IFRS 17 *Insurance Contracts* – Towards a DEA
Appendix I

Background to IFRS 17

1 This paper presents a summary of IFRS 17 *Insurance Contracts* as prepared by the EFRAG Secretariat. Although IFRS 17 applies to all insurance contracts, regardless of the business of the issuing party, the most significant impact is on insurers. As a result, the focus of this [draft] endorsement advice is on the impact on insurers.

2 IFRS 17 will replace IFRS 4 *Insurance Contracts*. IFRS 4 was an interim standard that allowed entities to use a wide variety of accounting practices for insurance contracts, reflecting national accounting requirements and variations of those requirements. The differences in accounting treatments across jurisdictions and products, together with the option for an entity not to have a single accounting policy, made it difficult for investors and analysts to understand and compare insurers' results. Most stakeholders, including insurers, agreed on the need for a global insurance accounting standard that addressed the limitations of IFRS 4 even though opinions varied as to what such a standard should require.

How the issues have been addressed

3 The objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents insurance contracts. This information will give a basis for users of financial statements to assess the effect that insurance contracts have on the entity's financial position, financial performance and cash flows.

4 Under IFRS 17, entities will apply a consistent accounting framework for all insurance contracts. The aim is to increase comparability (i) among insurers as many insurance accounting differences will be removed and (ii) with other industries as the deposit component is excluded from revenue, like banking. Furthermore, multinational companies who currently consolidate their subsidiaries using non-uniform accounting policies for insurance contracts issued in different jurisdictions will now apply consistent accounting policies.

What has changed?

5 Because the current standard, IFRS 4, permits a range of practices, the major change brought by IFRS 17 is to remove the options in IFRS 4 and mandate the measurement of insurance liabilities and the recognition of insurance income and expenses. Accordingly, this section first considers the measurement requirements in IFRS 17.

6 In doing so, in cases where a contract contains distinct components, IFRS 17 requires separation of these components where they would be within the scope of another standard if they were separate contracts. Furthermore, IFRS 9 *Financial Instruments* should be applied to determine whether there is an embedded derivative that should be separately recognised and measured.

Measurement of insurance liabilities

Introduction: general measurement model

<u>Initial recognition</u>

7 IFRS 17 describes principles for the measurement requirements for groups of insurance contracts. One of the key principles of IFRS 17 is that an insurer

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recognises and measures groups of insurance liabilities (often referred to as "technical provisions" under current accounting) as the sum of:

(a) The fulfilment cash flows, which are an unbiased risk-adjusted probability weighted estimate of the present value of the future cash flows that incorporates all available information about those cash flows in a way that is consistent with observable market information; plus (if this value is a liability) or minus (if this value is an asset);

(b) The contractual service margin, which is an amount representing the unearned profit in the group of contracts.

8 The fulfilment cash flows themselves are composed of the following building blocks:

(a) Estimates of future cash flows that will arise as the entity fulfils the contracts. This will include only the cash flows inside the contract boundary, i.e. the cash flows that do not relate to future insurance contracts. IFRS 17 requires the use of current estimates based on the most up-to-date information available and disclosure of the relevant assumptions. This measurement basis is entity-specific, e.g. the client portfolios of one insurer are often not the same as another insurer, and the expected lapse rate of clients of insurer A are likely to differ from the expected lapse rate of clients of insurer B.

Currently, insurers can use estimates that are not updated or not fully updated after contract inception.

(b) An adjustment that reflects the time value of money (discounting). IFRS 17 requires an insurer to discount the cash flows from insurance contracts using discount rates that reflect the characteristics of the cash flows arising from the insurance contract liability and are consistent with observable current market prices where relevant.

Currently, some insurers discount the future cash flows from insurance contracts using discount rates that are based on the expected return on assets backing the insurance contract liability. Other insurers use a discount rate specified by law or a regulator. A few insurers use a risk-free discount rate whilst others do not discount their future cash flows; and

(c) An explicit risk adjustment for non-financial risk that represents the compensation the entity requires for bearing the uncertainty about the amount and timing of cash flows that arise from non-financial risk.

Currently, insurers follow different approaches to reflecting risk: risk margins can be implicit or explicit; can be applied to some and not to all insurance contracts; or only used for regulatory purposes.

<u>Financial options and guarantees</u>

9 IFRS 17 requires an insurer to include all financial options and guarantees embedded in insurance contracts in the measurement of the fulfilment cash flows, in a way that is consistent with observable market prices for such options and guarantees. This is done including all possible outcomes as a probability-weighted mean.

