

STAFF PAPER

January 2019

IASB[®] meeting

Project	Amendments to IFRS 17 <i>Insurance Contracts</i>		
Paper topic	Cover note		
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Introduction

1. This cover note provides:
 - (a) background information about the tentative decisions made by the International Accounting Standards Board (Board) at its recent meetings about IFRS 17 *Insurance Contracts* and the ongoing extensive dialogue with stakeholders;
 - (b) an overview of the papers for this meeting, including a summary of staff recommendations;
 - (c) a table of concordance of the topics discussed at the October 2018 Board meeting; and
 - (d) an outline of the next steps.

Background

2. When IFRS 17 was issued, the Board initiated a comprehensive programme of stakeholder engagement. One objective of this engagement was to understand the practical challenges of implementing IFRS 17 and identify possible ways the Board could ease the burden of transition. Through this process, the Board has identified some concerns and implementation challenges, including those related to the balance of costs and benefits from applying IFRS 17.
3. Throughout the development of IFRS 17, the Board was aware that applying IFRS 17 for the first time will result in significant costs for some entities, but overall considered that the benefits of IFRS 17 would outweigh the costs (for discussion of the costs and benefits of IFRS 17 refer to the *Effects Analysis on IFRS 17*). Nonetheless, the Board indicated that it would consider whether additional action was needed to address matters identified as entities began their implementation efforts.
4. In October 2018, the Board considered the concerns and implementation challenges identified by stakeholders during their implementation processes, and commenced a process of evaluating the need for making possible amendments to the Standard. The Board is aware that making amendments to a recently issued Standard carries a risk of disruption to implementation processes that are already underway. The Board is also aware of the need to ensure that any amendments do not unduly delay the effective date of the Standard.
5. Accordingly, at its October 2018 meeting, the Board tentatively decided that, when proposing any amendment to IFRS 17, in addition to demonstrating a need for the amendment, the staff must show that any proposal meets the following criteria:
 - (a) the amendments would not result in significant loss of useful information relative to that which would otherwise be provided by IFRS 17 for users of financial statements—any amendments would avoid:
 - (i) reducing the relevance and faithful representation of information in the financial statements of entities applying IFRS 17;
 - (ii) causing reduced comparability or introducing internal inconsistency in IFRS Standards, including within IFRS 17; or

- (iii) increasing complexity for users of financial statements, thus reducing understandability.
 - (b) the amendments would not unduly disrupt implementation already under way or risk undue delays in the effective date of this Standard, which is needed to address many inadequacies in the existing wide range of insurance accounting practices.
- 6. The Board is now evaluating whether any of the concerns and implementation challenges identified justify amendments to the Standard that would meet these criteria. As at December 2018, the Board has tentatively decided to propose the following amendments:
 - (a) a one-year deferral of the effective date of IFRS 17; and
 - (b) an amendment to the requirements in IFRS 17 so that the presentation of insurance contract assets and liabilities in the statement of financial position is determined using portfolios of insurance contracts rather than groups of insurance contracts.
- 7. Since IFRS 17 was issued, the staff and the Board have continued their extensive dialogue with stakeholders around the world, through discussions with preparers and users of financial statements, national standard-setters, market and prudential regulators and actuaries. In addition, the Board has established a Transition Resource Group for IFRS 17, which provides a public forum for stakeholders to follow the discussion of questions raised on implementation and inform the Board in order to help the Board determine what, if any action will be needed to address those questions. This has allowed the Board to continue to monitor progress toward implementation of IFRS 17 and to understand implementation challenges that entities applying IFRS 17 have identified. As part of that work, the staff and the Board have reviewed possible solutions developed by stakeholders in different forms and have held discussions with stakeholders to further understand the proposals and their implications in more detail. The feedback from this dialogue has been reflected in the staff's development of the papers for the Board.

Papers for this meeting and summary of staff recommendations

8. The papers for this meeting provide an analysis of the following topics:
- (a) insurance acquisition cash flows—see Agenda Paper 2A *Insurance acquisition cash flows for renewals outside the contract boundary*;
 - (b) reinsurance contracts held—see Agenda Paper 2B *Reinsurance contracts held—onerous underlying insurance contracts*, Agenda Paper 2C *Appendix to reinsurance contracts held—onerous underlying insurance contracts* and Agenda Paper 2D *Reinsurance contracts held—underlying insurance contracts with direct participation features*; and
 - (c) recognition of the contractual service margin in profit or loss—see Agenda Paper 2E *Recognition of the contractual service margin in profit or loss in the general model*.
9. The following paragraphs summarise the staff recommendations in these papers.

Insurance acquisition cash flows for renewals outside the contract boundary (Agenda Paper 2A)

10. In Agenda Paper 2A the staff recommend the Board amend IFRS 17 to require an entity to:
- (a) allocate to any anticipated contract renewals part of the insurance acquisition cash flows directly attributable to newly issued contracts.
 - (b) recognise the insurance acquisition cash flows allocated to anticipated contract renewals as an asset applying paragraph 27 of IFRS 17 until the renewed contracts are recognised.
 - (c) assess the recoverability of the asset recognised according to paragraph 27 of IFRS 17 each period before the related contracts are recognised. The recoverability assessment would be based on the expected fulfilment cash flows of the related group of contracts.
 - (d) recognise a loss in profit or loss for any unrecoverable carrying amounts of the asset recognised by applying paragraph 27 of IFRS 17.

- (e) recognise in profit or loss the reversal of some or all of any such loss previously recognised when the impairment conditions no longer exist or have improved.

Reinsurance contracts held (Agenda Papers 2B–2D)

11. In Agenda paper 2B the staff recommend the Board amend IFRS 17 to:
 - (a) expand the scope of the exception in paragraph 66(c)(ii) of IFRS 17 to require an entity to recognise a gain in profit or loss when the entity recognises losses on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis; and
 - (b) require an entity to apply the expanded exception when the entity measures contracts applying the premium allocation approach (PAA);
12. Agenda Paper 2C provides illustrative examples to support the analysis in Agenda Paper 2B. Agenda Paper 2C makes no recommendations.
13. In Agenda paper 2D the staff recommend the Board amend IFRS 17 to expand the scope of the risk mitigation exception for insurance contracts with direct participation features in paragraph B115 of IFRS 17 so that the exception applies when an entity uses a derivative or a reinsurance contract held to mitigate financial risk, to the extent that the entity meets the conditions in paragraph B116 of IFRS 17.
14. The staff note that Agenda Paper 2B and Agenda Paper 2D both include recommendations relating to reinsurance contracts held. The objective of both recommendations is to resolve some accounting mismatches in IFRS 17 without unduly disrupting implementation. The staff note that the two recommendations achieve the objective in different ways:
 - (a) the recommendation in Agenda Paper 2B expands the scope of an existing exception in IFRS 17 relating to the accounting for reinsurance contracts held; and

- (b) the recommendation in Agenda Paper 2D expands the scope of an existing exception in IFRS 17 relating to the accounting for insurance contracts issued.

Recognition of the contractual service margin in profit or loss in the general model (Agenda Paper 2E)

15. In Agenda paper 2E the staff recommend the Board:
- (a) amend IFRS 17 so that in the general model the contractual service margin is allocated on the basis of coverage units that are determined by considering both insurance coverage and any investment return service;
 - (b) amend IFRS 17 to establish that an investment return service exists only when an insurance contract includes an investment component;
 - (c) amend IFRS 17 to require an entity to use judgement applied consistently in deciding whether to include an investment return service when determining coverage units, and not provide an objective or criteria for that determination;
 - (d) amend IFRS 17 to establish that the period of investment return services should be regarded as ending when the entity has made all investment component payments to the policyholder of the contract, ie not including payments to future policyholders;
 - (e) amend IFRS 17 to require the assessments of the relative weighting of the benefits provided by insurance coverage and investment return services and their pattern of delivery to be made on a systematic and rational basis;
 - (f) confirm that, applying IFRS 17, cash flows relating to fulfilling the investment return service are included in the measurement of the insurance contract;
 - (g) does not change the requirements of IFRS 17 relating to which changes in fulfilment cash flows adjust the contractual service margin in the general model; and

- (h) amend IFRS 17 to establish that the one-year eligibility criterion for the PAA should be assessed by considering insurance coverage and an investment return service, if any.

Table of concordance

16. The following table shows how the topics discussed in Agenda Paper 2D for the October 2018 Board meeting and the papers for this meeting correspond.

October 2018 Board meeting (Agenda Paper 2D)	Tentative decisions made	January 2019 Board meeting	Discussion planned at future meetings
1—Scope of IFRS 17 Loans and other forms of credit that transfer insurance risk			✓
2—Level of aggregation of insurance contracts			✓
3—Measurement Acquisition cash flows for renewals outside the contract boundary		Agenda Paper 2A	
4—Measurement Use of locked-in discount rates to adjust the contractual service margin	December 2018 meeting		
5—Measurement Subjectivity Discount rates and risk adjustment	December 2018 meeting		
6—Measurement Risk adjustment in a group of entities	December 2018 meeting		
7—Measurement Contractual service margin: coverage units in the general model		Agenda Paper 2E	
8—Measurement Contractual service margin: limited applicability of risk mitigation exception	December 2018 meeting (some aspects) ¹	Agenda Paper 2D	
9—Measurement Premium allocation approach: premiums received	December 2018 meeting		
10—Measurement Business combinations: classification of contracts	December 2018 meeting		
11—Measurement Business combinations: contracts acquired during the settlement period	December 2018 meeting		

¹ The Board will discuss the prohibition of retrospective application of the risk mitigation option at a future meeting. No decision was made at the December 2018 Board meeting.

October 2018 Board meeting (Agenda Paper 2D)	Tentative decisions made	January 2019 Board meeting	Discussion planned at future meetings
12—Measurement Reinsurance contracts held: initial recognition when underlying insurance contracts are onerous		Agenda Papers 2B and 2C	
13—Measurement Reinsurance contracts held: ineligibility for the variable fee approach		Agenda Paper 2D	
14—Measurement Reinsurance contracts held: expected cash flows arising from underlying insurance contracts not yet issued	December 2018 meeting		
15—Presentation in the statement of financial position Separate presentation of groups of assets and groups of liabilities	December 2018 meeting		
16—Presentation in the statement of financial position Premiums receivable	December 2018 meeting		
17—Presentation in the statement(s) of financial performance OCI option for insurance finance income or expenses	December 2018 meeting		
18—Defined terms Insurance contract with direct participation features	December 2018 meeting		
19—Interim financial statements Treatment of accounting estimates	December 2018 meeting		
20—Effective date Date of initial application of IFRS 17	November 2018 meeting		
21—Comparative information			✓
22—Effective date Temporary exemption from applying IFRS 9	November 2018 meeting		
23—Transition Optionality			✓
24—Transition Modified retrospective approach: further modifications			✓
25—Transition Fair value approach: OCI on related financial assets			✓

Next steps

17. The staff will bring papers on the remaining topics during the first quarter of 2019.

18. After the Board has considered all the individual topics, the Board plans to consider the package of amendments at a future meeting. At that meeting the Board will consider whether:
- (a) any amendments to the disclosure requirements are required as a result of the amendments tentatively decided by the Board;
 - (b) the benefits of the amendments outweigh the costs as a whole; and
 - (c) the package of amendments as a whole does not unduly disrupt implementation.
19. The staff expect to publish an Exposure Draft of the amendments to IFRS 17 around the end of the first half of 2019. The staff observe that the Board generally allows at least 12 to 18 months between the publication of new requirements and their mandatory effective date. The staff expect that this timetable would allow any proposed amendments to IFRS 17 to be finalised on a timely basis to allow for this period before 1 January 2022.

STAFF PAPER

January 2019

IASB[®] meeting

Project	Amendments to IFRS 17 <i>Insurance Contracts</i>		
Paper topic	Insurance acquisition cash flows for renewals outside the contract boundary		
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Purpose

1. This paper discusses the requirements in IFRS 17 *Insurance Contracts* for insurance acquisition cash flows for contract renewals outside the contract boundary.

Summary of staff recommendations

2. The staff recommend the International Accounting Standards Board (Board) amend IFRS 17 to require an entity to:
 - (a) allocate to any anticipated contract renewals part of the insurance acquisition cash flows directly attributable to newly issued contracts.
 - (b) recognise the insurance acquisition cash flows allocated to anticipated contract renewals as an asset applying paragraph 27 of IFRS 17 until the renewed contracts are recognised.
 - (c) assess the recoverability of the asset recognised according to paragraph 27 of IFRS 17 each period before the related contracts are recognised. The recoverability assessment would be based on the expected fulfilment cash flows of the related group of contracts.
 - (d) recognise a loss in profit or loss for any unrecoverable carrying amounts of the asset recognised by applying paragraph 27 of IFRS 17.

- (e) recognise in profit or loss the reversal of some or all of any such loss previously recognised when the impairment conditions no longer exist or have improved.

Structure of the paper

- 3. This paper provides:
 - (a) an introduction (paragraphs 4–6 of this paper);
 - (b) an overview of the requirements in IFRS 17 and a summary of the Board’s rationale for setting those requirements, including an overview of the Board’s previous discussions (paragraphs 7–24 of this paper);
 - (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued (paragraphs 25–31 of this paper);
 - (d) the staff analysis (paragraphs 32–42 of this paper); and
 - (e) staff recommendations and question for Board members (paragraphs 43–44 of this paper).

Introduction

- 4. Entities pay agent commissions as part of their insurance acquisition cash flows for new contracts that the entities expect policyholders to renew in the future. In some cases, the commissions are higher than the premium that an entity charges for the new contract it relates to, but the entity is nevertheless willing to pay the commission because it expects the contract to be renewed in the future, sometimes more than once.
- 5. In some cases, part of the commission is refundable from the agent if the future renewals do not occur as expected. In other circumstances, the commission is non-refundable. A discussion at the Transition Resource Group for IFRS 17 (TRG) on non-refundable commissions identified that some stakeholders are concerned about the effect of the application of the IFRS 17 requirement to attribute such non-

refundable commissions only to the new contract.¹ That concern is the subject of this paper.

6. Appendix A to this paper includes an extract from the summary of the TRG meeting held on 6 February 2018.

IFRS 17 requirements and Board's rationale

Definition of insurance acquisition cash flows

7. Appendix A of IFRS 17 defines insurance acquisition cash flows as:

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

8. Insurance acquisition cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts include cash flows that are not directly attributable to individual insurance contracts or groups of insurance contracts as long as the cash flows are directly attributable to the portfolio of insurance contracts to which the group of insurance contracts belongs. Accordingly, insurance acquisition cash flows directly attributable to the portfolio of insurance contracts comprise:
 - (a) insurance acquisition cash flows directly attributable to individual insurance contracts or groups of insurance contracts within the portfolio (if any); and
 - (b) insurance acquisition cash flows not necessarily directly attributable to individual insurance contracts or groups of insurance contracts within the portfolio but that are directly attributable to the portfolio (if any).
9. Insurance acquisition cash flows, as defined in IFRS 17, may include amounts paid, and amounts expected to be paid in the future, for the acquisition of contracts, including:

¹ See Agenda Paper 4 for the TRG meeting held on 6 February 2018.

