IFRS 17 Insurance Contracts: Contracts that change their nature over time - Issues Paper

Objective

1 The objective of this session is for EFRAG TEG to consider the impact of contracts that change their nature over time under IFRS 17 for possible inclusion in the DEA.

Background

2 During the comment period on the draft comment letter on the 2019 Exposure draft on Amendments to IFRS 17, EFRAG was informed about problems relating to contracts that may switch from contracts without direct participation features to contracts with direct participation and vice versa.

3 The following two examples were provided:

(a) Some contracts provide participation through a with-profit type policy during the initial savings phase. At the end of the savings phase, the policyholder has the option to convert the contract to a guaranteed annuity. The annuity is purchased from the annuity provider at current market rates when the option is exercised, and any additional costs are borne by the fund. The annuity rate in these products is guaranteed at inception and the annuity phase would fall within the contract boundary of the with-profit policy. Both phases of the contract are therefore either accounted for under the variable fee approach or the general model. (United Kingdom)

(b) Variable fee contracts with non-participating features that are common in the US and Asian markets, these may include:

(i) Variable annuities with a participating accumulation phase covered by underlying items and a non-participating annuity phase not covered by underlying items[1];

(ii) Variable annuities with guarantees that are not covered by underlying items; or

(iii) Certain unit-linked contracts with non-participating risk riders, for which the unbundling of the components is not permitted.

4 Where the corresponding assets backing the non-participating features in the insurance liability are not underlying items, the investment result do not adjust CSM but impacts profit or loss based on IFRS 9. This would mean that while the interest accretion adjusts the CSM, the same is not true for income earned on the related

[1] At inception the overall contract may qualify for the VFA even if the annuity phase would not qualify separately.

assets which would mean that a loss component may arise relatively quickly on these contracts even if the contract is not onerous.

5 The IASB staff in a paper for the February 2020 IASB meeting[2] considered the following suggestions to amend IFRS 17 to:

(a) Exclude the resulting cash flows from the exercise of some options from the contract boundary;

(b) Provide an accounting policy choice to separate some components of an insurance contract; or

(c) Make the requirements around financial guarantees in B113 (b) optional.

6 The IASB agreed with the staff that such adjustments would touch on the key aspects of IFRS 17 and there could be unintended consequences from such changes. Furthermore, more options would further reduce the comparability across insurers and increase the complexity of IFRS 17. Additionally, one of the suggested solutions relating to the inclusion of non-derivative financial instruments at fair value through profit and loss in the risk mitigation option has already been agreed by the IASB.

Information received from EFRAG IAWG

Contracts impacted

7 For one constituent the main concern is UK pension contracts with guaranteed annuity options. Another is hybrid contracts which are unit linked contracts with a unitised with-profit component.

8 Another constituent mentioned *Unfallversicherung mit Beitragsrückgewähr* in the German market which is life-long accident insurance with a savings component. Before a claim, the contract has participating features, but upon a claim it becomes a non-participating annuity.

9 Another preparer indicated that the issue relates to the treatment of specific cash flows arising from non-underlying items in the VFA, which leads to mismatches for the effects due to financial risks and time value of money according to the paragraph B113(b). For these cash flows, a treatment consistent with the general model would be more appropriate.

Accounting impact not mentioned in paper

10 The overall concern is that volatility would arise from continued measurement under VFA of contracts that have no underlying items. This would result in the change in liabilities to be reported in CSM while the results of the related assets will be reported in financial result.

11 The IASB's approach to expand the scope of the risk mitigation approach by adding non-derivative instruments at fair value, creates new problems as a result of the inconsistency within the individual annuities book. Some contracts will fall under VFA (where the contract was originally participating and then changed its nature over time) and some under general model (for instance where sold as an annuity product without a participating phase or features). This creates the following problems:

(a) resulting significant operational complexity of using two measurement models for the same product including additional cohorts;

[2] Refer to the IASB staff paper for further details : https://cdn.ifrs.org/-/media/feature/meetings/2020/february/iasb/ap2f-amendments-to-ifrs.pdf

(b) additional complexity on Transition given the differing treatment for similar contract;

(c) full and modified retrospective approaches on transition impossible for even the recent past for much of the book as unable to restate annuities from contracts written in 80's and early 90's where the option may only have been exercised recently;

(d) fair value approach allows choice on when to assess VFA eligibility at inception or date of transition - at inception these (with the guaranteed annuity option) are likely meet VFA eligibility, but unlikely at transition.

