Appendix 2: Relevance and Reliability Issues paper

Introduction and Objective

1 The objective of this paper is for EFRAG TEG to discuss two sections: Relevance and Reliability that will form part of the IFRS 17 *Insurance Contracts* draft endorsement advice. This is an updated version subsequent to the January 2020 EFRAG IAWG and EFRAG TEG meetings.

2 In providing its assessment on whether IFRS 17 results in relevant and reliable information, EFRAG has considered the requirements of IFRS 17, including the outcome of the December 2019 and January 2020 IASB tentative decisions relating to the amendments to IFRS 17. The EFRAG Secretariat does not intend to analyse all the IASB tentative decisions relating to the IFRS 17 Amendments, only topics with substantial debate. The EFRAG Secretariat notes that this paper does not cover annual cohorts nor topics that the IASB is re-deliberating in its February meetings. These topics will be brought to EFRAG IAWG and EFRAG TEG in a future meeting. The Appendix will be presented at the EFRAG Board once finalised in all its components. Preliminary discussions at the EFRAG Board on specific topics in the ongoing IASB deliberation process, if needed, will be supported by ad-hoc issue papers.

3 EFRAG has focused its assessment on the requirements it considered most significant in relation to each of the criteria, in continuity with previous Endorsement Advices. EFRAG has accordingly focused on guidance that:

(a) is fundamental to the accounting for insurance contracts;

(b) has been subject to substantial debate (evidenced by the comments EFRAG has received from constituents including participants in EFRAG's field-tests and the comment letter due process on the amendments to IFRS 17);

(c) may be problematic to apply evidenced by the results of EFRAG's field-tests; and

(d) relates to the issues raised by the European Commission in its request for endorsement advice.

4 EFRAG has assessed IFRS 17 requirements against each of the technical criteria for each of the following topics:

	Topic	Relevance	Reliability
1	Measurement of insurance contracts (including discount rates)	X	X
2A	Different insurance accounting models	X	X
2B	Reinsurance contracts held	X	X
3	Level of aggregation (including identification of onerous contracts)	X	X
4	Treatment of investment component	X	X
5	Risk mitigation	X	X
6	Sharing of risks	X	X

7	Contractual service margin	X	X
8	Presentation on the statement of comprehensive income	X	
9	Presentation on the statement of financial position	X	
10	Contract boundaries	X	
11	Separating components from an insurance contract	X	X
12	Recognition of liabilities arising from insurance contracts		
13	Disclosures	X	X[1]
14	Transition requirements	X	X
15	Restatement of comparatives		
16	Business combinations	X	
17	Acquisition costs		X
18	Premium allocation approach		X
19	Scope exclusions for loans	X	
20	Discount rates		X

Relevance

5 One of the technical criteria set out in the Regulation (EC) No 1606 2002 for the adoption of international accounting standards is Relevance. Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.

6 EFRAG considered whether IFRS 17 would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information. In its assessment of relevance, EFRAG has identified the following topics as being significant to this assessment:

(a) Scope exclusion for loans;

(b) Measurement of insurance contracts;

(c) Separating components from an insurance contract;

(d) Different insurance accounting models;

(e) Reinsurance contracts held;

(f) Level of aggregation;

(g) Sharing of risks;

(h) Treatment of investment component;

(i) Risk mitigation;

(j) Performance of the insurance business;

(k) Contract boundaries;

(l) Presentation on the statement of comprehensive income;

(m) Presentation on the statement of financial position;

(n) Disclosures;

[1] Disclosures relating to the contractual service margin release.

(o) Transition requirements; and

(p) Business combinations;

Scope exclusion for loans

7 IFRS 17 provides an accounting policy choice at portfolio level which is irrevocable, to apply IFRS 17 or IFRS 9 to contracts that meet the definition of an insurance contract but limit the compensation for insured events to the amount required to settle the policyholder's obligation created by the contract (for example, loans).