- (a) external and internal costs (agent commissions and internal sales bonuses);
 - (b) incremental, direct and indirect costs (sales bonuses, salary of sales team and overhead costs of the sales department); and
 - (c) any acquisition costs related to issuing a portfolio of insurance contracts, including costs not directly related to the successful acquisitions of contracts.
10. Insurance acquisition cash flows include both acquisition cash flows paid at the inception of a contract and recurring commissions that are expected to be paid to intermediaries if a particular policyholder continues to pay the premium within the boundary of the insurance contract. Cash flow expectations reflect the extent to which amounts are refundable.
11. The approach for identifying insurance acquisition cash flows in IFRS 17 results from the Board's views, as explained in paragraphs BC182–BC183 of the Basis for Conclusions on IFRS 17, that:
- (a) entities should not recognise different contractual service margins and expenses depending on the way they structure their acquisition activities (internal costs vs. outsourcing or costs that vary based on whether the acquisition of the contracts is successful), if such differences do not reflect economic differences between insurance contracts issued by the entities. This would not be the case if an entity included only insurance acquisition cash flows that are incremental at a contract level.
 - (b) entities typically price insurance contracts to recover not only incremental costs, but also other direct costs and a proportion of indirect costs incurred in originating insurance contracts. Given that entities measure and manage these costs for a portfolio of contracts, rather than for the individual contract, including insurance acquisition cash flows that are incremental at the portfolio level in the fulfilment cash flows of the insurance contracts would be consistent with identification of other cash flows that are included in the measurement of the contracts.

12. The concepts in paragraphs 24 and 33 of IFRS 17 are relevant² in deciding which insurance acquisition cash flows should be included in the measurement of a group, therefore:
- (a) insurance acquisition cash flows that are directly attributable to individual contracts (or a group) should be included only in the measurement of the group to which the individual contracts belong (or of that group) and not to other groups within the same portfolio.
 - (b) insurance acquisition cash flows directly attributable to the portfolio, but not necessarily directly attributable to individual contracts (or a group), will need to be allocated in an appropriate manner to the groups within the portfolio. An entity shall use reasonable and supportable information to do so.

Measurement approach

13. Insurance acquisition cash flows are accounted for by including them in the cash flows expected to fulfil contracts in a group. This means that the contractual service margin of a group of insurance contracts is determined in a way that reflects the profit of the group of contracts after considering all the related cash flows, including the amount of insurance acquisition cash flows allocated to the group of contracts. The contractual service margin is recognised over the period as services are provided. There is no separate recognition of an insurance acquisition cash flows asset once the group of insurance contracts has been recognised.
14. To illustrate the measurement approach in IFRS 17, assume a group of insurance contracts is initially recognised with the following assumptions:
- (a) estimates of future premiums of CU900;
 - (b) estimates of future claims of CU600;
 - (c) insurance acquisition cash flows of CU90;
 - (d) risk adjustment for non-financial risk of CU15; and

² See Appendix A to this paper for a summary of the TRG meeting held on 6 February 2018 with respect to Agenda Paper 4.

(e) the effect of discounting is immaterial.

The contractual service margin determined on initial recognition is CU195 (CU900 – CU600 – CU90 – CU15) and it will be recognised over the coverage period as services are provided. Assuming that the premiums and the insurance acquisition cash flows are paid on the initial recognition of the group, the insurance contract liability would be CU810 (fulfilment cash flows of CU615 and a contractual service margin of CU195).

15. Paragraph BC176 of the Basis for Conclusions on IFRS 17 explains the Board’s view that an entity should not depict insurance acquisition cash flows as a separately recognised asset because such an asset either does not exist (if the entity recovers insurance acquisition cash flows from premiums already received) or relates to future cash flows that are included in the measurement of the group of contracts. Including insurance acquisition cash flows for a group of contracts in the fulfilment cash flows of that group also results in the measurement of the insurance contract being a faithful representation of the obligation to pay for insured losses because the liability does not include the part of the premium intended to compensate for the cost of originating the contracts.

Consequences when there is a lack of recoverability

16. When insurance acquisition cash flows are included in the measurement of the group of contracts, the measurement model in IFRS 17 captures any lack of recoverability of insurance acquisition cash flows for a group of insurance contracts:³
- (a) at initial recognition of a group of contracts—by including insurance acquisition cash flows in determining the contractual service margin. If the contractual service margin is less than zero, any cash outflows that are not recoverable are recognised immediately as an expense in profit or loss.
 - (b) over time—by remeasuring the fulfilment cash flows of the group. The measurement model captures any lack of recoverability automatically by

³ See paragraphs 22–24 of this paper regarding insurance acquisition cash flows related to groups of insurance contracts yet to be recognised.

remeasuring the fulfilment cash flows and adjusting the contractual service margin. Any adjustment to the contractual service margin for unfavourable changes in the fulfilment cash flows would reduce the contractual service margin below zero and therefore be recognised as an expense in profit or loss.

Thus, it is not necessary to assess the recoverability of insurance acquisition cash flows by testing them separately for impairment.

The effect of insurance acquisition cash flows on revenue and expenses

17. The Basis for Conclusions on IFRS 17 explains the Board's view that insurance revenue should not be recognised when insurance acquisition cash flows are paid, often at the beginning of the coverage period, because at that time the entity has not satisfied any of the obligations to the policyholder under the contract.

18. Instead, IFRS 17 requires that insurance revenue is recognised as an entity provides coverage and other services arising from a group of insurance contracts. The total consideration for a group of insurance contracts includes amounts related to the provision of service as well as amounts related to insurance acquisition cash flows. The amount that relates to the insurance acquisition cash flows is allocated to each reporting period in a systematic way on the basis of passage of time. The same amount is recognised as insurance service expenses. Considering the example included in paragraph 14 of this paper, an amount of CU90 is related to insurance acquisition cash flows and will be recognised as revenue and insurance service expenses as coverage is provided.

19. The recognition of revenue and insurance service expenses at the same amount has a nil effect on the profit recognised in the period. However, the effect of insurance acquisition cash flows on profit is captured in the measurement and allocation of the contractual service margin. Considering the example in paragraph 14 of this paper, the effect of the insurance acquisition cash flows of CU90 is captured in the measurement of the contractual service margin of CU195, which is then recognised in profit or loss as coverage is provided.

Interaction with contract boundary

20. All cash flows within the boundary of a group of contracts are included in the fulfilment cash flows used to measure the group of contracts. The contract boundary limits the fulfilment cash flows to include only cash flows that arise from existing substantive rights and obligations, including those rights and obligations that arise from future contract renewals within the boundary of the contract. Thus, as described in paragraph 19 of this paper, the effect of insurance acquisition cash flows on profit is captured in the measurement and allocation of the contractual service margin over the coverage period including that of all future contract renewals within the contract boundary of the group of contracts.
21. However, depending on specific facts and circumstances and the related assessment of substantive rights and obligations, some contract renewals may be within the contract boundary of a newly issued contract and other contract renewals may not.

Insurance acquisition cash flows related to groups of insurance contracts yet to be recognised

22. A group of contracts is recognised at the earliest of the beginning of the coverage period of the group, when the first payment from a policyholder becomes due or when the group becomes onerous. The costs of originating insurance contracts are often incurred before the coverage period begins, and therefore may occur before the related group of contracts is recognised.
23. Paragraph 27 of IFRS 17 (reflecting amendments the Board has tentatively decided to propose as part of the annual improvement process⁴) requires an entity to recognise an asset or liability for any insurance acquisition cash flows relating to a group of insurance contracts issued or expected to be issued that the entity pays or receives before the group is recognised.⁵ An entity is required to derecognise the asset or liability resulting from such insurance acquisition cash flows when the group of insurance contracts to which the cash flows are allocated is recognised.

⁴ See Agenda Paper 2A of the June 2018 Board meeting.

⁵ Unless the entity chooses to recognise them as expenses or income applying paragraph 59(a) of IFRS 17.

24. Paragraph BC145 of the Basis for Conclusions on IFRS 17 explains that the Board observed that although an asset or liability is recognised from the date that the insurance acquisition cash flows are incurred, entities do not need to update assumptions until the date the group of contracts qualifies for initial recognition and they are required to determine the contractual service margin at that later date. No impairment requirements were developed with respect to this asset considering the period of time it exists was intended to be short.

Concerns and implementation challenges expressed since IFRS 17 was issued

25. Some stakeholders are concerned about the effect of the application of the requirements of IFRS 17 in the following circumstances:
- (a) the entity pays agent commissions to sell renewable insurance contracts and those commissions meet the definition of insurance acquisition cash flows;
 - (b) the commissions paid to the agent are not refundable; and
 - (c) cash flows related to renewals arising from the newly issued insurance contracts are outside the boundaries of the newly issued contracts.
26. A submission to the TRG provided a specific fact pattern of the circumstances described in paragraph 25 of this paper, as follows:
- (a) a commission of CU200 is paid to an agent for each initially written insurance contract. The commission, once paid, is non-refundable.
 - (b) the contract states that it has an unlimited coverage period. However, it is assumed that the boundary of the initially written contract applying IFRS 17 is one year.
 - (c) the commission is greater than the premiums in the initially written contract's boundary.
 - (d) the entity expects a substantial number of renewals over a number of years. Applying IFRS 17, those renewals are outside the initially written contract's boundary (for example, because the entity can reprice the contracts when they are renewed).

- (e) if a group comprises only the contracts initially written in the annual period, an onerous loss will be recognised immediately in profit or loss. The cash outflows, including the commission of CU200, are greater than the cash inflows (the premium charged). Even if the commission were the only cash outflow, an onerous loss would be recognised because the commission is greater than the premium charged.
 - (f) for the renewed contracts the cash inflows, ie the premiums charged, are significantly greater than the cash outflows. It is likely that, if the commission were allocated partly to the contracts that are expected on renewal, the group to which the renewed contracts belong would not be loss making.
- 27. Applying the requirements of IFRS 17 to the circumstances described in paragraph 25 of this paper, these non-refundable commissions are directly attributable to the newly issued contracts and included in the measurement of the groups of the newly issued contracts. They are not attributable to future contract renewals, and therefore no asset is recognised.
- 28. Some stakeholders noted that the amount of the non-refundable commission could be higher than the entire premium of the newly issued contracts (as illustrated in paragraph 26 of this paper). Therefore, they noted that applying the requirements of IFRS 17 could mean that the groups of the newly issued contracts might be identified as onerous, even if the entity expects, based on its experience, to recover those cash flows when the contracts are renewed.
- 29. These stakeholders expressed concerns that this accounting treatment does not reflect what they regard as the economic substance of these transactions—that the entity has incurred 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. That expectation exists even if the entity has no substantive right to compel the policyholder to renew the contract or a substantive obligation to provide the policyholder with services.
- 30. Some stakeholders stated that the requirements in IFRS 17 would result in inconsistent outcomes compared with other contracts within the scope of IFRS 15

Revenue from Contracts with Customers, for which the allocation of the acquisition costs considers expected future renewals of contracts.

31. Therefore, some stakeholders propose that IFRS 17 should be amended:
- (a) so that cash flows related to future renewals that do not arise from substantive rights and obligations that exist during the reporting period are included in the measurement of the group of newly issued contracts—this approach would extend the cash flows that are within the contract boundary; or
 - (b) to align the treatment of insurance acquisition cash flows that relate to anticipated renewals with the requirements of IFRS 15. This could be achieved by:
 - (i) allocating part of the insurance acquisition cash flows directly attributable to the group of newly issued contracts to future groups of contracts including the renewals of the newly issued contracts;
 - (ii) recognising this part of the insurance acquisition cash flow as an asset (similar to insurance acquisition cash flows that are directly attributable to future contracts) and including that part in the measurement of the renewed contracts when they are recognised; and
 - (iii) developing requirements for the impairment of the insurance acquisition cash flows asset (consistent with IAS 36 *Impairment of Assets* or IFRS 15).

Staff analysis

32. The requirements of IFRS 17 result in the recognition of a loss in the circumstances described in paragraph 25 of this paper. This reflects that:
- (a) the agent commission paid by the entity does not have any guarantee of recoverability from the agent. In contrast to situations where the commission is

refundable in the event that renewals do not occur,⁶ the entity has an economic exposure.

- (b) although the entity expects it will recover the non-refundable commission from expected contract renewals, the cash flows related to these contract renewals do not arise from existing substantive rights and obligations of the entity (they are outside the contract boundary).
- (c) recognising a loss in these circumstances would be similar to recognising a loss in circumstances that the entity sells newly issued contracts at a significant discount in anticipation of future contract renewals. The accounting outcome is similar, reflecting similar economic circumstances, regardless of whether the cause for a loss is a significant discount provided to the policyholder or a significant commission paid to the agent. Both might result in onerous groups of contracts.

33. The staff however observe that:

- (a) the outcome of applying the requirements of IFRS 17 in the circumstances discussed in paragraph 25 of this paper may not be viewed as reflecting the economic substance of these transactions. 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.
- (b) the outcome of applying the requirements in IFRS 17 may differ from that which may be achieved in arguably similar circumstances applying IFRS 15.

34. IFRS 15 requires an entity to recognise an asset for the incremental costs of obtaining a contract with the customer, if the entity expects to recover those costs. IFRS 15 defines the incremental costs as those that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, as sales commission). Costs that are incurred regardless of whether the contract was obtained are recognised as an expense when incurred (ie they are not considered to be incremental costs).

⁶ In this case, the commission is directly attributable to newly issued contracts and to their anticipated renewals.

35. The asset recognised applying IFRS 15 relating to the incremental costs of obtaining a contract may relate to goods or services to be transferred under an anticipated contract that the entity can specifically identify, such as renewal of an existing contract. That asset is amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. An impairment loss is recognised in profit or loss to the extent that the carrying amount of an asset for the incremental costs exceeds the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates less the costs that relate directly to providing those goods or services.⁷
36. If, applying IFRS 15 to the circumstances in paragraph 25 of this paper, the entity recognised an asset for the non-refundable commission, the commission would not cause the contract to be onerous. The non-refundable commission would be amortised over a period including anticipated renewal periods of the contract, provided that it can be recoverable from the consideration less costs related to the contract, including its anticipated renewals.
37. Considering the two Standards more broadly, the staff note that the requirements of IFRS 15 for incremental costs of obtaining a contract that relate to an anticipated contract renewal are not directly comparable to the requirements in IFRS 17, for the following reasons:
- (a) the scope and definition of acquisition costs under the two Standards differ—IFRS 17 includes a wider range of costs compared to IFRS 15;
 - (b) the unit of account under the two Standards differs—IFRS 17 specifies the group of contracts as the unit of account, while IFRS 15 specifies the accounting for an individual contract with a customer;⁸
 - (c) the measurement approach required in IFRS 17 differs from IFRS 15. IFRS 15 treats acquisition costs as a representation of the cost of a

⁷ Paragraphs 102–104 of IFRS 15 provide additional requirements with respect to the impairment test.

⁸ Paragraph 4 of IFRS 15 states that an entity may apply the Standard to the portfolio of contracts with similar characteristics as a practical expedient if it reasonably expects the effects on the financial statements would not differ materially from applying the Standard to the individual contracts within that portfolio.

recognisable asset which is amortised over a period including anticipated renewal periods of the contract—IFRS 17 includes insurance acquisition cash flows in the measurement of the group of contracts (except before initial recognition of a group of contracts) and recognises these as an expense over the coverage period that includes renewals within the boundaries of the insurance contracts.

- (d) applying IFRS 15, contract costs are subject to impairment testing whereas, under IFRS 17, lack of recoverability is captured through the remeasurement of the fulfilment cash flows, which automatically results in the recognition of an expense when a group of insurance contracts is onerous.

38. While the two Standards cannot be directly compared, the outcome of the accounting for the non-refundable commission described in paragraph 25 of this paper applying IFRS 17 and IFRS 15 could be different. Given the concerns raised about the information provided (as set out in paragraph 29 of this paper), the staff think that the Board could consider amending the requirements of IFRS 17 in a way that would align the requirements of IFRS 17 more closely with those of IFRS 15.

39. In evaluating the possible amendments, the staff considered the criteria set by the Board at its October 2018 meeting. Accordingly, the staff considered, but rejected the following possible amendments because they would add complexity and create internal inconsistencies within IFRS 17, thus reducing the usefulness of information to users of financial statements:

- (a) aligning the treatment of *all* insurance acquisition cash flows as defined in IFRS 17 with *all* the requirements of IFRS 15 related to incremental costs to obtain a contract; and
- (b) changing the contract boundary requirements to allow for cash flows that relate to future contract renewals that are outside the contract boundary to be inside the contract boundary.

