



## List of key outstanding issues with insurance contracts project – 16 January 2017

### (Purpose: to be shared with the EC Accounting Unit)

**The views presented below are tentative as based on our current understanding of IASB Board decisions and publicly available information only.**

As part of the process of finalising the Standard IFRS 17 'Insurance contracts' IASB has organised external testing of the draft IFRS 17 with some major insurance companies. The purpose of the testing which started on 22 July 2016 and ended on 23 September 2016 was to specifically address several topics of the future Standard:

- (1) Aggregation of contracts;
- (2) Scope of variable fee approach;
- (3) Derivatives used to mitigate financial market risk;
- (4) Determining the amount of insurance finance income or expenses in Other Comprehensive Income (OCI) (no particular comments made on this topic);
- (5) Recognition of changes in estimates;
- (6) Transition.

The objectives of the IASB were twofold: (1) to verify how the test participants understand/interpret the specific requirement in the forthcoming Standard (i.e., can the future Standard be applied consistently?); (2) to get evidence if the requirements of the future Standard might cause operational difficulties (i.e., is the future Standard operational?). It is important to state that only the test participants had an exclusive and confidential access to the draft of the future Standard.

Though the testing was useful in identifying problems in selected accounting area, we still consider the current level of testing of the future Standard as insufficient due to the following general concerns:

- The list of participants in the test was very short, which severely limits the understanding of how the Standard will be applied by the industry in general. Only 12 companies took part world-wide, and of those only three were in Europe and all of these were very large international listed companies. In Europe especially, there is a much greater variety of insurers, whose different perspectives and input will now only be reached instead through the EC/EFRAG's evaluation process;
- While the purpose of the testing was very narrow: only of whether specific aspects of the future standard are operational, and not at all of whether the standard as a whole delivers cost-effective benefits. This wider need will, again, feature now only in the EC/EFRAG's evaluation;
- The testing focused on the technical aspects only. While the issues raised in the testing represent the most sensitive ones for the industry, other significant issues also remain, which were not addressed in the testing, e.g.:
  - (1) Mandatory restatement of comparative information in IFRS 17 at transition;
  - (2) Patterns of CSM amortisation under premium allocation approach and general model.

The results of the external testing were summarised in IASB staff papers, which were discussed during IASB meeting on 16 November 2016. The staff papers illustrate that during the external testing specific concerns were raised by respondents on all of the topics mentioned above. As a result of those concerns, the IASB made tentative decisions at the November meeting to address these concerns.

In December 2016, the IASB shared, on a confidential basis, the amended draft of IFRS 17 with selected parties, mostly standard setters and audit firms, for fatal flaw review purposes. Our members are not able to assess whether the amended draft IFRS 17 has satisfactorily dealt with the issues raised by the field-testing results, as they were not privy to the fatal flaw review.

However, on the basis of the tentative decisions made by the IASB in November 2016, our members believe that whilst the IASB decisions move into the right direction, there are still significant issues that should be addressed before the standard is published.

*Note: On 10 January 2017, the IASB published a document "Extracts from external review draft of IFRS 17", however no requests for comments, for information purposes only. This document contains only two sections of the draft wording: on level of aggregation and on transition. The CFO Forum letter to the IASB on 2 February 2017 also raises this issue.*

This paper summarises the key remaining concerns for each of the tested topics mentioned above as follows:

- Level of aggregation of contracts: the level of granularity currently proposed by the IASB (annual cohorts, division of contracts into 3 groups) is excessive and does not correspond to industry's practice. The top-down approach is not implemented consistently enough, specifically when considering the tentative design of the onerous test at inception which seems to result in the bottom-up approach (i.e. individual insurance contracts' assessment) again;
- Scope of variable fee approach: to be further extended to include participation contracts with constructive obligations similar to those with contractual obligations, if a consistent pattern of distribution of significant share of the returns can be illustrated by historical data;
- Derivatives used to mitigate financial market risk: to provide consistent accounting treatment the scope of the option to recognise the changes in mitigated financial risks to profit or loss is to be extended to include contracts accounted for under the general model, as well as both financial and non-financial risks to the extent they are mitigated;
- Changes in estimates: treatment of experience adjustments to be further clarified, providing the entities a choice of accounting policy;
- Transition: the requirements to be relieved concerning use of modified retrospective approach in the case of relatively little reasonable and supportable historical information;
- Mandatory restatement of comparative information in IFRS 17 at transition: we urge the IASB to make comparative restatements optional under IFRS 17 as it is under IFRS 9;
- Methods of CSM amortisation under premium allocation approach and general approach: we urge the IASB to extend the option of applying expected timing of claim basis, currently permitted for contracts accounted for under premium allocation approach, to those recorded under the general model.