(e) contracts under the VFA will have fully current discount rate, where as the general model contracts will have a locked-in rate resulting in complexity for users.

12 This constituent would prefer to assess at transition and measure under general model to ensure comparability with Individual annuity contracts but are concerned that others may take a different view with resulting inconsistencies across the market.

13 Another constituent indicated that certain insurance contracts are covered by the general account assets, which contain to a large extent bonds measured at FVOCI. Use of the risk mitigation option would require re-designation of these assets to FVPL, which causes the following problems:

(a) The general account assets would need to be split into sub-sets of those covering VFA and designate at FVPL whereas those covering general model contracts would remain as FVOCI. This would increase operational complexity.

(b) Further concerns would remain as there may be hedge mismatches. At FVPL accounting, such a mismatch is recorded entirely in profit or loss. If FVOCI accounting would be possible, the mismatch would be disaggregated between P&L and OCI, as per the general model which would be more appropriate.

14 This constituent argues that the extension of the risk mitigation option to FVOCI instruments would not increase the complexity:

(a) The requirements in B115 target an "economic offset between the insurance contracts and the hedging instrument" which remains applicable; and

(b) Such offset is independent of recognition in OCI and profit or loss or profit or loss only as IFRS 17 states that any "accounting measurement differences shall not be considered in assessing the economic offset". This could be explicitly extended to "presentation differences", so that any differences in the recognition of policy choice between asset and liability side would not affect the applicability or documentation requirements of the risk mitigation option.

IASB tentative decision

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(c) Make the requirements around financial guarantees in B113 (b) optional.

16 The IASB agreed with the staff that such adjustments would touch on the key aspects of IFRS 17 and there could be unintended consequences from such

changes. Furthermore, more options would further reduce the comparability across insurers and increase the complexity of IFRS 17. Additionally, one of the suggested solutions relating to the inclusion of non-derivative financial instruments at fair value through profit and loss in the risk mitigation option has already been agreed by the IASB.

17 On extension of the risk mitigation option to include non-derivatives carried at FVOCI, the IASB concluded that it would be inconsistent with the approach in IFRS 9 for hedge accounting which does not allow FVOCI items. Furthermore, it would require complexity in identifying ineffectiveness and would not eliminate accounting mismatches in most cases. The latter would only be consistent where the related asset and the insurance contract started and ended at the same time, otherwise the unwind of the discount would progress differently.

Prevalence

18 The annuities with guaranteed options are a significant part of one of the EU top five insurer's business and the complexity is in understanding whether these are as a result of the guaranteed option (variable fee approach) or whether they were sold as such (general model) ignoring optionality under fair value approach on transition.

Further information received from LUCS

19 The EFRAG Secretariat has not yet completed its analysis of the information received under LUCS, but one of those analysed includes a full section on this topic. This is included in Appendix 1 for further information for EFRAG TEG.

Inclusion in DEA Appendix 2

20 The EFRAG Secretariat has included the following section(s) in Appendix 2:

Relevance

Some have indicated that certain products change significantly in nature during their life due to the execution of an option by the policyholder. For example, a policy with a savings phase with profit sharing may become an annuity in payment or remain paid-up without any participation if elected by the policyholder. The classification between general model and the variable fee approach is done at inception and is irrevocable. As a result, the option exercised results in the contract no longer having any direct participation features for the remainder of its term, or vice versa.

[To be completed]

Questions for EFRAG TEG

21 Are there other types of contracts that need to be included in consideration of this issue?

22 Please explain whether you agree with the description of the accounting implications under IFRS 17 or explain where there are further aspects to be considered.

23 Please provide information as to the prevalence of the contracts impacted by these issues – as a percentage of the line of business per country.

24 What is EFRAG TEG's conclusion under relevance in the draft endorsement advice? Please explain your answer. Please also indicate which of the other technical criteria are impacted by the concerns around these contracts.

Appendix 1: Information received from LUCS

Introduction

1 As the analysis of the responses on LUCS is not yet completed, it is not yet possible to conclude on that feedback received. However, the detailed analysis in this response supplements some of the information received from IAWG.