40. The staff think that it is possible to amend IFRS 17 to require an entity to:
- (a) allocate to any anticipated contract renewals part of the insurance acquisition cash flows that are directly attributable to newly issued contracts. This would result in the entity recognising that part of the insurance acquisition cash flows as an asset applying paragraph 27 of IFRS 17 until the renewed contracts are recognised.
 - (b) assess the recoverability of that asset, based on the fulfilment cash flows of the related contracts, each period before the related contracts are recognised. Consistent with the unit of account in IFRS 17, the staff recommend this assessment is performed *on a group of insurance contracts basis*—ie an entity will assess whether the fulfilment cash flows of the related group of contracts, comprising of anticipated contract renewals, is sufficient to recover the asset.
 - (c) recognise a loss in profit or loss for any unrecoverable carrying amounts of the asset recognised by applying paragraph 27 of IFRS 17.
 - (d) recognise in profit or loss the reversal of some or all of such loss previously recognised when the impairment conditions no longer exist or have improved.
41. The staff think that the Board should not develop specific requirements on how to allocate part of the insurance acquisition cash flows to anticipated contract renewals because:
- (a) it is unnecessary to add guidance to the concepts in paragraphs 24 and 33 of IFRS 17 which, as explained in paragraph 12 of this paper, provide guidance on cash flows allocation; and
 - (b) the benefits of developing additional specific requirements for insurance acquisition cash flows will not outweigh the costs related to the added complexity for preparers and users of financial statements.

42. The staff note that the amendment discussed in paragraph 40 of this paper would result in an entity recognising an asset for a wider range of costs compared to the costs that would have been recognised as an asset applying IFRS 15, which limit the asset to costs that are *incremental to a contract*. However, the staff do not recommend to seek consistency with IFRS 15 in this respect by limiting the insurance acquisition cash flows to costs incremental to a contract because:
- (a) the amendment discussed in paragraph 40 of this paper is consistent with the general approach to identifying insurance acquisition cash flows in IFRS 17 and the Board’s views about what costs should be included in insurance acquisition cash flows as explained in paragraph 11 of this paper;
 - (b) the staff think that modifying the definition of insurance acquisition cash flows will add complexity for both preparers and users of financial statements and may unduly disrupt implementation; and
 - (c) the impairment assessment recommended by staff is expected to address concerns related to the recoverability of such assets.

Staff recommendations and a question for Board members

43. In the light of the concerns expressed by stakeholders relating to the treatment of insurance acquisition cash flows, the staff think that amending IFRS 17 as discussed in paragraph 40 of this paper:
- (a) could provide useful information for users of financial statements, without unacceptably reducing understandability of financial statements.
 - (b) might not unduly disrupt implementation processes that are already under way given it is based on the existing requirements of IFRS 17. The definition of insurance acquisition cash flows, the contract boundary requirements and the unit of account of IFRS 17 will not be affected by the amendment discussed in paragraph 40 of this paper.

44. Therefore, the staff recommend that the Board propose an amendment to IFRS 17, as discussed in paragraph 40 of this paper.

Question for Board members

Do you agree the Board amend IFRS 17 to require an entity to:

- (a) allocate to any anticipated contract renewals part of the insurance acquisition cash flows directly attributable to newly issued contracts.
- (b) recognise the insurance acquisition cash flows allocated to anticipated contract renewals as an asset according to paragraph 27 of IFRS 17 until the renewed contracts are recognised.
- (c) assess the recoverability of the asset recognised according to paragraph 27 of IFRS 17 each period before the related contracts are recognised. The recoverability assessment would be based on the expected fulfilment cash flows of the related group of contracts.
- (d) recognise a loss in profit or loss for any unrecoverable carrying amounts of the asset recognised by applying paragraph 27 of IFRS 17.
- (e) recognise in profit or loss the reversal of some or all of any such loss previously recognised when the impairment conditions no longer exist or have improved.

Appendix A—Extract: summary of the TRG meeting held on 6 February 2018 with respect to Agenda Paper 4

Insurance acquisition cash flows paid on an initially written contract (Agenda Paper 4)

- A1. Agenda Paper 4 addresses a submission received about how to account for insurance acquisition cash flows unconditionally paid when a contract is initially written (ie it is not refundable), the entity expects renewals outside of the contract boundary to occur and has written new business with that expectation. The submission provides a specific fact pattern for the question raised and this is considered in the accounting analysis.
- A2. TRG members discussed the analysis in Agenda Paper 4 and observed that:
- (a) insurance acquisition cash flows included in the measurement of a group are those that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.
 - (b) insurance acquisition cash flows directly attributable to the portfolio, but not necessarily directly attributable to individual contracts (or a group), will need to be allocated in an appropriate manner to the groups within the portfolio. An entity shall use reasonable and supportable information to do so.
 - (c) acquisition cash flows that are directly attributable to individual contracts (or a group) should be included only in the measurement of the group to which the individual contracts belong (or of that group) and not to other groups within the same portfolio.
 - (d) the requirements of IFRS 17, for example paragraph 27, require acquisition costs paid or received that are directly attributable to future contracts to be recognised as an asset or liability before the group to which those future contracts belong is recognised. Those acquisition costs include those that were paid or received before those contracts are issued. The TRG members also noted that the reference to ‘a group of issued insurance contracts’ in

paragraph 27 of IFRS 17 is not intended to exclude insurance acquisition cash flows relating to contracts that have not yet been issued. It is intended to distinguish a group of insurance contracts issued from a group of reinsurance contracts held.

- (e) in the specific fact pattern, the specified commission is paid unconditionally on the initially written contract (ie it is not refundable). Therefore, applying IFRS 17 requirements, it cannot be allocated to future groups and accordingly the specified commission is included in the measurement of the group to which the initially issued contract belongs.
- (f) in the specified fact pattern provided in Agenda Paper 4, the initial contracts cannot be in the same group as contracts that are renewed during the same annual period applying the level of aggregation requirements. In this fact pattern the initial contracts are onerous contracts at initial recognition because, considering (e) above and allocating the acquisition cash flows to the initial group, the acquisition cash outflows are greater than the cash inflows included in the contract boundary. The renewed contracts belong to a different group because those contracts are not onerous at initial recognition.

A3. Some TRG members observed that in existing practice an entity would not consider the specified insurance acquisition cash flows in the determination of whether the initially written insurance contracts are onerous. Consequently, the requirements in IFRS 17 represent a change to existing practice which entities need to be aware for their implementation strategy.

STAFF PAPER

January 2019

IASB® meeting

Project	Amendments to IFRS 17 <i>Insurance Contracts</i>		
Paper topic	Reinsurance contracts held—onerous underlying insurance contracts		
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB® *Update*.

Purpose

1. This paper discusses the accounting for reinsurance contracts held when the underlying insurance contracts are onerous.
2. Agenda Paper 2C is an appendix to this paper. That paper includes examples of accounting for reinsurance contracts held when the underlying insurance contracts are onerous.

Summary of staff recommendations

3. The staff recommend the International Accounting Standards Board (Board) amend IFRS 17 *Insurance Contracts* to:
 - (a) expand the scope of the exception in paragraph 66(c)(ii) of IFRS 17 to require an entity to recognise a gain in profit or loss when the entity recognises losses on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis; and
 - (b) require an entity to apply the expanded exception when the entity measures contracts applying the premium allocation approach (PAA).

Structure of the paper

4. This paper provides:
 - (a) an overview of the requirements in IFRS 17 (paragraphs 5–10 of this paper);
 - (b) a summary of the Board’s rationale for setting those requirements, including an overview of the Board’s previous discussions (paragraphs 11–15 of this paper);
 - (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued (paragraphs 16–25 of this paper); and
 - (d) the staff analysis, recommendations and a question for Board members (paragraph 26–68 of this paper).

IFRS 17 requirements

5. Insurance contracts issued and reinsurance contracts held are measured applying a consistent measurement approach based on fulfilment cash flows. To reflect that reinsurance contracts held are not issued by the entity, paragraphs 60–70 of IFRS 17 modify the general requirements. Paragraphs 6–10 of this paper summarise the requirements relating to the contractual service margin.
6. For *insurance contracts issued*, the contractual service margin represents unearned profit. IFRS 17 prohibits the contractual service margin from becoming negative and therefore expected losses on a group of insurance contracts issued are recognised immediately in profit or loss.
7. At the end of each reporting period, the carrying amount of the contractual service margin for a group of insurance contracts issued is adjusted to reflect changes in estimates relating to future service. The contractual service margin cannot be negative.
8. For *reinsurance contracts held*, the entity is receiving services rather than providing them. Therefore, the contractual service margin is different. It represents the net cost of purchasing reinsurance. The contractual service margin can be in a net cost or a net

gain position. In either case, it is recognised over the coverage period as services are received.¹

9. The amount an entity pays for a reinsurance contract typically exceeds the expected present value of cash flows generated from that reinsurance contract plus the risk adjustment for non-financial risk. As such, the contractual service margin for a group of reinsurance contracts held at initial recognition is typically in a net cost position. However, in some cases the contractual service margin for a group of reinsurance contracts held may represent a net gain on purchasing reinsurance. In these cases, IFRS 17 treats the apparent gain on initial recognition as a reduction in the net cost of purchasing reinsurance. This means that gain is recognised over the coverage period of the reinsurance contract.
10. At the end of each reporting period, the carrying amount of the contractual service margin for a group of reinsurance contracts held is adjusted to reflect changes in estimates relating to future service, similarly to a group of insurance contracts issued. However, the contractual service margin can be in a net cost or a net gain position. There is one exception that relates to adjusting the contractual service margin for reinsurance contracts held. The exception relates to situations when an underlying group of insurance contracts becomes onerous after initial recognition because of adverse changes in estimates of fulfilment cash flows. In those circumstances, to the extent that there are corresponding changes in estimates of fulfilment cash flows for the reinsurance contract held, those changes do not adjust the contractual service margin of the reinsurance contract held, but are instead recognised in profit or loss. The result is that the entity recognises no net effect of the loss and gain in the profit or loss for the period to the extent that the change in the fulfilment cash flows of the underlying group of insurance contracts is matched with a change in the fulfilment cash flows of the group of reinsurance contracts held. Example A in Agenda Paper 2C illustrates the application of this exception.

¹ As an exception, if the reinsurance contract held covers events that have already occurred, the net cost at initial recognition is recognised immediately in profit or loss.

Board's rationale

11. In the 2010 Exposure Draft *Insurance Contracts*, the Board proposed symmetric treatment between the contractual service margin of reinsurance contracts held and insurance contracts issued. Because the contractual service margin for insurance contracts issued could not be negative, the Board proposed that the contractual service margin for reinsurance contracts held could never be in a net gain position.
12. However, some respondents to the 2010 Exposure Draft disagreed with the consequence that entities would recognise day one gains on reinsurance contracts held. This would not reflect that the insurer has not yet received reinsurance services from the reinsurer. In response to those concerns, the Board decided that the net gain or net cost of purchasing reinsurance should be recognised over the coverage period. This approach was first exposed for comment in the 2013 Exposure Draft *Insurance Contracts*.
13. Some respondents to the 2013 Exposure Draft said that an asymmetrical treatment between the contractual service margin of a reinsurance contract held and the reinsured portion of underlying insurance contracts would not appropriately depict the relationship between those contracts.
14. In response to those concerns, as an exception, the Board modified the requirements for subsequent measurement of the contractual service margin relating to *changes* in cash flows for reinsurance contracts held, as set out in paragraph 10 of this paper. The Board was persuaded by the view that changes in estimates of cash outflows on underlying insurance contracts that have corresponding changes in cash inflows from a reinsurance contract held should have no net effect in profit or loss for the period.
15. When the Board added this exception, it did not reconsider the measurement of the contractual service margin for a reinsurance contract held when an underlying group of contracts is onerous on initial recognition. The Board thought it would be rare for both:
 - (a) a group of underlying insurance contracts to be onerous on initial recognition; and
 - (b) the reinsurance contract held to result in a net gain.

Concerns and implementation challenges expressed since IFRS 17 was issued

16. Some stakeholders are concerned that although IFRS 17 includes an exception for reinsurance contracts held that is intended to avoid accounting mismatches, the requirements still give rise to accounting mismatches. Those stakeholders think that the scope of the exception is too narrow because:
- (a) it applies when an underlying group of insurance contracts become onerous after initial recognition because of adverse changes in estimates of future cash flows; but
 - (b) does not apply:
 - (i) when an underlying onerous group of insurance contracts is initially recognised; and
 - (ii) when further insurance contracts are issued and join the onerous group, if that does not result in a *change* in the fulfilment cash flows of the reinsurance contract held (ie when underlying insurance contracts are reflected in the measurement of the reinsurance contract held before they are issued and are later issued as expected).
17. Those stakeholders have identified the following requirements in IFRS 17 as the source of an accounting mismatch when a group of insurance contracts is issued and reinsured. An entity issuing a group of contracts that are onerous at initial recognition is required to recognise:
- (a) a loss for the underlying insurance contracts immediately in profit or loss when expected; and
 - (b) the gain in a reinsurance contract held over the period that reinsurance services are being received, even if the cash flows of the reinsurance contract held match those of the underlying insurance contracts.

Agenda Paper 2C includes examples that illustrate the application of the requirements in IFRS 17.

18. During the implementation of IFRS 17 some stakeholders have identified that the accounting mismatch may be significant in many circumstances. Those stakeholders note that the Board had expected accounting mismatches arising from the

asymmetrical treatment between the contractual service margin of a reinsurance contract held and the reinsured portion of underlying insurance contracts to be rare, because a reinsurance contract held is not expected to often be in a *net gain* position. However, those stakeholders think that the requirements also give rise to an accounting mismatch when a reinsurance contract held is in a *net cost* position and covers both onerous groups of underlying insurance contracts and profitable groups of underlying insurance contracts.

19. For example, an insurer might purchase a reinsurance contract that provides proportionate cover on all motor insurance contracts it sells over a one-year period. Most of the motor insurance contracts are likely to be profitable, but some might be onerous—for example, contracts sold to younger drivers at a premium that does not fully reflect the insurance risk in those contracts. IFRS 17 requires the insurer to group the onerous contracts separately to the other contracts and to recognise the loss on the onerous contracts immediately. However, in this example the reinsurance contract held covers all of those insurance contracts and is accounted for as a single contract. The contractual service margin for that contract is recognised over the coverage period of the reinsurance contract held. Example C in Agenda Paper 2C illustrates the application of IFRS 17 in this scenario.

20. Stakeholders note that even if the reinsurance contract held is a net cost to the entity overall, the reinsurer has accepted the risks of each underlying contract on a proportionate basis—including the onerous contracts. This means that for each cash outflow the insurer expects to pay to the underlying policyholder, it also expects a cash inflow from the reinsurer equal to a percentage of that cash outflow. For that reason, many stakeholders view reinsurance as a type of risk mitigation and think that the accounting should be similar to hedge accounting applying IFRS 9 *Financial Instruments*. Some stakeholders view proportionate reinsurance contracts as providing the insurer with an economically fully effective hedge for the reinsured portion of the insurance contracts. Contrary to this view, other stakeholders note that the measurement of the insurance contracts or the reinsurance contract held might include cash flows that are not proportionate. Examples of such cash flows include insurance acquisition cash flows or reinsurance commissions.