10 Current accounting for financial options and guarantees embedded in insurance contracts differs between entities. In some cases, embedded financial options and guarantees are not recognised until current rates fall below the guaranteed minimum. In other cases, embedded financial options and guarantees are recognised and their measurement reflects the possibility that they might become worthy of exercising (i.e. reflects both intrinsic value and time value). However, in some cases, the measurement is inconsistent with relevant market prices.

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Consistent treatment of acquisition costs

11 IFRS 17 requires an insurer to include in the measurement of insurance contracts all fulfilment cash flows, including directly attributable acquisition cash flows. Therefore, a separate asset associated with the acquisition of insurance contracts is not recognised for a recognised group of contracts. When applying IFRS 17, at inception any lack of recoverability of the acquisition cash flows will be reflected in the measurement of the contractual service margin.

12 Currently, most insurers recognise deferred acquisition costs as assets for costs associated with writing new insurance contracts. Other insurers recognise acquisition costs as they are incurred as an expense.

Consistency with other IFRS Standards

13 The measurement required by IFRS 17 results in:

(a) the liability for a group of insurance contracts relating to performance obligations for remaining service being measured broadly consistently with IFRS 15 *Revenue from Contracts with Customers*. However, the major differences from IFRS 15 are that:

(i) the measurement is updated for changes in financial assumptions; and

(ii) the liability often includes an investment component typically not found in contracts within the scope of IFRS 15; and

(b) the liability for a group of insurance contracts relating to incurred claims being measured broadly consistently with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, except that the liability often includes an investment component that is typically not in contracts within the scope of IAS 37.

Subsequent measurement

14 Subsequent to initial recognition, the total liability of a group of insurance contracts comprises:

(a) A liability for remaining coverage that represents the portion of the fulfilment cash flows relating to coverage that will be provided under the contracts in future periods, plus the remaining contractual service margin, if any; and

(b) A liability for incurred claims that represents the fulfilment cash flows for claims and expenses already incurred but not yet paid.

15 The contractual service margin is updated to reflect the time value of money and amounts recognised in profit or loss as services have been provided.

Changes or simplifications to the general measurement model

16 To accommodate specific types of contracts, changes to the general measurement model are made for:

(a) insurance contracts with direct participation features, recognising the specific conditions of these contracts;

(b) reinsurance contracts held, reflecting that these represent a service that has been purchased;

(c) investment contracts with discretionary participation features which are covered by IFRS 17 even if these contracts do not transfer significant insurance risk; and

(d) short term contracts or contracts where the measurement of the insurance liability would not differ materially from application of the general requirements (referred to as the Premium Allocation Approach).

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Insurance contracts with direct participation features

17 Insurance contracts with direct participation features are insurance contracts for which, at inception (i) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items; (ii) the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns from the underlying items; and (iii) the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.

18 For such contracts changes in fulfilment cash flows arising from the time value of money and changes in financial risks are recognised in the contractual service margin as they represent part of the variability of the fee for future service. Also, there is no explicit accretion of the contractual service margin as it is remeasured when it is adjusted for changes in financial risks.

Reinsurance contracts held

19 With the aim of reflecting the extent to which reinsurance contracts depend on the insurance contracts they are covering, entities use consistent assumptions in measuring the future cash flows of reinsurance contracts held. Also, the effect of non-performance of the reinsurer is considered. The risk adjustment for a group of reinsurance contracts held represents the amount of risk being transferred by the cedant to the reinsurer.

20 For these contracts, the contractual service margin on initial recognition represents a net cost or net gain from the purchase of the reinsurance. Currently the reinsurance contract held is usually measured consistently with the measurement of the underlying contracts rather than the expected cash flows.

Investment contracts with discretionary participation features

21 These contracts do not transfer significant insurance risk. The general measurement requirements are modified for these contracts as follows:

(a) the date of initial recognition is the date the entity becomes party to the contract;

(b) cash flows are within the contract boundary if they result from a substantive obligation of the entity to deliver cash at a present or future date. The entity has no substantive obligation to deliver cash if it has the practical ability to set a price for the promise to deliver the cash that fully reflects the amount of cash promised and related risks; and

(c) the contractual service margin is recognised over the duration of the group of contracts in a systematic way that reflects the transfer of investment services under the contract.

Premium Allocation Approach

22 Under this approach the insurance liability for remaining coverage is measured at initial recognition as the difference between the premiums received and insurance acquisition cash flows at that date (unless the insurer has chosen to recognise the payments as an expense).

