IFRS 17 DEA: discussion on Business models
Issues Paper

Objective

1 The objective of this session is for EFRAG TEG to consider proposed wording for the IFRS 17 DEA about IFRS 17 and insurance business models separately from the rest of Appendix III as it has not been considered by EFRAG TEG previously. The proposed wording has been discussed by EFRAG IAWG in May 2020 and the updated wording forms part of Appendix III previously shared with EFRAG TEG.

Request for Endorsement advice

2 The request for endorsement advice from the European Commission asked *How does IFRS 17 take into account the specificities of the insurance sector? Do the different accounting methods reflect properly the different business models?*

Background

3 There are various definitions of business models in general. In “What is a business model”, a literature summary of Harvard Business Review articles on the topic comments (link here): “In “Why Business Models Matter,” [Joan] Magretta goes back to first principles to make a simple and useful distinction, pointing out that a business model is a description of how your business runs, but a competitive strategy explains how you will do better than your rivals. That could be by offering a better business model — but it can also be by offering the same business model to a different market.”

4 IFRS 9 says the following about business models in respect of financial assets:” An entity’s business model refers to how an entity manages its financial assets in order to generate cash flows. That is, the entity’s business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both.”

Proposed wording in Appendix III of DEA

Specificities of insurance business models

5 As Insurance Europe (link here) sets out in its publication on how insurance works: insurance exists to transfer risk and as such “a means of reducing uncertainty. In return for buying an insurance policy for a smaller, known premium, the possibility of a larger loss is removed. By pooling premiums and insured events, the financial impact of an event that could be disastrous for one policyholder is spread among a wider group.”

6 Insurance business models differ from other businesses in that it receives money early in the business-cycle rather than at the end. Furthermore, like banks, it manages duration mismatches between assets and liabilities although the duration mismatch is more extreme in the case of insurers. In contrast to banks, liquidity risk

is less prominent for insurers insofar non-life contracts are involved. Due to the extended claim payment period insurers are generally able to prepare better the funding required to absorb the claims. For the same reason, insurers are far less likely to suffer from 'a run on the company' than banks. In contrast, for life contracts, there may be significant liquidity risks. For example, in case such life insurance contracts offer permanent surrender options. As premiums are received earlier than the related claims, insurers have large portfolios of investments, either as support for future claims, in terms of its regulatory framework or on behalf of its shareholders.

7 The insurance business is centred around pricing risk and taking on risk for the price it considers sufficient in terms of its risk and pricing strategy in the context of its regulatory environment. The policyholders that benefit from this are both individuals as well as businesses with commercial insurance.

8 The action of taking on various risks from various policyholders means that it is pooling the risk as described above. The pooled risk may be shared amongst policyholders only (sometimes referred to as mutualising risk) or shared between policyholders and capital providers.

9 Insurers manages their remaining risk by entering into reinsurance contracts where some of the risks are transferred to reinsurers. The insurer also has to consider asset liability management as there is often a duration gap between the assets it holds and its liabilities – for instance an insurer may have to pay claims 50 years into the future based on policies written today, but it is often not able to find low risk assets for the same period. Lastly, insurers often engage in hedging activities to minimise some of their remaining risks to acceptable levels.

10 IFRS 17 deals with the taking on of risks at specific prices, the sharing and reinsuring of such risks. The investment of assets and hedging are covered mostly by IFRS 9. For further information please refer to the sections on asset-liability management (paragraphs xx to xx), the interaction between IFRS 9 and IFRS 17 (paragraphs xx to xx) and hedge accounting in the context of insurance (paragraphs xx to xx), in Appendix III.

11 While there are various business models such as global composites or specialist insurers as IFRS 17 focusses on insurance contracts, this discussion focusses on the product related business models in the insurance sector. Risk management activities including reinsurance held are discussed further below. Product related business models include.:

(a) Short-term business

(b) Contracts with participation

(c) Other longer-term contracts

(d) Reinsurance issued

12 These corresponds to Lines of Business per EIOPA reporting (excluding reinsurance) as follows:

Business models discussed	EIOPA lines of business
Short-term contracts	Assistance[1] Credit and suretyship insurance Casualty non-proportional reinsurance Fire and other damage to property insurance General liability insurance Health non-proportional reinsurance Income protection insurance Legal expenses insurance Marine, aviation and transport insurance Marine, aviation and transport reinsurance Medical expense insurance Miscellaneous financial loss Motor vehicle liability insurance Other motor vehicle insurance Property non-proportional reinsurance Workers' compensation insurance
Contracts with participation	Insurance with profit participation Non-health annuities Credit and suretyship insurance Index-linked and unit-linked insurance
Other longer-term contracts	Health annuities Non-health annuities Health insurance Health reinsurance Index-linked and unit-linked insurance Life insurance Other life insurance General liability insurance

15 Please note that even if not specified by EIOPA, it is generally possible to purchase reinsurance for all the products above. Over time, hybrid contracts have developed where a contract may exhibit characteristics from more than one category.