21. Some stakeholders observe that an accounting mismatch similar to the one described in paragraph 19 of this paper could arise when the entity applies the PAA (ie the optional simplified measurement approach).
22. Some stakeholders have suggested amendments to IFRS 17 that they think would address their concerns.² The two suggested amendments are to:
- (a) amend the requirements for underlying onerous groups of insurance contracts. This amendment would defer expected losses on the statement of financial position, to the extent that those losses are covered by a reinsurance contract held that provides proportionate coverage (referred to as ‘the deferred loss solution’); or
 - (b) amend the requirements for groups of reinsurance contracts held that provide proportionate coverage. This amendment would recognise a gain in profit or loss in the same period that losses are recognised on the underlying insurance contracts, to the extent that a reinsurance contract held covers those losses on a proportionate basis (referred to as ‘the immediate loss mitigation solution’).
23. Some stakeholders that have suggested the deferred loss solution for underlying onerous groups of insurance contracts think that the insurer is acting like an agent for the reinsured portion of the underlying insurance contracts. Proponents of this view think:
- (a) the insurer is released from risk immediately at the time that it issues an insurance contract that is covered by a reinsurance contract that provides proportionate coverage; and
 - (b) the insurer delivers services for the reinsured portion of the underlying insurance contracts at the point in time that the insurance contract is issued.
24. Those stakeholders think that it would be consistent with IFRS 15 *Revenue from Contracts with Customers* to recognise the associated fee immediately. Thus, they have suggested that in addition to amending the requirements for onerous underlying

² These suggested amendments reflect input that was coordinated under the initiative of a group of national standard-setters.

contracts, a related amendment should also be made for profitable underlying contracts. In summary, those stakeholders have suggested:

- (a) for onerous groups of insurance contracts—the reinsured portion of the loss is deferred on the statement of financial position; and
- (b) for profitable groups of insurance contracts—the reinsured portion of the unearned profit is recognised immediately in profit or loss.

25. Some stakeholders have suggested that IFRS 17 is amended for circumstances when the reinsurance contract held is entered into *before or at the same time* as the onerous underlying insurance contracts are issued, and not in circumstances when the reinsurance contract held is entered into *after* the onerous underlying insurance contracts are issued. Those stakeholders noted that if an amendment was to apply also to reinsurance contracts entered into after the underlying contracts are issued, an entity might enter into a reinsurance contract at a later date to achieve a particular accounting outcome.

Staff analysis and recommendation

26. The staff analysis includes the following sections:
- (a) applying IFRS 17:
 - (i) scenario 1—when a reinsurance contract held is in a net gain position and provides coverage for an underlying onerous group of insurance contracts; and
 - (ii) scenario 2—when a reinsurance contract held is in a net cost position and provides coverage for an underlying onerous group of insurance contracts and an underlying profitable group of insurance contracts.
 - (b) possible amendments to IFRS 17:
 - (i) possible amendment A—deferred loss solution; and
 - (ii) possible amendment B—immediate loss mitigation solution.
 - (c) premium allocation approach.
 - (d) staff recommendation.

Applying IFRS 17

27. The requirements for reinsurance contracts held, including the treatment of the contractual service margin, are consistent with the Board’s general conclusions that:
- (a) a reinsurance contract held is a separate contract to the underlying insurance contracts issued; and
 - (b) the net cost of purchasing reinsurance is recognised as the reinsurance service is received.
28. However, these requirements result in asymmetrical treatment between the contractual service margin of a reinsurance contract held and the reinsured portion of onerous underlying insurance contracts. The asymmetrical treatment creates a mismatch that occurs purely because of an accounting measurement inconsistency (ie an accounting mismatch).
29. When the Board considered whether an exception was justified in response to comments to the 2013 Exposure Draft, it considered the trade-off between:
- (a) being consistent with the Board’s general conclusions in paragraph 27 of this paper; and
 - (b) avoiding accounting mismatches.
30. There are two circumstances described in this paper for which stakeholder concerns arise. In this analysis the staff consider both circumstances to identify whether an amendment to IFRS 17 could be justified. Those two circumstances are:
- (a) when a reinsurance contract held is in a net gain position and provides coverage for an underlying onerous group of insurance contracts (scenario 1); and
 - (b) when a reinsurance contract held is in a net cost position and provides coverage for an underlying onerous group of insurance contracts and an underlying profitable group of insurance contracts (scenario 2).

Scenario 1—when a reinsurance contract held is in a net gain position and provides coverage for an underlying onerous group of insurance contracts

31. Example B in Agenda Paper 2C illustrates scenario 1. In that example, the entity issues onerous insurance contracts with a coverage period of two years and measures the loss component at initial recognition as 200. At the same time, the entity enters into a reinsurance contract that provides 50% proportionate coverage for those onerous contracts. Applying IFRS 17, the insurance service result is calculated as:

(Dr)/Cr	Year 1	Year 2
Insurance contracts issued	(200)	0
Reinsurance contracts held	50	50
Insurance service result	(150)	50

32. The Board discussed scenario 1 when it decided to add an exception relating to adverse changes in estimates of future cash flows after initial recognition. At that time, the Board decided not to add an exception for the treatment of a net gain on reinsurance contracts held with respect to the initial recognition of underlying onerous insurance contracts, as explained in paragraph 15 of this paper.
33. The staff think that the Board added the exception relating to adverse *changes* in estimates of future cash flows because the accounting mismatch that would have arisen is one that would occur frequently and could be significant in size. Thus, on balance:
- (a) that accounting mismatch would likely reduce the faithful representation of information reported; and
 - (b) the benefit of avoiding the accounting mismatch outweighs the cost of creating an exception that is contrary to the general principles for accounting for reinsurance contracts held.
34. The staff think that the Board did not add a similar exception for the treatment of a net gain on reinsurance contracts held with respect to the *initial recognition* of underlying onerous insurance contracts because the circumstance in which a reinsurance contract

held is in a net gain position and covers underlying insurance contracts that are onerous on initial recognition was expected to be rare. As such, any resulting accounting mismatch on initial recognition was expected to occur infrequently.

35. The staff observe although some stakeholders continue to be concerned about scenario 1, the main concerns expressed since IFRS 17 was issued relate to accounting mismatches that stakeholders have identified could arise more often and be significant in size in scenario 2.

Scenario 2—when a reinsurance contract held is in a net cost position and provides coverage for an underlying onerous group of insurance contracts and an underlying profitable group of insurance contracts

36. Example C in Agenda Paper 2C illustrates scenario 2. In that example, the entity issues insurance contracts with a coverage period of two years. Some of the contracts are expected to be profitable and some are expected to be onerous. The entity recognises two groups of contracts: an onerous group with a loss component of 100; and a profitable group with a contractual service margin of 200. At the same time, the entity enters into a reinsurance contract that provides 50% proportionate coverage for both groups of contracts. Applying IFRS 17, the insurance service result is calculated as:

(Dr)/Cr	Year 1	Year 2
Profitable group of insurance contracts issued	100	100
Onerous group of insurance contracts issued	(100)	0
Insurance contracts issued	0	100
Reinsurance contracts held	(25)	(25)
Insurance service result	(25)	75

37. The Board did not discuss scenario 2 when it decided to add the exception relating to adverse changes in estimates of future cash flows after initial recognition. The likely significance of the accounting mismatch in scenario 2 has been identified by stakeholders in their implementation of IFRS 17. The staff think that the same trade-

off that the Board considered when it added the existing exception is relevant when considering the accounting mismatch in scenario 2.

38. The staff think that, consistent with the Board’s decision to add an exception relating to adverse changes in estimates of future cash flows, considering both scenario 1 and scenario 2, an amendment to IFRS 17 could be justified in respect of the initial recognition of underlying onerous contracts. The accounting mismatch that arises is likely to occur more frequently and could be significant in size.

Possible amendments to IFRS 17

39. The staff observe that the requirements in IFRS 17 for reinsurance contracts held are based on the following principles:
- (a) reinsurance contracts held are separate contracts to the underlying insurance contracts issued;
 - (b) reinsurance contracts held and insurance contracts issued are accounted for applying a consistent measurement approach;
 - (c) the contractual service margin for a reinsurance contract held represents the net cost of purchasing reinsurance (ie it does not represent a profit or a loss); and
 - (d) the net cost of purchasing reinsurance is recognised over the period that the entity receives services from the reinsurer.

There are two exceptions to these principles in IFRS 17. One of those is the exception discussed in this paper.³

40. The staff observe that to meet the criteria set by the Board, any amendment to IFRS 17 would not change the fundamental principles for accounting for reinsurance contracts held.
41. This paper considers amendments that would resolve the accounting mismatch that is created on initial recognition of onerous underlying insurance contracts if a

³ The other exception is that if the reinsurance contract held covers events that have already occurred, the net cost at initial recognition is recognised immediately in profit or loss.

reinsurance contract held is *entered into before or at the same time* as the onerous underlying insurance contracts are issued.

42. Consequently:
- (a) for the losses on the underlying insurance contracts and corresponding gains in the reinsurance contract held to be recognised at the same time, the amendment would need to be applied *at the time the underlying insurance contracts are issued and not before*; and
 - (b) any amendment would apply at the initial recognition of a new onerous group of insurance contracts, when further onerous contracts are issued and join an existing onerous group and would continue to apply when there are adverse changes in fulfilment cash flows as explained in paragraph 10 of this paper.
43. The staff agree with stakeholder concerns that if an amendment was to apply also to reinsurance contracts entered into *after* the underlying contracts are issued, an entity might enter into a reinsurance contract after the underlying contracts are issued to achieve a particular accounting outcome. Therefore, this paper does not consider any amendments that would apply in those circumstances.

Possible amendment A—deferred loss solution

44. One way to amend IFRS 17 would be to change the accounting for underlying insurance contracts to the extent that those contracts are covered by a reinsurance contract.
45. The requirements could be amended to require that an expected loss on an onerous group of insurance contracts is recognised as services are provided instead of when the expected loss is identified, to the extent that the expected loss is covered by a reinsurance contract that has been entered into before or at the same time as the underlying insurance contracts are issued.

Assessing whether possible amendment A would meet the criteria set by the Board

46. The staff think that to defer loss recognition on underlying groups of onerous insurance contracts would resolve the accounting mismatch. However, this

amendment would be a fundamental change to the IFRS 17 accounting model for insurance contracts issued and the staff think this amendment would:

- (a) result in a significant loss of information about the profitability of insurance contracts issued; and
- (b) introduce complexity for users of financial statements because the accounting for onerous groups of insurance contracts will be different depending on whether and when the entity purchases reinsurance.

47. For those reasons, the staff do not recommend the Board amend the requirements for underlying onerous groups of insurance contracts as described in paragraphs 44–45 of this paper.
48. The staff observe that some stakeholders that have suggested a deferred loss solution have also suggested a related amendment for underlying *profitable* groups of insurance contracts, as explained in paragraph 23 of this paper. This suggested amendment is to recognise profit immediately in profit or loss on those contracts, to the extent that a reinsurance contract held covers each contract on a proportionate basis.
49. The staff observe that the views expressed by proponents of this related amendment fundamentally differ from the principles that the IFRS 17 requirements for reinsurance contracts held are based on because:
- (a) proponents of this view think that the insurer is relieved of insurance risk for the reinsured portion of the underlying insurance contracts and is acting similarly to an agent making a fee; whereas
 - (b) IFRS 17 regards a reinsurance contract held as providing services to the holder of the contract over time. While a reinsurance contract mitigates the insurers risk exposure, it does not typically relieve the insurer of its primary obligations under the insurance contracts it has issued to policyholders. For example, if the reinsurer defaulted on the reinsurance contract, the insurer would still be obligated to pay the full amount of claims to the policyholder of the insurance contract.

50. The staff observe that paragraph 75 of IFRS 17 deals with circumstances in which an insurer is no longer at risk and can no longer be required to transfer any economic resources to satisfy an insurance contract in any single scenario. Paragraph 75 of IFRS 17 explains that when an entity buys reinsurance, it shall derecognise the underlying insurance contracts when, and only when, the underlying insurance contracts are extinguished (ie when the obligation specified in the insurance contract expires or is discharged or cancelled).
51. The staff also observe that in circumstances that an entity is acting solely as an agent it is not issuing insurance contracts for the purposes of applying IFRS 17.
52. For those reasons, this paper does not consider further the amendment suggested by stakeholders to recognise an immediate profit for the reinsured portion of underlying profitable groups of insurance contracts.

Possible amendment B—immediate loss mitigation solution

53. An alternative way to amend IFRS 17 would be to change the accounting for reinsurance contracts held. The scope of the existing exception in paragraph 66(c)(ii) of IFRS 17 could be expanded to require an entity to recognise a gain in profit or loss when the entity recognises losses on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis.⁴
54. This possible amendment would adjust the contractual service margin for reinsurance contracts held when losses are recognised on onerous underlying insurance contracts, to the extent that the reinsurance contract covers the losses of each contract on a proportionate basis.

⁴ Applying this amendment, an entity would also be required to recognise a *loss* in profit or loss when it recognises *reversal of losses* on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis.

55. The following table illustrates the effect of this possible amendment on the accounting for reinsurance contracts held entered into before or at the same time as the underlying onerous contracts are issued:

Does the exception apply when:	IFRS 17	IFRS 17 with amendment
an underlying onerous group of insurance contracts is initially recognised?	no	yes
further onerous insurance contracts are issued and join the onerous group?	in some circumstances	yes
an underlying group of insurance contracts become onerous after initial recognition because of adverse changes in estimates of future cash flows?	yes	yes

56. The staff observe that the measurement of insurance contracts includes cash outflows other than insurance claims. For example, allocations of general overheads and insurance acquisition cash flows. Those other cash flows might not be recovered from the reinsurer in the same proportion as claims, if recovered at all. Equally, the measurement of reinsurance contracts held might include cash inflows other than reimbursement of claims, such as reinsurance commissions. Those other cash flows might not be proportionate to cash flows included in the measurement of the underlying insurance contracts. Therefore, even when a reinsurance contract provides proportionate coverage for insurance claims, not all cash flows included in the measurement of that contract are necessarily proportionate to the underlying insurance contracts.
57. For example, assume an entity issues an onerous contract with an expected loss of 100. The measurement of the onerous contract includes expected claims and insurance acquisition cash flows. At the same time, the entity purchases a reinsurance contract that covers all insurance contracts the entity issues, providing 50% proportionate

coverage for claims. The measurement of the reinsurance contract held includes expected claims reimbursements and reinsurance commissions.

58. Applying this possible amendment, the entity would recognise an immediate loss of 100 on the onerous insurance contract, and a corresponding gain of 50 on the reinsurance contract held at the same time. The entity would not be required to identify whether the reinsurance commissions relate to the insurance acquisition cash flows, and, if so, to what extent (for example, whether or not they are 50% proportionate).
59. In other words, this possible amendment makes an assumption that the loss recognised on the onerous insurance contract is caused by the insurance claims that are covered by the reinsurance contract held on a proportionate basis. The staff observe that this assumption is arbitrary. However, the staff think that if an alternative approach was taken, that alternative approach would likely require an entity to identify whether and to what extent all cash flows are proportionate. This could be both complex and arbitrary. Therefore, the benefits of that alternative approach would likely not outweigh the costs.
60. To recognise a gain on reinsurance contracts held as described in the example in paragraph 58 of this paper, an entity would credit profit or loss and debit the contractual service margin of the reinsurance contract asset. If the contractual service margin is in a net cost position, this debit would increase the net cost. If the contractual service margin is in a net gain position, this debit would reduce the net gain. This adjusted contractual service margin would, in effect, relate to the profitable underlying insurance contracts. The adjustment reflects that the entity is essentially giving up some of its profit on profitable contracts to the reinsurer (ie the cost of purchasing reinsurance) in exchange for the reinsurer taking on some of the loss on onerous contracts (ie the gain on purchasing reinsurance).
61. The staff think the accounting mismatch identified by stakeholders could be resolved by requiring an entity to recognise a gain on a reinsurance contract held when losses are recognised on the onerous underlying contracts, to the extent that the reinsurance contract held covers the losses of each contract on a proportionate basis. Example B and Example C in Agenda Paper 2C illustrate the application of IFRS 17 with and

without this possible amendment for Scenario 1 and Scenario 2 discussed in this paper. The following tables show the calculations of the insurance service result for each scenario.