Background

2 The full response of one participant was dedicated to this issue. The relevant product is with-profits savings contracts that contain a guaranteed annuity option ("GAO") where the policyholder can take an annuity at a guaranteed rate similar to IFRS 17 paragraph B24. The contract would meet the definition of VFA at inception, but after the option has been exercised, if a reassessment were done, it would fall under the general model.

3 For the participant, the total for with-profit savings contracts with an unvested[3] GAO is around £2.4bn and its total annuity portfolio (i.e. with both open market annuities and those vested from savings contracts with GAOs) is approximately £12bn.

4 The participant notes that this is a common type of product in the UK market and indicates that there may be similar products in other jurisdictions, such Asia and the US which may be relevant to European insurance groups.

Concerns

Accounting mismatches

5 As IFRS 17 does not allow re-assessment of the contract for changes due to time, it could result in such a contract being treated under the VFA even though for a significant part of the life of the contract there will be no underlying items or participation features. The participant mitigates its exposure to discount rates with appropriate assets to achieve a well matched position, but under the annuity phase, as the assets are not underlying items, the changes with respect to financial risk is not recognised in CSM (as would happen for the insurance liability) and so volatility would exist. This would not be the case, if for this phase, the contracts would fall under the general model. The general model would not be appropriate if the contract does not qualify for the VFA[4] given the participation features during the accumulation phase.

6 On transition, the FVA may be followed due to lack of reasonable and supportable information of conditions at inception date. At such a date the with-profit accumulation phase will make a smaller proportion of the contract meaning that the contract may not qualify for the VFA.

Inconsistent treatment of annuities

7 Where the annuities are purchased by the policyholders, these do not have an accumulation phase with participation features and so these would fall under the

[3] i.e. the policyholder has not yet exercised its option under the contract.

[4] Note: the participant comments that given the length of the annuity phase, the contract may not meet the VFA requirements in paragraph B101 as the portion paid to the policyholder may not be a substantial portion of the fair value changes of the underlying items. The EFRAG Secretariat accepts for purposes of this paper that the accounting requirements for the VFA is met as not enough information has been provided. However, this is an area of significant judgement and could have a significant impact on the accounting outcomes. Furthermore, it may warrant disclosures per IAS 1 on accounting judgements and estimates.

general model. As discussed above, the participation features in a contract with a GAO may fall under the VFA.

8 This would impair comparability of economically the same contracts within the same entity and the participant envisages needing the use of alternative performance metrics in order to explain the results internally and externally. This would lead to greater costs on implementation and on an ongoing basis.

Reduced availability of options at transition

9 For contracts that have converted already to an annuity, the participant would need to identify the inception date and not the conversion date for the fully retrospective approach on transition. The current systems only record the date the savings contract was changed into an annuity and not the original inception date.

10 The participant suggests that under the MRA it may be able to assess for VFA eligibility at the transition date due to a lack of reasonable and supportable information to assess at inception date and given the conversion to annuities, these would fall under the general model on transition. However, as there is no such specific relief in the MRA, further analysis would be required to determine whether the history of the accumulation phase can be ignored. This would add to implementation costs and effort and would be disruptive to the implementation programme.

Operational concerns

11 The systems are set-up to facilitate current accounting treatment and so have separate policy administration systems for the accumulation and annuity phases. However, the contract boundary requirements under IFRS 17 would require significant changes and will be disruptive to the IFRS 17 implementation programme. The participant would also need to develop methodology and modelling solutions for the treatment of annuity contracts under the VFA or the accumulation phase under the general model.

12 Furthermore, as there is no data as to whether current annuities were purchased or are the result of exercise of an option ending the accumulation phase, if the participant is unable to conclude that an annuity did not result from a GAO, these annuities may also have to follow the fair value option at transition. This could potentially result in the whole annuity portfolio and not those resulting from vested GAOs having to be fair valued at transition. The participant believes that this would impair the usefulness of the information.

Suggested solutions

13 The participant considers that EFRAG should request the IASB to reconsider its position and amend the standard to allow the contract boundary to ‘reset’ at conversion. A European or UK carve-out would not be desirable as the participant is an SEC filer and such a solution would undermine the benefit of a consistent global standard.