Please see details on these conclusions in the discussion below.

## **1. Level of aggregation of contracts**

**Issue:** During the field testing phase of 'Draft IFRS 17', specific concerns were raised by respondents when it comes to the level of aggregation of insurance contracts for the measurement of the contractual service margin (CSM). Only contracts with similar profitability and that responded similarly to changes in key assumptions could be grouped together. All field testing respondents identified that the level of granularity required is excessively higher than under current reporting practice, implying that insurers would have to establish a very high number of groups of contracts based on the proposed wording in the draft of IFRS 17.

Granularity was considered primarily important when contracts moved closer to becoming onerous. For business accounted for under the premium allocation approach, an onerous contract test based on the current data available was deemed not possible at a more granular level than homogenous risk groups. In addition, where the terms and

conditions of the contracts enable mutualisation of policyholders' benefits, the impact of mutualisation was considered as unclear and not clearly reflected in the aggregation requirements.

**IASB approach:** As a response to the feedback received on the level of aggregation in the external review of a draft IFRS 17 *Insurance contracts*, the IASB staff partly addressed the issue at its November 2016 meeting. In particular, the critical similar profitability precondition for grouping got removed and the bottom-up approach replaced by the top-down approach. However, the IASB also concluded that contracts in a portfolio (i.e. a group of contracts with similar risks and managed together as a single pool) should be disaggregated into at least 3 groups (onerous contracts, contracts that have no significant risk of becoming onerous and a group of other profitable contracts). In addition, the Board approved the staff proposal to introduce the restriction that only contracts which are issued not more than one year apart can be grouped together (annual cohorts). The Board also clarified that an entity is permitted to divide profitable portfolios into more than two groups and an entity can also choose to have cohorts covering periods of less than one year.

In addition, the IASB intended to further address mutualisation in the drafting process. The IASB staff has considered the effect on mutualised contracts on the requirement to restrict groups to contracts that are issued within one year ('one year cohorts'). Contracts are mutualised if some policyholders have subordinated their claims to those of other policyholders, thereby reducing the direct exposure of the insurer to the collective risk of the group. However, though it was confirmed by the IASB that mutualisation principle should overlay the cohort requirement, it was not dealt with in detail, how this would work for open portfolios. Other aspects of the problem also remain unclarified.

**Why we think the IASB approach can be further improved:** We commend the IASB for moving into the right direction, i.e. for the efforts when trying to avoid individual contracts assessment at inception which would be not proportional as demonstrated globally by the testing excursive. The top-down approach is in line with the nature of insurance business and the portfolio thinking should be applied consistently.

However, whilst from the look of it the IASB seem to become closer to top-down approach in assessing the level of aggregation, we are concerned that the requirement to assess and identify individual contracts that are onerous at inception will still lead to additional granularity, cost and complexity due to data storage requirements with no apparent benefits to users. Furthermore, the existing approach set in para 16 (b) (the set of contracts will "either all be onerous or will contain no onerous contracts") still seems to be a requirement to apply bottom-up approach. Indeed, users are unlikely to be interested in whether a profitable portfolio (with thousands of contracts) includes one or two onerous contracts. Similarly, the requirement to separate and subsequently track profitable contracts that have no significant risk of becoming onerous from other profitable contracts will lead to unjustified complexity. Furthermore, we are also concerned that requirement to have annual cohorts will lead to operational complexity with no apparent benefits to users. Whilst the IASB argues that annual cohorts are necessary to ensure the CSM is fully amortised to profit or loss when the related contracts end, we disagree on the basis that the objective to fully amortise the CSM when contracts end is actually achieved through the use of coverage units. Equally, this objective can be achieved through the derecognition principle, which effectively requires the liability to be equal to zero at contract expiry. In fact, the use of annual cohorts is senseless in a mutualisation situation, where contracts include a requirement/possibility to share returns or transfer cash flows to/from policyholders of other contracts regardless of the year of issue.

**What we propose:** The requirements to assess onerous contracts should follow top-down approach. This is because the pricing of insurance contracts is not generally based on a single individual contract but rather on the expected number of such contracts, i.e. the law of large numbers. For example, in case of life insurance, even though the price may be set individually for each contract, the expected returns are achieved from a portfolio of contracts which follow a unified approach to pricing. It would be burdensome to identify the one or two contracts that might be onerous when that life insurance portfolio is profitable, which cannot be done without analysing individual contracts. The assessment of onerous contracts should therefore be made at portfolio level.