Scenario 1—when a reinsurance contract held is in a net gain position and provides coverage for an underlying onerous group of insurance contracts

(Dr)/Cr	IFRS 17		IFRS 17 with amendment	
	Year 1	Year 2	Year 1	Year 2
Insurance contracts issued	(200)	0	(200)	0
Reinsurance contracts held	50	50	100	0
Insurance service result	(150)	50	(100)	0

Scenario 2—when a reinsurance contract held is in a net cost position and provides coverage for an underlying onerous group of insurance contracts and an underlying profitable group of insurance contracts

(Dr)/Cr	IFRS 17		IFRS 17 with amendment	
	Year 1	Year 2	Year 1	Year 2
Profitable group	100	100	100	100
Onerous group	(100)	0	(100)	0
Insurance contracts issued	0	100	0	100
Reinsurance contracts held	(25)	(25)	0	(50)
Insurance service result	(25)	75	0	50

Assessing whether possible amendment B would meet the criteria set by the Board

62. On balance, the staff think this possible amendment would:
- (a) avoid significant loss of useful information relative to that which would be provided by IFRS 17 for users of financial statements. The accounting for the underlying insurance contracts issued would be unaffected. The accounting for the reinsurance contracts held would change but IFRS 17 already provides an exception to the general requirements for reinsurance contracts held to avoid some accounting mismatches. This possible amendment would expand the scope of the existing exception.
 - (b) not be contrary to the general principle in IFRS Standards that gains should not be recognised before service is provided. This was a concern expressed by some stakeholders in response to the 2010 Exposure Draft. The staff think that this possible amendment would not result in an overall gain being recognised in profit or loss because a gain on the reinsurance contract held would only be recognised to the extent that the reinsurance contract held covers a loss that is also recognised in profit or loss at the same time.
63. The staff observe that exceptions, by nature, add complexity. However, in this circumstance, expanding the existing exception could reduce complexity in applying the requirements in IFRS 17 because it would introduce consistency between the accounting treatment relating to the initial recognition of underlying onerous contracts and adverse changes in underlying onerous contracts subsequently. It could also reduce complexity for users of understanding the accounting, by eliminating accounting mismatches.
64. The staff think that this possible amendment might disrupt implementation for entities that have already begun to develop their systems. However, the staff think that the disruption could be justified given stakeholder feedback about the likely significant impact of the accounting mismatch which some stakeholders suggest reduces the usefulness of the information provided by IFRS 17.

65. The staff observe that recognising a gain for the reinsurance contract held that reflects the loss mitigation, when the reinsurance contract held is actually in a net cost position overall, is inconsistent with the principle that a reinsurance contract held is a separate contract to the underlying insurance contracts issued.
66. On balance, the staff think that the benefits of expanding the existing exception in IFRS 17 to resolve the accounting mismatch that is currently outside of the scope of that exception outweigh the costs of that possible amendment. The staff observe that this approach links the accounting for the reinsurance contract held to the accounting for the underlying insurance contracts, and that the existing exception already introduces this link. The staff think that the possible amendment would meet the criteria set by the Board.

Premium allocation approach

67. The staff observe that, as noted by stakeholders in paragraph 21 of this paper, a similar accounting mismatch could arise when the underlying insurance contracts are measured applying the PAA, or the reinsurance contract held is measured applying the PAA, or both. Therefore, the staff think that the expanded exception should apply both for contracts measured applying the general model and the PAA. Example D in Agenda Paper 2C illustrates applying IFRS 17 with and without the possible amendment when an entity applies the PAA.

Staff recommendation

68. The staff recommend the Board amend IFRS 17 to:
- (a) expand the scope of the exception in paragraph 66(c)(ii) of IFRS 17 to require an entity to recognise a gain in profit or loss when the entity recognises losses on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis; and
 - (b) require an entity to apply the expanded exception when the entity measures contracts applying the PAA.

Questions for Board members

Do you agree the Board amend IFRS 17 to:

- (a) expand the scope of the exception in paragraph 66(c)(ii) of IFRS 17 to require an entity to recognise a gain in profit or loss when the entity recognises losses on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis; and
- (b) require an entity to apply the expanded exception when the entity measures contracts applying the PAA?

STAFF PAPER

January 2019

IASB[®] meeting

Project	Amendments to IFRS 17 <i>Insurance Contracts</i>		
Paper topic	Appendix to reinsurance contracts held—onerous underlying insurance contracts		
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS[®] Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB[®] *Update*.

Purpose

1. This paper is an appendix to Agenda Paper 2B which discusses the accounting for reinsurance contracts held when the underlying insurance contracts are onerous.
2. This paper includes examples of accounting for reinsurance contracts held when the underlying insurance contracts are onerous.

Examples

3. This paper includes the following examples:
 - (a) **Example A**—existing exception for adverse changes in fulfilment cash flows (paragraphs 5–10 of this paper)
 - (b) **Example B**—Scenario 1—when a reinsurance contract held is in a net gain position and provides coverage for an underlying onerous group of insurance contracts (paragraphs 11–20 of this paper):
 - (i) applying IFRS 17 (paragraphs 15–17 of this paper);
and
 - (ii) applying IFRS 17 with amendment recommended by staff (paragraphs 18–20 of this paper).
 - (c) **Example C**—Scenario 2—when a reinsurance contract held is in a net cost position and provides coverage for an underlying onerous group of insurance

contracts and an underlying profitable group of insurance contracts (paragraphs 21–30 of this paper):

- (i) Applying IFRS 17 (paragraphs 25–27 of this paper); and
 - (ii) applying IFRS 17 with amendment recommended by staff (paragraphs 28–30 of this paper).
- (d) **Example D**—when a reinsurance contract held and an underlying onerous group of insurance contracts are measured applying the PAA (paragraphs 31–43 of this paper):
- (i) applying IFRS 17 (paragraphs 36–39 of this paper); and
 - (ii) applying IFRS 17 with amendment recommended by staff (paragraphs 40–43 of this paper).

4. For simplicity, the following assumptions apply in all examples:

- (a) discount rates are 0% and the risk adjustment for non-financial risk is zero;
- (b) services are provided evenly over the coverage period, claims are incurred evenly over the coverage period and claims are paid when incurred;
- (c) reinsurance premiums are paid to the reinsurer at the same time premiums are received from the policyholder of the underlying insurance contracts;
- (d) claims reimbursements are received from the reinsurer at the same time claims are paid to the policyholder of the underlying insurance contracts; and
- (e) the effect of any risk of non-performance by the reinsurer on the expected future cash flows is ignored.¹

¹ Applying paragraph 63 of IFRS 17, an entity shall include in the estimates of the present value of future cash flows for a group of reinsurance contracts held the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

Example A—existing exception for adverse changes in fulfilment cash flows

5. At the beginning of Year 1, an entity issues a set of insurance contracts with a coverage period of two years. At initial recognition, the entity receives premiums of 1,000. The entity expects future cash outflows of 800. The entity treats the set of contracts as a group of insurance contracts. Applying paragraph 38 of IFRS 17 the entity measures the contractual service margin at initial recognition as 200 (1,000 – 800).
6. At the same time, the entity enters into a reinsurance contract that provides 50% proportionate coverage for the group of underlying insurance contracts. At initial recognition, the entity pays reinsurance premiums of 500. The entity expects future cash inflows of 400. Applying paragraph 65 of IFRS 17, the entity measures the contractual service margin at initial recognition as a net cost of 100 (500 – 400).
7. At the end of year 1, everything has occurred as expected for the group of underlying insurance contracts and the entity has incurred and paid 400 of claims. However, the group of underlying insurance contracts is now expected to be onerous due to an expected increase in claims in Year 2. The entity revises its expectations about Year 2 and now expects to incur 700 of cash outflows, compared to 400 expected at initial recognition. The revised total expected cash outflows are 1,100 (400 incurred in Year 1 + 700 expected in Year 2), which is 300 higher than the 800 total expected cash outflows at initial recognition.

8. All events in Year 2 occur as expected in Year 1. The change in the insurance contract liability for Year 1 following initial recognition can be analysed as follows:

	CF	CSM	Total
Beginning of Year 1	800	200	1,000
Changes related to future service	300	(200)	100
Changes related to current service	0	0	0
Cash outflows	(400)	0	(400)
End of Year 1	700	0	700
Cash outflows	(700)	0	(700)
End of Year 2	0	0	0

9. The change in the 50% proportionate coverage reinsurance contract asset for year 1 following initial recognition can be analysed as follows:

	CF	CSM	Total
Beginning of Year 1	400	100	500
Changes related to future service (exception applies here - see footnote)	150	(100)²	50
Changes related to current service	0	0	0
Cash inflows	(200)	0	(200)
End of Year 1	350	0	350
Cash inflows	(350)	0	(350)
End of Year 2	0	0	0

² The CSM for a reinsurance contract held can be in a net cost or a net gain position (ie the contractual service margin *can* be lower than zero). However, 50 of the total 150 changes related to future service results from a change of 100 in the fulfilment cash flows of the group of underlying insurance contracts that does not adjust the CSM of that group (ie the loss component). Therefore, applying the exception in paragraph 66(c)(ii) of IFRS 17, that 50 does not adjust the CSM of the reinsurance contract held.

10. Calculation of the insurance service result:

	Year 1	Year 2
Insurance revenue ³	400	600
Insurance service expenses ⁴	(500)	(600)
Insurance contracts issued total	(100)	0
Reinsurance premiums ⁵	(200)	(300)
Amounts recovered from reinsurance ⁶	250	300
Reinsurance contracts held total	50	0
Insurance service result	(50)	0

Example B—Scenario 1—when a reinsurance contract held is in a net gain position and provides coverage for an underlying onerous group of insurance contracts

11. At the beginning of Year 1, an entity issues a set of insurance contracts with a coverage period of two years. At initial recognition, the entity receives premiums of 1,000. The entity expects future cash outflows of 1,200. The entity treats the set of contracts as a group of insurance contracts. Applying paragraph 47 of IFRS 17 the entity measures the loss component at initial recognition as 200 (1,000 – 1,200).
12. At the same time, the entity enters into a reinsurance contract that provides 50% proportionate coverage for the group of underlying insurance contracts. At initial

³ Year 1 400 (change in liability for remaining coverage (LRC) excluding the loss component of 100) and Year 2 600 (change in liability for remaining coverage excluding 100 reversal of loss component).

⁴ Year 1 500 (400 claims + 100 loss component) and Year 2 600 (700 claims – 100 reversal of loss component).

⁵ Year 1 200 (change in asset for remaining coverage (ARC) plus 50 applying paragraph 66(c)(ii) of IFRS 17) and Year 2 300 (change in ARC minus 50 applying paragraph 66(c)(ii) of IFRS 17).

⁶ Year 1 250 (200 claims reimbursed + 50 applying paragraph 66(c)(ii) of IFRS 17) and Year 2 300 (350 claims reimbursed – 50 applying paragraph 66(c)(ii) of IFRS 17).

recognition, the entity pays reinsurance premiums of 500. The entity expects future cash inflows of 600.

13. Everything occurs in Year 1 and Year 2 as expected at initial recognition.
14. The change in the insurance contract liability following initial recognition can be analysed as follows:

	CF	CSM	Total
Beginning of Year 1	1,200	0	1,200
Cash outflows	(600)	0	(600)
End of Year 1	600	0	600
Cash outflows	(600)	0	(600)
End of Year 2	0	0	0

(i) *Applying IFRS 17*

15. Applying paragraph 65 of IFRS 17, the entity measures the contractual service margin of the reinsurance contract held at initial recognition as a net gain of 100 (500 – 600).
16. The change in the 50% proportionate coverage reinsurance contract asset following initial recognition can be analysed as follows:

	CF	CSM	Total
Beginning of Year 1	600	(100)	500
Changes related to current service	0	50	50
Cash inflows	(300)	0	(300)
End of Year 1	300	(50)	250
Changes related to current service	0	50	50
Cash inflows	(300)	0	(300)
End of Year 2	0	0	0

17. Calculation of the insurance service result:

	Year 1	Year 2
Insurance revenue ⁷	500	500
Insurance service expenses ⁸	(700)	(500)
Insurance contracts issued total	(200)	0
Reinsurance premiums ⁹	(250)	(250)
Amounts recovered from reinsurance ¹⁰	300	300
Reinsurance contracts held total	50	50
Insurance service result	(150)	50

(ii) *Applying IFRS 17 with amendment recommended by staff*

18. Applying IFRS 17 with the amendment recommended by staff, the entity measures the reinsurance contract held at initial recognition as being in a net gain position of 100 (500 – 600). 100 of the cash inflows that the entity expects to receive from the reinsurer correspond to 200 cash outflows that the entity expects to pay to policyholders of the underlying insurance contracts that have contributed to the 200 loss expected on those underlying insurance contracts. The 200 loss component on the underlying insurance contracts is recognised immediately and, applying the recommended amendment, a 100 gain on the reinsurance contract held is also recognised immediately.

⁷ Year 1 500 (change in LRC excluding loss component) and Year 2 500 (change in LRC excluding loss component).

⁸ Year 1 700 (600 claims + 200 loss component at initial recognition – 100 reversal of loss component subsequently) and Year 2 500 (600 claims – 100 reversal of loss component).

⁹ Year 1 250 (change in ARC) and Year 2 250 (change in ARC of 250).

¹⁰ Year 1 300 (300 claims reimbursed) and Year 2 300 (300 claims reimbursed).

19. The change in the 50% proportionate coverage reinsurance contract asset following initial recognition can be analysed as follows:

	CF	CSM	Total
Beginning of Year 1	600	0	600
Cash inflows	(300)	0	(300)
End of Year 1	300	0	300
Cash inflows	(300)	0	(300)
End of Year 2	0	0	0

20. Calculation of the insurance service result:

	Year 1	Year 2
Insurance revenue	500	500
Insurance service expenses	(700)	(500)
Insurance contracts issued total	(200)	0
Reinsurance premiums ¹¹	(250)	(250)
Amounts recovered from reinsurance ¹²	350	250
Total reinsurance contracts held	100	0
Insurance service result	(100)	0

¹¹ Year 1 250 (change in ARC minus 50 applying amendment recommended by staff) and Year 2 250 (change in ARC minus 50 applying amendment recommended by staff).

¹² Year 1 350 (300 claims reimbursed plus 100 at initial recognition and minus 50 subsequently applying amendment recommended by staff) and Year 2 250 (300 claims reimbursed minus 50 applying amendment recommended by staff).

Example C—Scenario 2—when a reinsurance contract held is in a net cost position and provides coverage for an underlying onerous group of insurance contracts and an underlying profitable group of insurance contracts

21. At the beginning of Year 1, an entity issues a set of insurance contracts with a coverage period of two years. At initial recognition, the entity receives premiums of 1,000. Some of the contracts are expected to be profitable and some are expected to be onerous. The entity recognises two groups of contracts: the group that is onerous at initial recognition; and a group of remaining contracts in the portfolio (ie the profitable contracts). The entity measures the groups at initial recognition as follows:

	Profitable group	Onerous group
Premiums received	800	200
Expected cash outflows	(600)	(300)
Contractual service margin / (loss component)	200	(100)

22. At the same time, the entity enters into a reinsurance contract that provides 50% proportionate coverage for the two groups of underlying insurance contracts. At initial recognition, the entity pays reinsurance premiums of 500. The entity expects future cash inflows of 450.
23. Everything occurs in Year 1 and Year 2 as expected at initial recognition.

24. The change in the insurance contract liability following initial recognition can be analysed as follows:

	Profitable Group			Onerous Group		
	CF	CSM	Total	CF	CSM	Total
Beginning of Year 1	600	200	800	300	0	300
Changes related to current service	0	(100)	(100)	0	0	0
Cash outflows	(300)	0	(300)	(150)	0	(150)
End of Year 1	300	100	400	150	0	150
Changes related to current service	0	(100)	(100)	0	0	0
Cash outflows	(300)	0	(300)	(150)	0	(150)
End of Year 2	0	0	0	0	0	0

(i) *Applying IFRS 17*

25. Applying paragraph 65 of IFRS 17, the entity measures the contractual service margin of the reinsurance contract held at initial recognition as a net cost of 50 (500 – 450).