23 Subsequently, the carrying amount of the liability is the carrying amount at the start of the reporting period:

(a) plus the premiums received in the period;

(b) minus insurance acquisition cash flows, unless the entity chooses to recognise these payments as an expense when incurred;

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(c) plus the amortisation of insurance acquisition cash flows recognised as an expense in the reporting period; unless the entity chooses to recognise insurance acquisition cash flows as an expense when incurred;

(d) plus any adjustment to a financing component;

(e) minus the amount recognised as insurance revenue for coverage provided in that period; and

(f) minus any investment component paid or transferred to the liability for incurred claims.

Other issues

24 Other topics that will require changes in current practice are:

(a) Grouping of insurance contracts;

(b) Onerous contracts;

(c) Accounting policy choices;

(d) Risk mitigation;

(e) Reinsurance contracts issued and held;

(f) Sharing of risks;

(g) Presentation and disclosure; and

(h) Transition.

Grouping of insurance contracts

25 Most insurers do not manage their contracts on an individual basis. IFRS 17 requires insurers to identify portfolios of contracts that are subject to similar risks and that are managed together. For example, contracts within a product line would be expected to have similar risks and in the same portfolio if they are managed together. However, contracts in different product lines (such as single premium fixed annuities compared to regular term life assurance) would not be expected to have similar risks and therefore would be expected to be in different portfolios. Further division of the portfolios into groups of (i) onerous contracts, if any, (ii) contracts that have a significant possibility of becoming onerous, if any and (iii) contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any, is aimed at identification of losses. A group of contracts cannot include contracts issued more than one year apart. This is to ensure that the contractual service margin relating to a group of contracts is released to profit or loss appropriately over the period of the contract and is entirely recognised in profit or loss when the last contract in the group is derecognised.

26 Situations occur when law or regulation constrains the entity's practical ability to set a different price or level of benefits for contracts or policyholders with different characteristics. IFRS 17 permits an exception to the overall grouping requirements, in that, when law or regulation constrains the entity's practical ability to set a different price or level of benefits for contracts or policyholders with different characteristics, insurance entities can include such contracts in the same group.

27 Existing insurance practices on grouping of insurance contracts vary depending on jurisdiction, type of contracts and underlying purpose of the grouping. Practices range from individual contract level to groupings that are broader than the grouping required by IFRS 17.

Onerous contracts

28 One effect of the grouping required by IFRS 17 is that losses on contracts that are onerous at initial recognition are recognised immediately in profit or loss to achieve

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timely recognition of losses. Subsequently, the insurer is required to regularly update the fulfilment cash flows:

(a) for existing groups of onerous contracts, to recognise any additional losses for groups of onerous contracts in profit or loss; and

(b) for groups of contracts that become onerous during the reporting period, to recognise changes for additional expected outflows in in profit or loss.

29 Under existing requirements, entities may assess onerous contracts at a high level of aggregation (using a liability adequacy test), allowing loss-making contracts to be offset with profit-making contracts and losses to be recognised only when all of the aggregated contracts considered within the test are loss-making. Also, under current practice there is generally no identification of onerous contracts on initial recognition.

Accounting policy choices

<u>Discounting</u>

30 Both for contracts with and without participating features, IFRS 17 offers an accounting policy choice for dealing with insurance finance income or expenses. This accounting policy choice allows entities to recognise insurance finance income or expenses either in profit or loss or disaggregating it between other comprehensive income and profit or loss.

<u>Own debt or equity instruments as underlying items</u>

31 IFRS 17 amends IFRS 9 and IAS 32 *Financial Instruments: Presentation*, by providing an irrevocable accounting policy choice on an instrument-by-instrument basis, where the entity holds its own debt or treasury shares as underlying items for a group of direct participating contracts or similar investment funds.

32 In the case of own debt instruments, an entity may elect not to derecognise its financial liability that is included in such a fund or is an underlying item. Instead, the entity may elect to continue to account for that instrument as a financial liability and to account for the repurchased instrument as if the instrument were a financial asset, and measure it at fair value through profit or loss.

33 In the case of treasury shares, the entity may elect to continue to account for treasury shares as equity or to account for the reacquired equity instrument as if it were a financial asset measured at fair value through profit or loss.

Risk mitigation

34 For contracts with direct participation features, an entity may choose not to recognise a change in the contractual service margin relating to some or all of the changes in the effect of financial risk on the entity's share of underlying items. The documentation requirement for this option is analogous to that for hedge accounting in IFRS 9. This risk mitigation requirement is to be applied prospectively from application of the standard.