Likewise, the requirement to split profitable contracts into two categories should be removed. For example, where an insurer provides car insurance to both male and female policyholder, the IASB proposals would result in separating female contracts from male contracts on the basis that one category has no significant risk of becoming onerous. This would make no sense since the insurer is not allowed, under European Law, to price differently based on gender. The insurer should be permitted to group profitable contracts together if they are managed together as a single pool. We understand that the IASB may be willing to make an exception in the next February meeting by allowing a narrow exemption on grouping where pricing is impacted by regulation.

The use of annual cohorts is, in the view of the IASB, a way to ensure that entities do not use the CSM as an endless pot of reserves to draw on. Avoiding abuse cannot be considered as a sound basis for developing a standard. In addition, the IASB's objective can be achieved differently. Therefore, we propose to remove the reference to annual cohorts and keep instead the concept of coverage units, ensuring that at the reporting date any outstanding CSM reflects the expected duration and size of the contracts in the group. In this regard, it should be highlighted that CSM is derecognised from the balance sheet when the coverage unit has lapsed. The existence of coverage units' concept ensures that no potential abuse might take place.

Consequently, the IASB should re-think its decisions and remove the additional restrictions on the top-down approach. Neither annual cohorts nor separation of portfolios in different sub-groups is necessary to safeguard meaningful financial reporting of insurers.

## **2. Scope of variable fee approach**

**Issue:** During the field testing phase of 'Draft IFRS 17', specific concerns were raised by respondents regarding the scope of the Variable Fee Approach ('VFA'). Based on current Board decisions reflected in the current draft of IFRS 17, the scope of the VFA includes insurance contracts with direct participation features, provided the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items. However, a significant pool of economically similar contracts is left outside the scope of VFA, because these contracts are based on constructive, rather than contractual obligations.

**IASB approach:** In response to the concern raised by the industry, the IASB addressed the issue at its November 2016 meeting. In its staff paper issued in November 2016, the IASB has emphasized that the link to the underlying assets in the contract with direct participation features should be enforceable. The notion of "enforceability" is supposed to be consistent with the requirements in paragraph 10 of IFRS 15, which states: "Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations".

On the contrary, IAS 37 defines a constructive obligation as "an obligation that derives from an entity's actions where (a) By an established pattern of past practice, published policies or a sufficiently specific statement, the entity has indicated to other parties that it will accept certain responsibilities; and (b) As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities".

The Board concluded that while a contract can arise because of constructive obligations, not all constructive obligations would give rise to contracts as defined by IFRS 15.

**Why we think the IASB approach can be further improved:** The treatment proposed by the IASB does not fully take into account the specific features of the insurance industry in different business environments. In some jurisdictions, there is no legal obligation for the insurer to distribute a significant share of the returns to policyholders.

However, many European insurers have set up a group policy that distributes a significant share of returns to policyholders regardless of the local legal requirements. Such insurers view those participating contracts as economically similar. The IASB argues that such contracts are not economically similar on the basis that in case of a financial crisis the insurer has a discretion not to distribute a significant share of returns to policyholders in jurisdictions where sharing is not a legal requirement. We disagree with that view. For example, where an insurer has for the last 100 years distributed a significant share of returns to policyholders, albeit discretionarily, the fact that the insurer might not do so during one year of financial crisis should not alter the economic substance of the policy. Accounting principles should be based on what happens in the ordinary course of business rather than what happens in exceptional cases (which drive instead the prudential determination of capital requirements). In our view, such contracts should be treated similarly to the other contracts where there is a legal obligation to distribute a significant share of returns, provided the insurer can demonstrate that historical and market practice has created a valid expectation by policyholders that the insurer will distribute a significant share of returns on underlying items to them.

The treatment proposed by the IASB will also result in various methods of accounting for contracts which are effectively managed in a similar way. The inconsistency may result in both reduced comparability of financial statements of different companies and various treatments of economically similar contracts in the consolidated financial statements of multinational insurance companies which would create a significant operational burden without benefits for users.

**What we propose:** Where an entity can clearly demonstrate from its historical statistics that it has consistently distributed a significant share of returns on underlying items to policyholders and that it intends to continue doing so, the entity should be able to apply the variable fee approach alongside the other contracts where such a share stems from a legal basis. Economic substance should override legal forms of contracts.