26. The change in the 50% proportionate coverage reinsurance contract asset following initial recognition can be analysed as follows:

	CF	CSM	Total
Beginning of Year 1	450	50	500
Changes related to current service	0	(25)	(25)
Cash inflows	(225)	0	(225)
End of Year 1	225	25	250
Changes related to current service	0	(25)	(25)
Cash inflows	(225)	0	(225)
End of Year 2	0	0	0

27. Calculation of the insurance service result:

	Year 1	Year 2
Insurance revenue ¹³	500	500
Insurance service expenses ¹⁴	(500)	(400)
Insurance contracts issued total	0	100
Reinsurance premiums ¹⁵	(250)	(250)
Amounts recovered from reinsurance ¹⁶	225	225
Reinsurance contracts held total	(25)	(25)
Insurance service result	(25)	75

(ii) *Applying IFRS 17 with amendment recommended by staff*

28. Applying IFRS 17 with amendment recommended by staff, the entity measures the reinsurance contract held at initial recognition as being in a net cost position of 50 (500 reinsurance premiums – 450 reinsurance claims). 50 of the cash inflows that the entity expects to receive from the reinsurer correspond to 100 cash outflows that the entity expects to pay to policyholders of the underlying insurance contracts that have contributed to the 100 loss expected on the onerous group of underlying insurance contracts. The 100 loss component on the onerous group is recognised immediately and, applying the recommended amendment, a 50 gain on the reinsurance contract held is also recognised immediately. The contractual service margin of the reinsurance

¹³ Year 1 500 (change in LRC excluding loss component) and Year 2 500 (change in LRC excluding loss component).

¹⁴ Year 1 500 (450 claims + 100 loss component at initial recognition – 50 reversal of loss component subsequently) and Year 2 400 (450 claims – 50 reversal of loss component).

¹⁵ Year 1 250 (change in ARC) and Year 2 250 (change in ARC).

¹⁶ Year 1 225 (225 claims reimbursed) and Year 2 225 (225 claims reimbursed).

contract held is a net cost of 100 (500 reinsurance premiums – 400 reinsurance claims excluding the amount that relates to the loss component).

29. The change in the 50% proportionate coverage reinsurance contract asset following initial recognition can be analysed as follows:

	CF	CSM	Total
Beginning of Year 1	450	100	550
Changes related to current service	0	(50)	(50)
Cash inflows	(225)	0	(225)
End of Year 1	225	50	275
Cash inflows	(225)	(50)	(275)
End of Year 2	0	0	0

30. Calculation of the insurance service result:

	Year 1	Year 2
Insurance revenue	500	500
Insurance service expenses	(500)	(400)
Insurance contracts issued total	0	100
Reinsurance premiums ¹⁷	(250)	(250)
Amounts recovered from reinsurance ¹⁸	250	200
Reinsurance contracts held total	0	(50)
Insurance service result	0	50

Example D—when a reinsurance contract held and an underlying onerous group of insurance contracts are measured applying the PAA

31. This example is the same as Example B, except that the entity applies the PAA to both the underlying insurance contracts and the reinsurance contract held. At the beginning of Year 1, an entity issues a set of insurance contracts with a coverage period of two years. At initial recognition, the entity receives premiums of 1,000. The entity treats the set of contracts as a group of insurance contracts. At initial recognition, facts and circumstances indicate that the group of insurance contracts is onerous. Applying paragraph 57 of IFRS 17 the entity calculates the difference between:

¹⁷ Year 1 250 (change in ARC minus 25 applying amendment recommended by staff) and Year 2 250 (change in ARC minus 25 applying amendment recommended by staff).

¹⁸ Year 1 250 (225 claims reimbursed plus 50 at initial recognition minus 25 subsequently applying amendment recommended by staff) and Year 2 200 (225 claims reimbursed minus 25 applying amendment recommended by staff).

The carrying amount of the liability for remaining coverage applying paragraph 55 of IFRS 17 (PAA)	1,000
The fulfilment cash flows that relate to remaining coverage applying the general model ¹⁹	1,200
Difference	200

32. Consequently, at initial recognition the entity recognises a loss of 200 and increases the liability for remaining coverage to 1,200.
33. At the same time, the entity enters into a reinsurance contract that provides 50% proportionate coverage for the group of underlying insurance contracts. At initial recognition, the entity pays reinsurance premiums of 500.
34. In each of Year 1 and Year 2 the entity pays claims of 600 and receives claims reimbursements from the reinsurer of 300.
35. The change in the insurance contract liability following initial recognition can be analysed as follows:

	Total
Beginning of Year 1	1,200
Insurance revenue applying paragraph 55(b)(v) of IFRS 17	(500)
Reversal of loss applying paragraphs 57-58 of IFRS 17	(100)
End of Year 1	600
Insurance revenue applying paragraph 55(b)(v) of IFRS 17	(500)
Reversal of loss applying paragraphs 57-58 of IFRS 17	(100)
End of Year 2	0

¹⁹ With a relief relating to the practical expedient in paragraph 59(b) of IFRS 17.

(i) *Applying IFRS 17*

36. Applying paragraph 55 of IFRS 17 adapted to reflect the features of reinsurance contracts held, the entity measures the reinsurance contract held at initial recognition as an asset of 500.
37. The change in the 50% proportionate coverage reinsurance contract asset following initial recognition can be analysed as follows:

	Total
Beginning of Year 1	500
Allocation of reinsurance premiums applying paragraph 55(b)(v) of IFRS 17	(250)
End of Year 1	250
Allocation of reinsurance premiums applying paragraph 55(b)(v) of IFRS 17	(250)
End of Year 2	0

38. Calculation of the insurance service result:

	Year 1	Year 2
Insurance revenue ²⁰	500	500
Insurance service expenses ²¹	(700)	(500)
Insurance contracts issued total	(200)	0
Reinsurance premiums ²²	(250)	(250)
Amounts recovered from reinsurance ²³	300	300
Reinsurance contracts held total	50	50
Insurance service result	(150)	50

39. Note that the outcome of applying the PAA to this fact pattern in Example D is the same as the outcome of applying the general model to this fact pattern in Example B.

²⁰ Total expected premium receipts of 1,000/2.

²¹ Year 1 700 (600 claims incurred + 200 loss at initial recognition – 100 loss reversal) and Year 2 500 (600 claims incurred – 100 loss reversal).

²² Total expected premium payments of 500/2.

²³ Year 1 300 (300 claims reimbursed) and Year 2 300 (300 claims reimbursed).

(ii) *Applying IFRS 17 with amendment recommended by staff*

40. Applying paragraph 55 of IFRS 17 adapted to reflect the features of reinsurance contracts held and with the amendment recommended by staff, the entity measures the reinsurance contract held at initial recognition as an asset of 600 (500 premiums paid + 100 gain recognised in profit or loss applying the amendment recommended by staff, at the same time as the 200 loss recognised on underlying insurance contracts).
41. The change in the 50% proportionate coverage reinsurance contract asset following initial recognition can be analysed as follows:

	Total
Beginning of Year 1 (initial recognition)	600
Allocation of reinsurance premiums applying paragraph 55(b)(v) of IFRS 17	(250)
Applying amendment recommended by staff	(50)
End of Year 1	300
Allocation of reinsurance premiums applying paragraph 55(b)(v) of IFRS 17	(250)
Applying amendment recommended by staff	(50)
End of Year 2	0

42. Calculation of the insurance service result:

	Year 1	Year 2
Insurance revenue	500	500
Insurance service expenses	(700)	(500)
Insurance contracts issued total	(200)	0
Reinsurance premiums ²⁴	(250)	(250)
Amounts recovered from reinsurance ²⁵	350	250
Reinsurance contracts held total	100	0
Insurance service result	(100)	0

43. Note that the outcome of applying the PAA to this fact pattern in Example D is the same as the outcome of applying the general model to this fact pattern in Example B.

²⁴ Total expected reinsurance premium payments of 500/2.

²⁵ Year 1 350 (300 claims reimbursed *plus 100 at initial recognition minus 50 subsequently applying amendment recommended by staff*) and Year 2 250 (300 claims reimbursed minus 50 applying amendment recommended by staff).

STAFF PAPER

January 2019

IASB® meeting

Project	Amendments to IFRS 17 <i>Insurance Contracts</i>		
Paper topic	Reinsurance contracts held—underlying insurance contracts with direct participation features		
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB® *Update*.

Purpose

1. This paper discusses the accounting for reinsurance contracts held when the underlying insurance contracts are insurance contracts with direct participation features.

Staff recommendation

2. The staff recommend the International Accounting Standards Board (Board) amend IFRS 17 to expand the scope of the risk mitigation exception for insurance contracts with direct participation features in paragraph B115 of IFRS 17 *Insurance Contracts* so that it applies when an entity uses a derivative or a reinsurance contract held to mitigate financial risk, to the extent that the entity meets the conditions in paragraph B116 of IFRS 17.

Structure of the paper

3. This paper provides:
 - (a) an overview of the requirements in IFRS 17 (paragraphs 4–6 of this paper);
 - (b) a summary of the Board’s rationale for setting those requirements, including an overview of the Board’s previous discussions (paragraphs 7–11 of this paper);
 - (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued (paragraphs 12–16 of this paper); and
 - (d) the staff analysis, recommendations and a question for Board members (paragraphs 17–28 of this paper).

IFRS 17 requirements

4. The variable fee approach applies to insurance contracts that meet the definition of insurance contracts with direct participation features. Insurance contracts with direct participation features are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items. IFRS 17 requires the contractual service margin for variable fee approach contracts to be updated for more changes than those affecting the contractual service margin of other contracts. For variable fee approach contracts, the contractual service margin is also adjusted for the effect of changes in:
 - (a) the entity’s share of the underlying items; and
 - (b) financial risks other than those arising from the underlying items, for example the effect of financial guarantees.
5. The variable fee approach includes a choice when an entity mitigates the financial risks of variable fee approach contracts using derivatives. The entity may choose to recognise changes in financial risk in such insurance contracts, such as those created by minimum payments guaranteed to the policyholder, in profit or loss, instead of adjusting the contractual service margin as normally required by the variable fee

approach. In other words, an entity can ‘switch-off’ the variable fee approach to the extent that the derivative mitigates the risks.

6. Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purpose of applying IFRS 17.

Board’s rationale

Risk mitigation exception in the variable fee approach

7. When the Board introduced the variable fee approach, it noted that the variable fee approach would create accounting mismatches when an entity purchases derivatives to mitigate risks that are included in the measurement of the contractual service margin.¹ The Board concluded that to avoid such accounting mismatches, an entity should be allowed to choose not to adjust the contractual service margin for the changes in the fulfilment cash flows and the entity’s share of the fair value return on the underlying items that the derivatives are intended to mitigate.

Ineligibility of reinsurance contracts for the variable fee approach

Reinsurance contracts held

8. For reinsurance contracts an entity holds, the entity and the reinsurer do not share in the returns on underlying items, and so the criteria for the scope of the variable fee approach are not met. This is the case regardless of whether the underlying insurance contracts issued are insurance contracts with direct participation features.
9. During the development of IFRS 17, some stakeholders stated that the treatment of the contractual service margin for reinsurance contracts held should be the same as the treatment of the contractual service margin for the underlying insurance contracts issued. They argued that this would avoid mismatches that result when the pattern of recognition of the contractual service margin for reinsurance contracts differs from the pattern of recognition of the contractual service margin for the underlying insurance contracts. This would mean that the variable fee approach would apply to reinsurance contracts held that provide coverage for insurance contracts within the scope of the

¹ This is discussed in Agenda Paper 2C of the December 2018 Board meeting

variable fee approach, and that the general model would apply to reinsurance contracts held that provide coverage for insurance contracts within the scope of the general model.

10. The Board considered this feedback and decided it would not modify the scope of the variable fee approach to include reinsurance contracts held when the underlying insurance contracts issued are insurance contracts with direct participation features. The Board concluded that such an approach would be inconsistent with its view that a reinsurance contract held should be accounted for separately from the underlying insurance contracts issued.

Reinsurance contracts issued

11. The Board also considered stakeholder feedback that some reinsurance contracts *issued* might meet the criteria for the scope of the variable fee approach. The Board decided that, although some types of reinsurance contracts issued might meet the criteria for the scope of the variable fee approach, reinsurance contracts issued are not eligible for the variable fee approach. This is because the Board developed the variable fee approach for contracts for which, in the Board’s view, the returns to the entity from a pool of underlying items should be viewed as part of the compensation that the entity charges the policyholder for the services provided by the insurance contract. That view does not apply to reinsurance contracts issued.

Concerns and implementation challenges expressed since IFRS 17 was issued

Reinsurance contracts held

12. Consistent with feedback during the development of IFRS 17, some stakeholders are concerned that measuring a reinsurance contract held applying the general model when the underlying insurance contracts are measured applying the variable fee approach may give rise to mismatches they regard as accounting mismatches. In their view, the resulting accounting fails to reflect the economics of the arrangement mitigating the entity’s risk exposure.
13. Some stakeholders note that the economic effect of some reinsurance arrangements is to transfer both non-financial and financial risk from the entity to the reinsurer. For

example, some reinsurance contracts are structured to share the entity's share of the returns on underlying items between the entity and the reinsurer. However, generally the underlying items are managed by the insurer and are not transferred to the reinsurer.

14. Some stakeholders have suggested two amendments to IFRS 17 that they think would address their concerns. Those two amendments are:
- (a) permit an entity to choose to account for reinsurance contracts it holds applying the variable fee approach when the underlying insurance contracts are insurance contracts with direct participation features; or
 - (b) expand the risk mitigation exception in the variable fee approach that applies when an entity uses derivatives to mitigate financial risk so that the exception also applies when an entity uses reinsurance contracts held to mitigate financial risks.

Reinsurance contracts issued

15. Some stakeholders note that in some internal reinsurance arrangements between subsidiaries of a group, the reinsuring subsidiary might hold or manage the underlying items on behalf of the insuring subsidiary. Those stakeholders think that those internal reinsurance contracts might meet the criteria for the scope of the variable fee approach if IFRS 17 did not explicitly exclude them from the variable fee approach.
16. Some stakeholders that have suggested the amendment in paragraph 14(a) of this paper have also suggested a related amendment for reinsurance contracts *issued*. Those stakeholders have suggested that IFRS 17 is amended to permit an entity to choose to account for reinsurance contracts it issues applying the variable fee approach, if the contract meets the criteria for the scope of the variable fee approach.

Staff analysis and recommendation

Reinsurance contracts held

17. The staff observe that some reinsurance contracts held do not mitigate the financial risks of variable fee approach insurance contracts. However, stakeholders have noted that some reinsurance contracts held may do so. For those reinsurance contracts, there may be an accounting mismatch similar to the accounting mismatch created when an entity uses derivatives to mitigate financial risks of underlying variable fee approach contracts. Therefore, the staff think an amendment to IFRS 17 that would resolve that accounting mismatch could be justified.

18. The staff think that either of the two amendments suggested by stakeholders in paragraph 14 of this paper would resolve that accounting mismatch.

19. The staff observe that the variable fee approach was developed to give a faithful representation of insurance contracts that are substantially investment-related service contracts. The Board views these contracts as creating an obligation for the entity to pay policyholders an amount equal in value to specified underlying items, minus a variable fee for service. Reinsurance contracts that the entity *holds*, by definition, cannot be considered to be such contracts from the perspective of the entity.

