transition date from the measurement of the contractual service margin at the transition date. EFRAG does not consider that this reduces the reliability of information because fair value reflects future cash flow expectations and does not reflect past cash flows.

209 Finally, some have argued that when applying the fair value approach, the contractual service margin on transition does not appropriately represent the profit for future services to be provided and therefore does not provide relevant information. Refer to paragraphs 204 to 207 for EFRAG's analysis on this point.

210 During the user outreach performed by EFRAG, users indicated their preference for a single transition method. One user specifically asked that such approach should be the fair value approach.

Risk mitigation relating to transition

211 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

Disclosures on the release of the contractual service margin

212 IFRS 17 requires an entity to disclose, either quantitatively or qualitatively, when it expects to recognise the contractual service margin remaining at the end of a reporting period into profit or loss. EFRAG notes that entities are also required to disclose the approach used to determine the relative weighting of the benefits provided by insurance coverage and investment-return service or investment-related service.

213 EFRAG acknowledges that judgement will be required in assessing this. However, EFRAG considers that this is incorporated when determining the release pattern of the contractual service margin using the coverage units, i.e. in determining the quantity of benefits provided under the group of contracts and the expected coverage duration. In addition, entities have to disclose the approach used to determine the weighting. Therefore, for these reasons, EFRAG does not consider that the resulting information in applying this disclosure would reduce the reliability of the information and can be depended upon by the users.

Conclusion about the reliability of information resulting from IFRS 17

214 It is acknowledged that judgement is inherent in the insurance business and therefore in the measurement of insurance contracts. This judgement would not lead to reduced reliability. On the treatment of acquisition cash flows, judgement is required for the allocation, expected renewals and impairment testing, however, extensive disclosure would help the users in assessing the judgement used. The premium allocation approach is considered to be a simplification within the bounds of materiality and cost.

215 EFRAG considers that for reinsurance contracts held, there may be a reduction in reliability in estimating contracts expected to be written in the future. However,

entities are expected to have a budget or forecast and the estimations would be measured using the IFRS 17 principles. Regarding the recovery of losses from reinsurance contracts held, EFRAG acknowledges that judgement is required on the calculation of the expected loss-recovery, however, this is already required when the entity has to determine the cash flows for the reinsurance contracts held for measurement purposes.

216 [LEVEL OF AGGREGATION – TO BE COMPLETED BASED ON FUTURE IASB DECISIONS]

217 [RISK MITIGATION OPTION – TO BE COMPLETED BASED ON FUTURE IASB DECISIONS]

218 In assessing whether insurance components should be separated reliably, the entity would need to consider the interdependency among the insurance components. and whether the components can be priced and sold separately.

219 The difference between the expected and actual cash flows of an investment component are recognised in the contractual service margin instead of profit or loss. Also, the changes in estimates relating to the future would adjust the contractual service margin. EFRAG considers that the combined effect of such events adjusting the contractual service margin provides a faithful representation of information because it avoids the recognition of a loss or gain in the current period and a consequential gain or loss in future periods.

220 [SHARING OF RISKS – TO BE COMPLETED BASED ON FUTURE IASB DECISIONS]

221 [BUSINESS COMBINATIONS – TO BE COMPLETED BASED ON FUTURE IASB DECISIONS]

222 [COVERAGE UNITS FOR CONTRACTS WITHOUT DIRECT PARTICIPATION CONTRACTS – TO BE COMPLETED BASED ON FUTURE IASB DECISIONS] For contracts with direct participation contracts, the weighting between insurance and investment would faithfully represent these types of contracts because these are substantially investment-related contracts. Disclosures on the approach used for the weighting would help users to assess the weighting. In terms of accreting the contractual service margin at a locked-in rate for contracts without direct participation features, EFRAG assesses that this leads to reliable information for the same reasons as in the relevance section.

223 Regarding transition approaches, the full retrospective approach would provide reliable information because the contracts are measured as if IFRS 17 had always been applied. [MODIFIED RETROSPECTIVE APPROACH – TO BE COMPLETED BASED ON FUTURE IASB DECISIONS] EFRAG acknowledges that when applying the fair value approach at transition date, the contractual service margin on transition does not represent the estimates of the profit for future services calculated under the entity's previous accounting policies. EFRAG points out however that the fair value approach avoids a day 1 impact on equity relating to contractual service margin recognition and it allows an entity to represent the long-term business model (along with the other transition approaches) and this is then recognised in accordance with the services being provided. These effects balance any reduction in reliability.

224 Regarding disclosures on the contractual service margin, EFRAG acknowledges that there will be judgement in disclosing the expected recognition of the contractual service margin and the weighting of the benefits provided. However, this already needs to be done when computing the coverage units for the release of the contractual service margin. Therefore, EFRAG considers that the disclosures can be depended upon by the users.

225 **EFRAG's overall assessment is to be finalised.**

Questions for EFRAG TEG

226 Do you have any comments from paragraphs 200 to 225? Please explain.

227 Are there additional topics that EFRAG TEG considers should be included in these sections? Please explain.