Reinsurance contracts issued and held

35 Reinsurance contracts issued are recognised and measured as with any other insurance contract issued. This will require a change to many current practices as many insurers measure reinsurance contracts held based on the measurement of the insurance contracts underlying the reinsurance contract.

36 Like IFRS 4, IFRS 17 requires a reinsurance contract held to be accounted for separately from the underlying insurance contracts to which it relates. This because an entity that holds a reinsurance contract does not normally have a right to reduce the amounts it owes to the underlying policyholder by amounts it expects to receive from the reinsurer.

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37 Reinsurance contracts held and issued cannot be contracts with direct participation features for the purposes of IFRS 17.

Sharing of risks

38 Some insurance contracts affect the cash flows to policyholders of other contracts by requiring those policyholders to share with policyholders of other contracts the returns on the same specified pool of underlying items. Therefore, either of the policyholder groups may bear a reduction in their share of the returns because of payments to other policyholder groups. IFRS 17 requires the cash flows of each group to reflect the extent to which it is affected.

39 Sharing of risks is not captured explicitly in current accounting requirements. However, as a common business practice it is considered in the calculation of the insurance liabilities (but at a higher level of aggregation than required by IFRS 17).

Presentation and disclosure

Presentation in the statement of financial position

40 Insurance contracts are presented on the statement of financial position as insurance contract liabilities (or as insurance contract assets). This is a change from many existing practices as currently most insurers do not show insurance assets and liabilities separately.

Presentation in the statement of financial performance

41 IFRS 17 requires the income statement to separately present the insurance service result and insurance finance income and expenses.

Insurance service result

42 The insurance service result reflects changes in the insurance liability and it is presented as insurance revenue less insurance service expenses.

43 Under IFRS 17, insurance revenue is determined and presented consistently with the approach in IFRS 15 for the recognition of revenue from contracts with customers. Therefore, insurance revenue depicts the provision of coverage and other services arising from the group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services.

44 Revenue for insurance services arises from the:

(a) Allocation of the contractual service margin;

(b) Release of the risk adjustment for non-financial risk;

(c) Insurance service expenses incurred; and

(d) Amounts related to insurance acquisition cash flows.

45 As IFRS 17 requires an insurer to report as insurance revenue the consideration for services as they are provided, insurance revenue excludes deposit components which represent policyholders' investments, rather than consideration for services provided. Under current practice, some insurers recognise all premiums (including any deposit component) as revenue.

46 Insurance service expenses includes incurred claims; other incurred service expenses; amortisation of insurance acquisition cash flows; and changes relating to past and future services. As for insurance revenue, this excludes repayment of deposit components which represent policyholder investments.

Insurance finance expenses or income

47 IFRS 17 requires an insurer to report separately the insurance finance income or expenses. This comprises the investment return on assets, the effect of the time

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value of money on the investments as well as the insurance liability and the effect of changes in financial assumptions for example changes in discount rates.

Disclosures

48 To enable users of financial statements to assess the effect that contracts within the scope of IFRS 17 have on the financial position, financial performance and cash flows of an insurer. IFRS 17 requires disclosure of qualitative and quantitative information about:

(a) the amounts recognised in its financial statements from insurance contracts;

(b) the significant judgements, and changes in those judgements, made when applying IFRS 17;

(c) detailed reconciliations of opening and closing balances; and

(d) the nature and extent of the risks from contracts within the scope of IFRS 17.

Transition

49 An insurer is required to account for its insurance and reinsurance contracts as if IFRS 17 had always been applied unless this is impracticable (for example, if, after making every reasonable effort, the insurer is unable to gather historical data for contracts issued many years before). When retrospective application is impracticable, an insurer can measure existing insurance contracts when it first applies IFRS 17 using either:

(a) a modified retrospective approach - which can be used only if reasonable and supportable information is available; or

(b) fair value.

50 For the transition requirements, the date of initial application is the start of the annual reporting period in which an insurer first applies IFRS 17, and the transition date is the beginning of the period immediately preceding the date of initial application. On transition, an insurer should restate the numbers for the comparative period, i.e. from the transition date.

When does IFRS 17 become effective?

51 An insurer shall apply IFRS 17 for annual periods beginning on or after 1 January 2021. An insurer can choose to apply IFRS 17 before that date, but only if it also applies IFRS 9 and IFRS 15.

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