20. The staff think that to apply the variable fee approach to contracts for which it was not developed, as suggested by stakeholders in paragraph 14(a) of this paper, would not be suitable. The staff therefore do not recommend that the Board amend IFRS 17 to permit an entity to account for reinsurance contracts it holds applying the variable fee approach when the underlying insurance contracts are insurance contracts with direct participation features.

21. The staff observe that the risk mitigation exception in paragraph B115 of IFRS 17 was introduced to resolve an accounting mismatch introduced by the variable fee approach. The accounting mismatch discussed in this paper is similar to that accounting mismatch. Therefore, the staff think that amending IFRS 17 to expand the scope of the risk mitigation exception for insurance contracts with direct participation features in paragraph B115 of IFRS 17 so that it applies when an entity uses a

derivative *or a reinsurance contracts held* to mitigate financial risk would be appropriate.

22. The staff observe that the risk mitigation exception is a choice and therefore expanding the scope of the exception may reduce comparability. However, the staff think that the benefit of avoiding accounting mismatches that the Board considered when it added the existing exception for derivatives applies equally here.
23. The staff think the amendment discussed in paragraph 21 of this paper would meet the criteria set by the Board at its October 2018 meeting because it would not:
 - (a) result in a significant loss of useful information compared to that which would be provided applying IFRS 17. Although this amendment would change the accounting for the underlying insurance contracts, it is an expansion of an exception that already exists in IFRS 17.
 - (b) unduly disrupt implementation. The staff observe that this expanded exception would only apply when reinsurance contracts held meet the existing conditions for the risk mitigation exception in paragraph B116 of IFRS 17, and that the expanded exception is permitted but not required.
24. The staff therefore recommend the Board amend IFRS 17 to expand the scope of the risk mitigation exception for insurance contracts with direct participation features in paragraph B115 of IFRS 17 so that it applies when an entity use a derivative *or a reinsurance contract held* to mitigate financial risk, to the extent that the entity meets the conditions in paragraph B116 of IFRS 17.

Reinsurance contracts issued

25. The staff note that some stakeholders also expressed views that IFRS 17 should be amended to permit an entity to choose to account for reinsurance contracts it issues applying the variable fee approach, if the contract meets the criteria for the scope of the variable fee approach.
26. The staff observe that some stakeholders think that some internal reinsurance contracts issued might meet the criteria for the variable fee approach if IFRS 17 did not explicitly exclude them from the variable fee approach. Those stakeholders noted that in some internal reinsurance arrangements between subsidiaries of a group, the

reinsuring subsidiary might hold or manage the underlying items on behalf of the insuring subsidiary. The staff observe that, at a consolidated group of entities level, there is no reinsurance.

27. As explained in paragraph 11 of this paper, the Board developed the variable fee approach for contracts for which, in the Board’s view, the returns to the entity from a pool of underlying items should be viewed as part of the compensation that the entity charges the policyholder for the services provided by the insurance contract. That view does not apply to reinsurance contracts issued. The staff think that to apply the variable fee approach to contracts for which it was not developed, as suggested by stakeholders in paragraph 16 of this paper, would not be suitable.
28. The staff therefore do not recommend the Board amend IFRS 17 to permit an entity to choose to account for reinsurance contracts it issues applying the variable fee approach.

Question for Board members

Do you agree the Board amend IFRS 17 to expand the scope of the risk mitigation exception for insurance contracts with direct participation features in paragraph B115 of IFRS 17 so that it applies when an entity use a derivative *or a reinsurance contract held* to mitigate financial risk, to the extent that the entity meets the conditions in paragraph B116 of IFRS 17?

STAFF PAPER

January 2019

IASB® meeting

Project	Amendments to IFRS 17 <i>Insurance Contracts</i>		
Paper topic	Recognition of the contractual service margin in profit or loss in the general model		
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB® *Update*.

Purpose

1. This paper discusses the requirements in IFRS 17 *Insurance Contracts* for the recognition of the contractual service margin in profit or loss for contracts without direct participation features (ie contracts to which the general model applies).

Summary of staff recommendations

2. The staff recommend the International Accounting Standards Board (Board):
 - (a) amend IFRS 17 so that in the general model the contractual service margin is allocated on the basis of coverage units that are determined by considering both insurance coverage and any investment return service;¹
 - (b) amend IFRS 17 to establish that an investment return service can exist only when an insurance contract includes an investment component;
 - (c) amend IFRS 17 to require an entity to use judgement applied consistently in deciding whether to include an investment return service when determining coverage units, and not provide an objective or criteria for that determination;
 - (d) amend IFRS 17 to establish that the period of investment return services should be regarded as ending when the entity has made all investment

¹ The staff will consider in drafting whether to replace the term ‘coverage units’ with ‘service units’.

component payments to the policyholder of the contract, ie not including payments to future policyholders;

- (e) amend IFRS 17 to require the assessments of the relative weighting of the benefits provided by insurance coverage and investment return services and their pattern of delivery to be made on a systematic and rational basis;
- (f) confirm that, applying IFRS 17, cash flows relating to fulfilling the investment return service are included in the measurement of the insurance contract;
- (g) does not change the requirements in IFRS 17 relating to which changes in fulfilment cash flows adjust the contractual service margin in the general model; and
- (h) amend IFRS 17 to establish that the one year eligibility criterion for the premium allocation approach (PAA) should be assessed by considering insurance coverage and an investment return service, if any.

Structure of the paper

3. This paper provides:
 - (a) an overview of the requirements in IFRS 17 (paragraphs 4–7 of this paper);
 - (b) a summary of the Board’s rationale for setting those requirements, including an overview of the Board’s previous discussions (paragraphs 8–12 of this paper);
 - (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued (paragraphs 13–15 of this paper);
 - (d) the staff analysis (paragraphs 16–54 of this paper); and
 - (e) the staff recommendations and questions for Board members (paragraphs 55–57 of this paper).

IFRS 17 requirements

4. The contractual service margin is the unearned profit in a group of insurance contracts. It forms part of the liability for remaining coverage and is initially measured as the amount that results in no gain being recognised on initial recognition of a group of insurance contracts. After initial recognition, in the general model the contractual service margin is:
 - (a) adjusted for the accretion of interest and changes in estimates of cash flows relating to future service; and
 - (b) recognised in profit or loss to reflect the entity's provision of service under the contract.
5. The recognition of the contractual service margin in profit or loss is determined by allocating the balance of the contractual service margin at the end of the reporting period to coverage units provided in the current period and expected to be provided in the future. The amount allocated to coverage units provided in the current period is recognised in profit or loss.
6. The number of coverage units in a group of contracts is determined by considering for each contract in the group, the quantity of benefits provided under the contracts and its expected coverage duration.
7. Applying the general model, the quantity of benefits includes only insurance coverage and the contractual service margin is recognised only over the period during which the entity provides coverage for insured events. Applying the variable fee approach, the Board tentatively decided at its June 2018 meeting to propose an annual improvement to clarify that coverage units should be determined by considering both insurance coverage and investment-related services.²

Board's rationale

8. In determining coverage units, IFRS 17 requires an entity to assess the services provided to the policyholder. The Board acknowledges that some insurance contracts

² Agenda Paper 2B of the June 2018 Board meeting

provide services other than insurance coverage. Paragraph BC222 of the Basis for Conclusions on IFRS 17 explains that the key service provided by insurance contracts is insurance coverage, but contracts may also provide investment-related or other services. However, paragraph BC279 of the Basis for Conclusions on IFRS 17 observes that insurance coverage is the defining service provided by insurance contracts. The focus in these statements on insurance coverage reflects the fact that contracts are in the scope of IFRS 17 because they provide insurance coverage.

9. Hence, for general model contracts, the Board decided that useful information is provided by recognising the contractual service margin in profit or loss over the period in which insurance coverage is provided. Not considering any other service is a simplification, but doing so avoids complexity and subjective or arbitrary allocations, and reflects the key service of insurance.
10. The Board decided a different approach to reflect the effect of investment-related services was appropriate only for those contracts that fall within the scope of the variable fee approach. In contrast to contracts applying the general model, IFRS 17 acknowledges that variable fee approach contracts ‘are substantially investment-related service contracts’. As discussed in Agenda Paper 2C for the December 2018 Board meeting, this perspective is fundamental to the requirements of the variable fee approach and to its scope, which was carefully considered during its development.
11. IFRS 17 uses the scope of the variable fee approach to identify insurance contracts that provide investment-related services to an extent that justifies a modified approach to their measurement. In these contracts, the obligation to the policyholder can be regarded as a promise to return the underlying items, including any returns generated, to the policyholder after deducting a variable fee. The entity is promising an investment return based on underlying items, in effect providing an asset management service.
12. The measurement is modified so that changes in the entity’s share of the underlying items adjust the contractual service margin. At the June 2018 Board meeting, the Board tentatively decided to clarify that the determination of coverage units should be determined by considering both insurance coverage and investment-related services, to make the modified measurement internally consistent.

Concerns and implementation challenges expressed since IFRS 17 was issued

13. Some stakeholders agree that there is an economic distinction between insurance contracts without direct participation features (to which the general model applies) and insurance contracts with direct participation features (to which the variable fee approach applies). Those stakeholders agree with the outcome of IFRS 17 that:
- (a) for contracts to which the general model applies, the quantity of benefits includes only insurance coverage and the contractual service margin is recognised only over the period during which the entity provides coverage for insured events; and
 - (b) for contracts to which the variable fee approach applies, the quantity of benefits includes investment-related services and the coverage period includes periods in which the entity provides investment-related services.
14. Other stakeholders disagree. They think that some insurance contracts that are not direct participating contracts provide investment-related services or other services and those services should be reflected in the coverage units applied for the contractual service margin allocation of those contracts. They observe that the contractual service margin is determined based on all the expected cash flows discounted at a current market-consistent rate.³ Hence it includes the effect of any difference between the expected return on an investment component promised to a policyholder and the market rate for such returns. They think it would be consistent with that calculation to recognise the contractual service margin in profit or loss over the period that difference arises.
15. Some of those stakeholders noted that without amending IFRS 17 to reflect investment-related services in determining coverage units for contracts accounted for applying the general model, the application of the requirements would result in unintended consequences. For example:

³ It also includes the effect of the risk adjustment for non-financial risk.

- (a) contracts that provide insurance coverage that ends significantly before the investment-related services would result in a front-end revenue recognition; and
- (b) deferred annuity contracts with an account balance accumulating in the period before the annuity payments start could result in back-end revenue recognition if insurance coverage is provided only during the annuity periods.

Staff analysis

16. The staff analysis is structured as follows:
- (a) identification of a service related to investment returns for insurance contracts without direct participation features;
 - (b) consequences of determining coverage units based on the identification of such a service; and
 - (c) alternative approach based on any service provided (ie not just insurance coverage and a service related to investment returns).

17. The staff use the following example from a submission to the Transition Resource Group for IFRS 17 (TRG) to illustrate the analysis given below.⁴

Example: an investment contract matures in year 10 and pays the customer the account value at maturity. The account value is determined as the premiums received plus the return on underlying items less 1%. The contract also includes a death benefit that varies depending on which year in the 10 year period the death occurs. Specifically, if the customer dies during the 1–5 year period, the customer’s beneficiary would receive a death benefit that is the higher of 110 per cent of the premium paid or the accumulated account value (assume the death benefit for years 1–5 results in significant insurance risk). However, if the customer dies in years 6 to 10 the customer’s beneficiary only gets the account value. There is no surrender penalty.

18. Applying IFRS 17:
- (a) if the contract falls within the scope of the variable fee approach:

⁴ Example 14 in Appendix C of Agenda Paper 5 of the May 2018 TRG meeting.

- (i) the contract provides insurance and investment-related services. The coverage period for total services is 10 years.
 - (ii) the coverage units should be determined reflecting the benefits to the policyholder of the insurance coverage and the investment-related services. Determining the amount and pattern of the insurance and investment-related services is a matter of judgement. Methods that rely solely on the amount of the investment component or solely on the death benefit would not be a faithful representation of the provision of services.
- (b) if the contract does not fall within the scope of the variable fee approach, only insurance coverage is considered for the purpose of determining coverage units applying IFRS 17. The coverage period for those services is the first five years. In years 6–10, the policyholder can make no valid insurance claim and receives no insurance coverage from the entity. Hence, coverage units are determined using the insurance benefits that exist only in the coverage period of years 1-5.

Identification of a service related to investment returns for insurance contracts without direct participation features

19. Many insurance contracts include an investment component,⁵ whereby a policyholder pays amounts to the insurer which will be repaid (often plus a return) even if an insured event does not occur. IFRS 17 distinguishes between such contracts, depending on whether they include direct participation features.
20. For insurance contracts with direct participation features, IFRS 17 treats the investment component as an investment in a specific pool of assets that the entity manages on behalf of the policyholders. In effect, all the returns on the assets flow to the policyholder, except for a fee that the entity retains. The entity receives this fee substantially⁶ for a service that is regarded as equivalent to an asset management

⁵ Any references to an investment component in this paper are to investment components that cannot be separated from the insurance contract applying paragraph 11 of IFRS 17.

⁶ The fee also covers the insurance coverage.

service.⁷ The definition of an insurance contract with direct participation features identifies contracts for which such a depiction of the services provided and related fee provides useful information.

21. Applying IFRS 17 to insurance contracts without direct participation features, the investment component is regarded in the same way as any other investment made in an entity, for example investments made by bond holders. The policyholder gets its investment plus a return on its investment, and no service related to the investment component is separately identified.

22. Using the example in paragraph 17 of this paper, suppose the expected rate of return on the underlying items is 5%. The fulfilment cash flows will include cash flows to the policyholder giving them a return of 4%. The discount rate reflecting the uncertainty of the cash flows for the return of 4% would be the expected market return of 5%.⁸ Suppose the policyholder pays a premium of 100 and the entity expects the investment component to exist for 10 years with a lump sum payment at the end of the 10 years. The expected value of the lump sum would be $100 \times 1.04^{10} = 148$. The fulfilment cash flows for the investment component would be 148 discounted at the market rate on the underlying items of 1.05, ie 91, giving a contractual service margin of 9.⁹

23. Ignoring for simplicity any cash flows arising from the insurance component, applying the general model in IFRS 17 the entity would recognise the interest expense at the market rate of 5% equal to 57 over the 10 years, and profit of 9 over the 5 years in which insurance coverage is provided.¹⁰ The spread of 1% (the profit of 9) is regarded as payment for the insurance coverage.

⁷ This perspective of the fee applies regardless of whether or not the entity holds the assets (the underlying items).

⁸ Applying IFRS 17 the discount rate would not be exactly 5% because of the spread. That effect has been ignored in this example for simplicity.

⁹ The fulfilment cash flows would also include cash flows, risk adjustment and an adjustment to the discount rate for the insurance component. It may not be possible to identify separately the amount of the fulfilment cash flows that relates to the insurance component and the amount described here as relating to the investment component.

¹⁰ Applying IFRS 17 the amount of the contractual service margin would be increased by interest accreted at a risk-free rate. That amount would depend on the risk-free rate and the pattern of recognition of the contractual

24. The staff compared the IFRS 17 accounting with that applying IFRS 9 *Financial Instruments* to a financial liability issued by the entity with the characteristics of the example in paragraph 17 without the insurance component. The IFRS 9 accounting will depend on the characteristics of the cash flows of the liability that depend on the underlying assets. For example, if the underlying assets are equity assets, it is likely that the liability would either be measured at fair value or include an embedded derivative that would be measured at fair value. Hence, the spread would not be recognised evenly over time but if the initial assumptions were ultimately realised, the value of the 1% spread would have been recognised cumulatively as the fair value of the liability or embedded derivative changes over time over the life of the liability.
25. The staff continue to think there is a difference between:
- (a) insurance contracts with direct participation features—for which the entity is regarded as providing a service equivalent to asset management; and
 - (b) insurance contracts without direct participation features—for which the entity is providing a return that reflects the uncertainty of the cash flows to be repaid to the policyholder, just like any financial liability.
26. However, the staff acknowledge that many stakeholders do not think useful information is provided for contracts that have an insurance coverage period that differs from the period in which the policyholder gets return on an investment component if the total profit is recognised over only the insurance coverage period. The staff also acknowledge that applying IFRS 9 would likely result in the recognition of any spread between market rates and the rate payable to an investor (the entity's profit) over the period the investor receives a return.
27. The staff think it is possible to justify the recognition of the contractual service margin over a period that includes the period in which the policyholder gets a return, even when this extends beyond the period when insurance coverage is provided, on the grounds that the entity is providing a service in that period. The service is not an asset management service because the entity is not managing assets on behalf of the policyholders. Rather it is providing the policyholder with access to an investment

service margin over the five-year period, Dr interest expense, Cr CSM. That amount has been ignored in this example for simplicity.

return that would not otherwise be available to the policyholder because of the amounts invested, liquidity, complexity and expertise. The staff use the term ‘investment return service’ for this service.