### 3. Derivatives used to mitigate financial market risk

**Issue:** Derivative instruments are frequently used in the industry to mitigate financial market risk of insurance contracts with participation features. When an entity applies the variable fee approach to contracts in which financial risks, such as options and guarantees, have been mitigated with a derivative, there is a volatility in profit or loss due to the fact that changes in the fair value of the derivative are recognised in profit or loss while the related mitigated financial risks are recognised on the balance sheet in the CSM. The IASB provided an option for contracts qualifying for the variable fee approach to recognise the changes in mitigated financial risks to profit or loss so as to offset the changes in fair value of the derivatives used to mitigate those risks. Initially, the IASB had restricted this treatment to options and guarantees only. Most test participants welcomed the option, but noted that insurers mitigate (or economically hedge) more risks than just options and guarantees and that such a mitigation of risks occur in the general model. Also, it should be noted that the hedging adjustment under the variable fee approach is only to be applied prospectively on transition, which can lead to misstatement of equity on transition and of future profits.

**IASB approach:** In November 2016, the IASB decided to expand the treatment to all financial risks (i.e. beyond options and guarantees embedded into insurance contracts) that are mitigated but re-confirmed its restriction to the variable fee approach only.

**Why we think the IASB approach can be further improved:** We commend the IASB for expanding the option to all financial risks, however we note that insurers mitigate more than just financial risks. For example, insurers may mitigate longevity risk or mortality risk using a derivative. Even if such a mitigation is performed on contracts that fall within the variable fee approach, it seems that it would not avail of the option since the mitigated risks are not financial risks. The IASB should therefore allow the treatment to be applied to all risks, including non-financial risks, to the extent that they are mitigated or economically hedged.

Furthermore, insurers mitigate risks on contracts that fall within the scope of the general model. In the absence of the application of the option to the general model, insurers who use the OCI option under the general model would

endure accounting mismatch arising from the fact that changes in the mitigated risks would be recognised in OCI while changes in fair value of related derivatives are recognised in profit or loss. Therefore, the IASB current proposal gives rise to inconsistency in the treatment of insurance contracts that are mitigated (or economically hedged) similarly. The IASB argues that the option was intended to mitigate the unintended consequence of applying the variable fee approach. However, we note that similar unintended consequence arises in the general model where the OCI option applies and the option for profit or loss presentation is considered to not be an adequate alternative.

**What we propose:** A further expansion of scope of the option should be introduced that would allow to be applicable to both financial and non-financial risks to the extent that they are mitigated, regardless of whether the underlying insurance contract falls within the variable fee approach or the general model. This would result in consistent accounting treatment of all risks mitigated similarly. Such an option would equally be welcome by many insurers who macro-hedge risks and therefore do hold hedged items and hedging instruments in the same unit of accounts.

#### 4. Changes in estimates

**Issue:** In June 2016, the Board tentatively decided that when an experience adjustment causes a change in the estimate of the present value of future cash flows the combined effect is regarded as relating to future coverage or other services, and thus recognised into CSM.

During the field testing phase of 'Draft IFRS 17', some respondents found it difficult to determine if a change in estimate of the present value of future cash flows related to an experience adjustment arising in the current period or not. If it did, the entire effect of the experience adjustment would be recognised in the CSM. Under the general model, the majority of experience adjustments would cause a change in the estimates of the present value of future cash flows and would, therefore, adjust the CSM (rather than be recognised in profit or loss). Respondents noted operational challenges, for example, if systems do not identify the causes of change in estimates and considered as not meaningful that all experience adjustments impacting future cash flows would be taken to CSM. Indeed, such a treatment would not result in a meaningful revenue and net income, e.g. in the case of a pandemic event.

**IASB approach:** In response, the IASB addressed the issue at its November 2016 meeting and concluded that when an experience adjustment directly causes a change in the estimate of the present value of future cash flows, the combined effect of the experience adjustment and the change in the estimate of the present value of the future cash flows should not adjust the contractual service margin, but should be recognised in profit or loss instead. Similarly, the Board decided that, for contracts measured under the variable fee approach, experience adjustments arising from non-financial risk that do not affect the underlying items, and any directly caused changes in the estimates of the present value of future cash flows should not adjust the CSM but should be recognised in profit or loss.

**Why we think the IASB approach can be further improved:** We commend the IASB for taking these decisions. However, we are concerned that the wording of the requirement may result in unintended consequences. For example, when there is an unexpected additional premium paid by a policyholder which results in additional future benefits, it is not clear whether the combined effect would also be recognised in profit or loss as a result of the experience adjustment amendments. Clearly, such effects should be recognised in CSM as the additional premium is received in consideration for future services.

It would be more relevant, where operationally feasible, to recognize the impact of variances between actual and expected experience on future period cash flows in the CSM. Otherwise a need arises to distinguish between those changes and impact of changes in estimates unrelated to experience adjustments. We recommend that reporting entities should have the possibility to develop its own accounting policy in this regard.