16 The products above do not include contracts issued by insurers that do not have an insurance component. These generally fall under IFRS 9 except for those savings contracts with direct participating features which may be treated under IFRS 17.

IFRS 17 recognition of insurance liabilities

17 Overall, like financial instruments, insurance contracts are about cash inflows and outflows subject to certain contractual terms. However, it was decided in order to capture the special characteristics of insurance contracts to deal with them in a separate standard rather than with other financial instruments in IFRS 9.

18 In general, IFRS 17 reflects all the cash flows related to the contracts based on the contract boundary as defined. IFRS 17 also measures and presents the underwriting decisions and underwriting results separately from the investment decisions for the related assets. The returns on the financial assets are governed by IFRS 9.

[1] In some cases, IFRS 15 *Revenue from Contracts with Customers may apply*. Please refer to paragraphs xx to xx in Appendix III where this is further discussed.

Short-term business

19 Examples of these include theft or telephone coverage where the coverage period is short with usually annual renewals. EFRAG notes that the PAA is a simplified method of accounting (compared to the other models) whereby the profit is recognised over the coverage period and is well suited for contracts of a shorter duration. It also has the benefit of being broadly similar with current practice. IFRS 17 allows acquisition costs related to the PAA to be expensed to profit or loss immediately as a simplified proxy for these short-term contracts.

Contracts with participation

20 This includes savings contracts with and without insurance coverage where policyholders participate in the return on the assets underlying the insurance contracts. Examples may include annuities and life insurance. These contracts may fall under the VFA measurement model which works on the basis that the insurer earns variable compensation for the services it provides rather than a share of returns from an investment. Where the variable fee the insurer earns changes due to changes in financial factors (such as return in assets or the discount rate), this is not recognised in OCI or profit or loss but adjusts the unrecognised profit (the CSM). The CSM is then recognised in profit or loss over time. IFRS 17 was amended to allow amortisation of CSM based on investment-related services combined with the insurance coverage to better reflect the services provided. For further information about the recognition of CSM in profit and loss please refer to Appendix II.

21 For these type of contracts, IFRS 17 also suspends the normal measurement rules in some other standards (such as IFRS 9, IAS 32 and IAS 41 related to own equity instruments and own debt issued as well as investment properties) to reflect the nature of these contracts. For further information please refer to Appendix II.

22 Therefore, EFRAG considers that the VFA reflects the business model of these type of products reflecting the long-term nature of the contract duration as well as the economics of the contracts.

Other longer-term contracts

23 Lastly, from a product perspective, contracts that do not qualify for the other two models will be captured under the general model. This includes life insurance contracts that do not qualify for the VFA as discussed above and general insurance with a longer coverage period than allowed for the PAA. Examples may include annuities, commercial insurance and life insurance without participation.

24 Here the principle is that changes due to changes in financial factors do not affect the CSM. As the underwriting result is regarded separately from the result of financing activities, the financial results reflect the gains/losses from investments and the change in the insurance contract liability related to changes in interest rate. The general model reflects the lack of a legally enforceable right to set off the liability with the investment portfolio even if the assets were perfectly matched.

25 IFRS 17 was amended to allow amortisation of CSM based on investment-return services combined with the insurance coverage. This would allow the allocation of CSM during the accumulation phase of annuities in some case where previously this was not possible. For further information on how the profit is reflected in profit or loss via the allocation of CSM please refer to Appendix II.

26 Some contracts may have cash flows that are at the discretion of the insurer that may fall under the general model. Where the insurer exercises its discretion with respect to these discretionary cash flows, this impacts the CSM (i.e. the unrecognised profit) the insurer can recognise in the future. However, where the changes in assumptions relate to financial risk, these do not adjust the CSM, but rather the financial result. For more information about the boundary between the general model and the VFA, please refer to Appendix II.

Reinsurance issued

27 Where a reinsurer issues reinsurance contracts, the requirements of IFRS 17 is *mutatis mutandis* applicable, except that any reinsurance contract does not qualify for the VFA. For further information about the concerns related to this, please refer to Appendix II.

Principles-based standard and use of judgement

28 As other IFRSs, IFRS 17 is principles based and requires the use of judgement. In various cases, an appropriate balance has been struck to allow entity-specific accounting without too significant a loss in comparability. Examples include the risk adjustment, the recognition of fulfilment cash flows, the allocation of CSM and interim reporting. Please refer to Appendix II.