28. The staff think there is a balance on whether including an investment return service when determining coverage units results in useful information because:
- (a) doing so could provide relevant information about the services the entity regards itself as providing to the policyholder; but
 - (b) doing so also introduces greater subjectivity and potentially less comparability between entities.
29. To assess where that balance lies, the staff investigated the consequences of including an investment return service in determining coverage units.

Consequences of determining coverage units based on the identification of such a service

30. The staff have identified a number of consequential questions relating to the determination of coverage units based on insurance coverage and an investment return service:
- (a) circumstances in which the investment return service exists;
 - (b) subjectivity in weighting of services;
 - (c) cash flows in the contract boundary;
 - (d) subsequent adjustments to the contractual service margin; and
 - (e) eligibility for the premium allocation approach.

Circumstances in which the service exists

31. The staff considered when an investment return service should be regarded as existing. First, the staff considered insurance contracts with no investment components. An investment component exists only if amounts are paid to

policyholders in all circumstances, including the contract lapsing.¹¹ Examples of contracts without investment components include:

- (a) car insurance contracts with no rebates;
- (b) deferred annuities with at least one of the following features:
 - (i) no surrender value in the accumulation phase;
 - (ii) no payment on death in the accumulation phase; or
 - (iii) no guaranteed payments in the annuity phase.
- (c) a contract that provides an annuity if a policyholder becomes disabled. The amount of the annuity is linked to the returns on a pool of assets. The entity treats the payment of the annuity after an insured disability event as a liability for incurred claims.¹² There is no investment component because there is no amount paid to the policyholder in all circumstances, for example if there is no claim.

32. Stakeholders have not raised problems relating to an investment return service for the type of contract described in paragraph 31(a) of this paper.

33. In contrast, deferred annuities are often given as an example of when restricting coverage units to the period in which insurance coverage is provided is a problem. Looking at the cases in which there is no investment component in such contracts as described in paragraph 31(b) of this paper:

- (a) if there is a payment on death in the accumulation phase, there is insurance coverage in the accumulation phase which will be included in the determination of coverage units. Hence, there should not be a problem in terms

¹¹ IFRS 17 requires identification of the amount of an investment component only when a payment is made to a policyholder. But it is always clear whether or not the contract includes an investment component, even if the amount cannot be identified in advance.

¹² At its September 2018 meeting, TRG members observed an entity would use its judgement to develop an accounting policy on whether the provision of an annuity consequent to a disability claim involved the provision of insurance coverage, ie whether the liability for the annuity payments would be regarded as a liability for incurred claims or a liability for remaining coverage.

of the period over which the contractual service margin is recognised in profit or loss.

- (b) if there is no payment on death in the accumulation phase, the staff think it is appropriate not to regard the contract as providing investment services: if the policyholder dies in the accumulation phase, the beneficiary receives no benefit from the investment. Any investment benefit arises only if the policyholder survives to receive the annuity. Hence the staff think it is appropriate to recognise the contractual service margin over the insurance coverage period only.
34. The staff think the reasoning in paragraph 33(b) of this paper also applies to the annuity payments after a disability claim described in paragraph 31(c) of this paper: the policyholder only benefits from the investment returns if the policyholder becomes disabled. Hence, the entity is not providing an investment return service beyond the insurance coverage service.
 35. The staff therefore think that an entity should consider investment return services only when an insurance contract includes an investment component.
 36. The staff then considered whether an investment return service always exists when there is an investment component. The staff observed that in some contracts, the entity does not provide an investment return service, for example when the entity provides only custodial services in relation to the investment component or when the investment component is included solely to facilitate insurance coverage, such as the inclusion of a no claims bonus in some insurance contracts. The staff think it is a matter of judgement for the entity to determine whether it provides an investment return service in addition to insurance coverage. That judgement should be applied consistently to similar contracts.
 37. The staff considered whether it would be helpful to:
 - (a) set specific criteria for when an entity should include an investment return service in the determination of coverage units. For example, whether the

promised return needs to be variable, or different from market rates, or greater than zero;

- (b) set an objective of considering an investment return service only when it is expected that the policyholder will identify an investment benefit in addition to the insurance coverage in the contract, rather than the investment component being included solely to facilitate the provision of insurance coverage. Examples of investment components when the policyholder might not identify an investment benefit could be a no claims bonus or fixed surrender value, where the entity does not perform significant activities to meet its obligation to pay the investment component; and/or
- (c) state that if changes in financial assumptions do not have a substantial effect on the amounts paid to the policyholder, then any investment service could be regarded as minimal and hence disregarded. This criterion is used in paragraphs B131–B132 of IFRS 17 to determine what amounts should be included in profit or loss when an entity uses the option in IFRS 17 to include some insurance finance income and expenses in other comprehensive income. The objective of paragraphs B131–B132 of IFRS 17 is to identify an amount effectively equivalent to an amortised cost amount applying IFRS 9. In doing this, the paragraphs effectively distinguish between contracts that provide a fixed return and contracts that provide a variable return.

38. The staff acknowledge that setting criteria or an objective could help with consistent application of any amendment to IFRS 17 in relation to investment return services and comparability of results. However, the staff think that it is not possible to identify strict criteria for when an investment return service exists. For example, the staff think that in some economic conditions a promise of a fixed return could involve as much service as the promise of a variable return. The staff also think that it would be difficult to develop an objective that is clear and applicable in all circumstances. Further, the staff note that any criteria or objective for identifying when an entity

provides an investment return service will add complexity for users, preparers and auditors in understanding and applying the criteria or objective.

39. The staff think it is unlikely that any benefits of consistent application or comparability of results would outweigh the costs of the added complexity created by criteria or an objective developed at this time.
40. Finally, the staff considered insurance contracts under which some investment component payments are expected to be paid to future policyholders rather than the current policyholder.¹³ Does the entity provide a service during the period in which payments are expected to be made to future policyholders?¹⁴
41. The staff think that the contractual service margin should be regarded as the amount a policyholder pays for services that *it* receives, not for services to future policyholders. Also, the staff think that from a practical perspective, tracking the contractual service margin across periods in which payments are expected to be made would be complex and probably arbitrary. The staff therefore recommend that the period of investment return service is regarded as ending when all investment component payments to the policyholder of the contract have been made, without considering payments to future policyholders.

Subjectivity in weighting of services

42. Including an investment return service in addition to insurance coverage services in the determination of coverage units adds subjectivity and complexity to that determination. An entity would have to assess the relative weighting of the benefits of the investment return service and the insurance coverage services, and the pattern of delivery of these services.
43. An entity is already required to make similar assessments for contracts under the variable fee approach, and for contracts applying the general model which provide more than one type of insurance coverage. As noted in Agenda Paper 2B for the June

¹³ Payments can be expected to be made to future policyholders when an entity is obliged to pay amounts based on the returns on underlying items, but has discretion over the timing of such payments. An entity may retain some returns in a good period to be able to pay out more in future periods with lower returns. All the expected payments are included in the fulfilment cash flows, regardless of to whom they are expected to be made.

¹⁴ This question also applies to the recognition of the contractual service margin for groups of insurance contracts with direct participation features, as does the proposed staff solution in paragraph 41 of this paper.

2018 Board meeting in relation to the variable fee approach, practice will develop as IFRS 17 is implemented. The staff observe similar assessments are required in applying IFRS 15 *Revenue from Contracts with Customers* and guidance in that Standard considers potential or actual transaction prices services had they been offered on a standalone basis. The staff note that in practice, a similar type of analysis may be helpful in identifying whether an investment return service exists and the relative benefits for the policyholder. However, the staff do not recommend developing further guidance in IFRS 17 on how to make such assessments at this time, for the same reasons set out in paragraph 38–39 of this paper in relation to criteria or an objective for when an investment return service exists. Instead, the staff recommend requiring the assessments to be made on a systematic and rational basis, consistent with TRG members observations on the determination of insurance coverage units.¹⁵

44. The staff observe the pattern in which services are provided is a significant judgment in measuring groups of insurance contracts, which IFRS 17 requires to be disclosed. Also, IFRS 17 specifically requires extensive disclosure of changes in the contractual service margin and an explanation of when it expects to recognise in profit or loss the contractual service margin remaining at the end of a period. The staff think these disclosures will facilitate users' understanding of the entity's approach to recognising the contractual service margin.

Cash flows in contract boundary

45. Some stakeholders have questioned whether the costs of managing assets that form underlying items for insurance contracts can be included in the fulfilment cash flows for the contracts, both for variable fee contracts and for general model contracts.
46. The staff observe that IFRS 17 includes in the fulfilment cash flows those cash flows that relate directly to the fulfilment of the contract, including an allocation of fixed and variable overheads directly attributable to fulfilling insurance contracts. For variable fee contracts, where the policyholder is regarded as investing in assets that the entity manages on its behalf, it follows that the asset management costs should be regarded as part of the costs of fulfilling the contracts. Hence, they will be included in

¹⁵ Summary of the TRG meeting held on 2 May 2018.

the fulfilment cash flows. Further, the staff think that to the extent that an entity includes an investment return service for general model contracts in the determination of coverage units, it should also include cash flows related to the fulfilment of that service in the fulfilment cash flows.

Subsequent adjustments to the contractual service margin

47. Paragraph 4 of this paper explains that after initial recognition the contractual service margin is adjusted for changes in fulfilment cash flows that relate to future service. In the general model, all changes in financial assumptions are regarded as relating to the current period, not to future service. In contrast, applying the variable fee approach, some changes in financial assumptions are regarded as relating to future service.

48. The staff considered whether extending the type of service that determines coverage units in the general model would have any implications for the sort of changes in fulfilment cash flows that are regarded as relating to future service in that model. For example, should some changes in financial assumptions be regarded as relating to future service, similar to the variable fee approach?

49. There are two aspects of contracts under the variable fee approach that result in differences between the variable fee approach and the general model. The first is the type of service provided under the contract, as discussed in paragraphs 19–21 of this paper. The second is the nature of the fee that compensates the entity for that service, which is the entity’s share of the change in the fair value of the underlying items less the fulfilment cash flows that do not vary depending on the returns on underlying items.¹⁶ It is the second aspect, the nature of the fee, that causes the contractual service margin to be remeasured for changes in the fair value of the underlying item. Other effects of changes in financial assumptions adjust the contractual service margin in the variable fee approach because it is not possible to separate them from the change in fair value of the underlying items. The extension of the type of service used to determine coverage units in the general model does not change the nature of

¹⁶ IFRS 17 paragraph B104.

the fee in those contracts. Hence, there is no need to change the treatment of the effects of changes in financial assumptions.

Eligibility for the premium allocation approach

50. Insurance contracts are eligible to use a simplified approach, the PAA, if:
- (a) the entity reasonably expects that the simplified approach would produce a measurement of the liability for remaining coverage for a group of insurance contracts that would not differ materially from the one that would be produced applying the core requirements of IFRS 17; or
 - (b) the coverage period of each contract in the group is one year or less.
51. Including an investment return service may increase the reporting periods in which the entity is regarded as providing service and the reporting periods in which the contractual service margin exists. It will therefore increase the reporting periods in which the liability for remaining coverage exists, affecting the first criterion for the PAA (paragraph 50(a) of this paper). The staff think it would be consistent to also specify that the coverage period referred to in the second criterion would also include the period in which the entity provides an investment return service. This would mean that an entity would need to assess whether insurance contracts with investment components provide such a service, and could potentially reduce the number of contracts eligible for the PAA.

Alternative approach based on any services

52. Some stakeholders suggested IFRS 17 should require the recognition of the contractual service margin in profit or loss to be determined based on services provided under the contract. An entity would then use its judgement to decide what services were provided.
53. These stakeholders observed that their specific concerns related to investment-related services rather than any other types of service.
54. The staff think the recognition of the contractual service margin in profit or loss is a fundamental aspect of the depiction of the performance of groups of insurance contracts. As discussed in paragraphs 42–44 of this paper, the staff acknowledge that

there is inevitable subjectivity in determining the pattern of provision of service. Given the feedback identifying the two key services provided by insurance contracts without direct participation features as insurance coverage and an investment return service, the staff think using these services as the basis for the recognition of the contractual service margin will provide useful information, without introducing more subjectivity by allowing for other services.

Staff recommendations and questions for Board members

55. As noted in paragraph 28 of this paper, the staff think there is a balance on whether including an investment return service when determining coverage units results in useful information because:
- (a) doing so could provide relevant information about the services the entity regards itself as providing to the policyholder; but
 - (b) doing so also introduces greater subjectivity and potentially less comparability between entities.
56. The staff are persuaded by feedback that the benefits of 55(a) outweigh the costs of 55(b), because of the extensive disclosures required around the contractual service margin. Including an investment return service in the determination of coverage units also could reduce the differences between the general model and the variable fee approach because it would reduce differences in the pattern of recognition of the contractual service margin in profit or loss.
57. The staff acknowledge that any change to the requirements on the recognition of the contractual service margin in profit or loss have the potential to disrupt implementation—the calculation of the contractual service margin is an important part of any system for implementing IFRS 17. Further, a large number of insurance contracts have investment components, so this change could have a widespread effect. On the other hand, some entities may judge that investment return services should not be considered in the determination of coverage units. On balance, the staff think the

potential disruption could be justified given the stakeholder feedback about the lack of useful information given by the existing requirements in IFRS 17.

Questions for Board members

1—Do you agree the Board amend IFRS 17 so that in the general model the contractual service margin should be allocated on the basis of coverage units that are determined by considering both insurance coverage and any investment return service? (See paragraphs 19–28 and 55–57 of this paper)

2—Do you agree the Board amend IFRS 17 to establish that an investment return service exists only when an insurance contract includes an investment component? (See paragraphs 31–35 of this paper)

3—Do you agree the Board amend IFRS 17 to require an entity to use judgement applied consistently in deciding whether to include an investment return service when determining coverage units and the Board should not provide an objective or criteria for that determination? (See paragraphs 36–39 of this paper)

4—Do you agree the Board amend IFRS 17 to establish that the period of investment return services should be regarded as ending when the entity has made all investment component payments to the policyholder of the contract, ie not including payments to future policyholders? (See paragraphs 38–41 of this paper)

5—Do you agree the Board amend IFRS 17 to require the assessment of the relative weighting of the benefits provided by the insurance coverage and investment return service and their pattern of delivery to be made on a systematic and rational basis? (See paragraphs 42–44 of this paper)

6—Do you agree the Board confirm that, applying IFRS 17, cash flows relating to fulfilling the investment return service are included in the measurement of the insurance contract? (See paragraphs 45–46 of this paper)

7—Do you agree the Board does not change the requirements in IFRS 17 relating to which changes in fulfilment cash flows adjust the contractual service margin in the general model (See paragraphs 47–49 of this paper)

8—Do you agree the Board amend IFRS 17 to establish that the one year eligibility criterion for the PAA should be assessed by considering insurance coverage and an investment return service, if any? (See paragraphs 50–51 of this paper)