**What we propose:** We would recommend the IASB to clarify the situation of experience adjustments in the final drafting to avoid unintended consequences. We understand that the IASB intends to make some changes in this area at their next February meeting and we will be following up on their decisions closely.

## 5. Transition

**Issue:** The IASB proposed that at the beginning of the earliest period presented, the CSM should be calculated on (1) a fully retrospective approach unless impracticable; (2) a simplified retrospective approach unless impracticable; or (3) a fair value basis where both fully and simplified retrospective approaches impracticable.

Most field testing respondents noted that given the long-term nature of insurance contracts, it would be difficult to find historical information that allows to apply the retrospective approaches because of practical constraints affecting the ability to perform retrospective calculations, such as:

- Lack of availability of historic data, e.g. administration systems often do not store the premium payment history.
- Actuarial valuation models are developed over time. Consequently, it is often not possible to run existing actuarial valuation models on historic data.
- Historic cash flow data is only available for a limited number of years.
- Historic cash flow data is only available to a limited level of granularity.
- Historic assumption sets (e.g. used to determine best estimate liabilities) are only available for a limited number of years.

This would result in almost all insurers defaulting to the use of the fair value approach. However, we believe that the fair value approach is not suitable for measuring insurance contracts for the following reasons:

- The notion of fair value takes into account any possible contract renewals even if the renewal is outside the insurance contract boundary, unless the IASB introduces an exception similar to IFRS 3 exception on re-acquired rights; and
- IASB has not clarified how the principles of IFRS 13 can be applied to measure insurance contracts, i.e. there is no active market price for insurance contracts and discounting expected cash flows with risk adjustment may not yield appropriate results.

**IASB approach:** In response, the IASB addressed the issue at its November meeting and decided to provide a choice between the modified retrospective approach (i.e. previously known as the simplified approach) and the fair value approach, where full retrospective application of IFRS 17 is impracticable. However, where there is no reasonable and supportable information to apply the modified retrospective approach the fair value approach is to be applied.

**Why we think the IASB approach can be further improved:** We welcome the IASB decision to allow a choice between the modified retrospective approach and the fair value approach. However, we are concerned that in the absence of reasonable and supportable information, the IASB staff papers appeared to restrict the use of the modified retrospective approach to a list of permitted modifications. Such a restriction may result in many insurers still defaulting to the use of the fair value approach on transition. However, the general concern is that the fair value approach might be relatively less difficult to implement, while modified retrospective approach represents a more desirable and suitable option to achieve a proper determination of CSM at transition. The appropriately determined CSM on business in-force is key to ensure a faithful performance reporting afterwards.

**What we propose:** We would urge the IASB to clarify in the final drafting that under the modified retrospective approach, if there is relatively little reasonable and supportable historical information, the insurer should be permitted to use modifications, including judgements and estimates other than just those listed in paragraphs C9-C18 of the Extracts from external review draft of IFRS 17, to arrive at an amount that approximates full retrospective application.

**Other important topics not covered by IASB testing:**

**1. Mandatory restatement of comparative information in IFRS 17 at transition**

We note the lack of alignment of comparative restatements as a result of the implementation of IFRS 9 and IFRS 17 and we urge the IASB to make comparative restatements optional under IFRS 17 as it is under IFRS 9. This would avoid a mismatch of comparative figures and provide an operational relief for insurers when adopting IFRS 17.

**2. Patterns of CSM amortisation under premium allocation approach and general model**

The CSM should be released to profit or loss in a way that best reflects the transfer of services under the contract, rather than always on a straight line basis. However, the IASB has mandated that the transfer of services is recognised on straight line basis through passage of time. We note that the IASB has made an exception for premium allocation approach, under which either straight line basis or expected timing of claim basis are permissible. This option is not provided under the general model, which only allows straight line amortisation of the CSM. However, in some cases expected timing of claim basis may best reflect the transfer of services for the contracts accounted for under the general model.

For example, for a hurricane insurance, the recognition of CSM amortisation should duly reflect the risks of the hurricane seasons, rather than be evenly spread during the term of the contract. Whilst the IASB also allows amortisation of the CSM on expected timing of claim basis under the premium allocation approach, some insurers may prefer to account for the same contract under the general model for practical reasons (if they use a single model for all contracts). In this case, these insurers would have to amortise the CSM on straight line basis, which would not make sense, given the nature of the contract.

To avoid inconsistency of measurement of the CSM under different approaches we urge the IASB to extend the option of applying expected timing of claim basis to contracts accounted for under general model.