Examples of other options in IFRS 17 to accommodate the business models of insurance entities

29 IFRS 17 provides a number of options, both on transition and post transition, in order to reflect the insurer's business models. Examples of these options are as follows:

Presentation of financial result

30 An entity can choose to present the financial risk, such as interest rate, either completely in profit or loss or disaggregated between profit or loss and other comprehensive income. This is done on a portfolio by portfolio basis.

31 These two options represent two business approaches of European insurers for the following reasons:

(a) Those that would select the disaggregation between profit or loss and other comprehensive income consider it effective to reduce short-term volatility on long-duration contracts, and to distinguish market noise from long-term trends.

(b) Those that would select financial risk to be presented fully in profit or loss currently use a form of current value measurement for insurance contracts and therefore would consider profit or loss to provide a better reflection of the extent to which they manage interest rate risk.

In some cases, the latter could also be reflecting the business model for short term contracts.

Transition

32 The transition requirements also acknowledge the long-term nature of insurance contracts and the related challenges such as data availability and technology in allowing for three methods to transition to IFRS 17. For further information on transition please refer to Appendix II.

IFRS 17 on risk management techniques

Reinsurance held

33 Insurers have various techniques to manage the risks in their portfolios, the most important of which is reinsurance held which is covered by IFRS 17. The main principle in IFRS 17 is that reinsurance contracts are measured separately from the related issued insurance contracts. This gives rise to differences compared to current accounting as discussed in Appendix II. Furthermore, IFRS 17 prohibits the classification of reinsurance contracts as VFA contracts which is further discussed in Appendix II. However, the recognition of a gain on reinsurance contracts held offsets the related onerous contract losses on underlying contracts as discussed in Appendix II.

Risk mitigation option

34 For contracts with direct participating features, IFRS 17 allows a risk mitigation option for derivatives, reinsurance contracts held and non-derivative financial instruments at FVPL covering the related financial risks. This means that where changes would be recognised in CSM under the VFA, these are recognised in order to avoid accounting mismatches introduced by the VFA. For further information about the risk mitigation please refer to Appendix II.

Hedge accounting

35 Although hedge accounting was discussed in the previous letters of endorsement advice, please refer to paragraphs xx to xx in Appendix III which discuss whether and when hedge accounting may be applicable in the insurance context specifically.

Other aspects in IFRS 17

Mutual entities

36 Please refer to Appendix II for further information how IFRS 17 relates to mutual entities.

Level of aggregation with respect to balance sheet measurement

37 IFRS 17 takes into consideration the pooling of risk by allowing the recognition and measurement of insurance contracts not on an individual basis as is the case in other IFRSs. For example, some contracts may have more claims than others and the outcome is only visible later in the cycle or period. Measuring contracts individually may result in reflecting some contracts as onerous with a resulting loss in the profit or loss whereas the claims may have developed as expected and the overall group is not onerous. Therefore, IFRS 17 allows the measurement of the liability at a level of aggregation that is most appropriate practically with allocations as needed.

Annual cohorts

38 Refers to CSM allocation [to be updated]

39 Ability to provide relevant information about the economic characteristics of the long-term contracts with intergenerational mutualization [to be updated, EFRAG comment letter supported the need for a special solution]

Acquisition costs

40 Acquisition costs for long term contracts may mean that contracts appear to be loss making in the early periods after inception. IFRS 17 recognises this and do not reflect such losses unless the contract group is overall in a loss position. IFRS 17 was also amended specifically to reflect acquisition costs related to expected renewals of contracts as assets. This is discussed in Appendix II.

Business combinations

41 Some argue that where those with short term contracts would acquire another insurer with short term contracts the requirement on treatment of contracts in settlement (discussed in appendix II) would not reflect the business model. EFRAG notes that such costs should form part of considerations whether a business combination is worthwhile and that for each portfolio, there would be only one group per assessed profitability bucket for the allocation of the CSM as the inception of the contracts are the acquisition date. Therefore, the onus is unlikely to outweigh other benefits related to the business combination.

Disclosures

42 As insurers accept and manage risk, there are various disclosures to provide information for users about the insurance risk retained.

Conclusion

43 The requirements of IFRS 17 takes into account the broad categories of products offered by European insurers with relevant modifications to the general model to capture the specificities of the different types of products. It also caters also for risk management in as far as this is not covered by other standards. The business models related to financial assets were considered as part of the endorsement of IFRS 9. [subject to annual cohort discussion]

Questions for EFRAG TEG

44 Does EFRAG TEG have comments and/or drafting suggestions on the proposed wording in Appendix III?