8 EFRAG considers that this choice provides relevant information because an entity would apply the same Standard to those contracts as it applies to other similar contracts it issues. For example, an entity that mainly issues insurance contracts may apply IFRS 17 to these loans while an entity that mainly issues financial instruments may apply IFRS 9.

Measurement of insurance contracts

9 EFRAG discusses issues relating to contract boundaries in the paragraphs 82 to 87 below.

Measurement components

10 The distinction between contracts with and without direct participation features is discussed in paragraphs 35 to 41 below.

11 The general measurement model for an insurance contract comprises:

(a) the fulfilment cash flows which consist of (i) current expected future cash inflows and outflows, (ii) adjustment to reflect the time value of money and financial risks related to the future cash flows (discount rate) and (iii) a risk adjustment to reflect the uncertainty about the amount and timing of future cash flows for non-financial risk; and

(b) the contractual service margin which represents the expected unearned profit that the entity will recognise as it provides services in the future.

<u>Future cash flows</u>

12 IFRS 17 requires an entity to make an unbiased probability-weighted estimate of the future cash flows. Since the cash flows generated by insurance contracts are uncertain, entities will assess and capture a full range of foreseeable outcomes and their probabilities. As a result, EFRAG is of the view that this estimate will result in relevant information together with the associated disclosure requirements as more fully discussed in paragraph 110.

13 EFRAG considers that estimating only those cash inflows and outflows within the contract boundary (see paragraphs 82 to 87) will provide relevant information because it reflects the rights and obligations that arise from the contract, law or regulation.

<u>Embedded options and guarantees in insurance contracts</u>

14 Many insurance contracts contain significant embedded options and guarantees. The cash flow estimates will incorporate the intrinsic value of embedded options and guarantees as IFRS 17 requires the entity to look at a full range of possible scenarios in estimating the options and guarantees. In addition, the time value of options and guarantees, which reflects the uncertainty about the amount and timing of the options and guarantees occurring, is included in the measurement. Therefore, incorporating options and guarantees in the measurement of the cash flows will provide relevant information.

Treatment of acquisition cash flows

15 IFRS 17 requires an entity to allocate, on a systematic and rational basis, insurance acquisition cash flows that are directly attributable to a group of insurance contracts to that group and to any groups that include contracts that are expected to arise from renewals of the contracts in that group. An asset is recognised before the group of insurance contracts to which they are allocated is recognised and the recoverability of this asset is assessed if facts and circumstances indicate the asset may be impaired.

16 EFRAG considers that 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. Therefore, the allocation of insurance acquisition cash flows to expected renewals will provide relevant information to users of financial statements by better reflecting the economic substance and general understanding of these transactions.

17 In addition, the impairment test will also provide relevant information to users for their decision-making because they will be provided with information regarding to what extent an entity considers the acquisition cash flow asset would be recoverable.

18 Other areas analysed relating to the contract boundary of insurance contracts are presented in paragraphs 82 to 87.

Discounting

19 IFRS 17 requires entities to discount cash flows using observable current market data. The discount rates should include only relevant factors relating to the liability, i.e., factors that reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts. An entity may determine the appropriate discount rates using either a top-down[2] or a bottom-up approach[3].

20 As insurance contracts can run over many years, EFRAG considers that discounting the future cash flows reflects the impact of the passage of time, thus providing relevant information for users of financial statements on an entity's financial position.

21 EFRAG assesses that the reflection of the time value of money provides relevant information. Incorporating liquidity characteristics is also considered to provide relevant information because it reflects the liquidity of the items being measured. For many insurance contracts, the entity cannot be forced to make payments earlier than the occurrence of insured events, or dates specified in the contract. In addition, EFRAG considers that the discount rate chosen by entities will provide useful information on the characteristics of the cash flows because it will be focussed on the nature of the liability, for example, cash flows that vary based on returns from underlying items would use rates that reflect that variability.

22 The analysis of the locked-in discount rate for the contractual service margin is presented from paragraphs 76 to78. The analysis on accounting policy choice for insurance finance income or expenses to be recognised either in profit or loss or

[2] This is where the discount rates of the liability reflect the current market rates of return implicit in a fair value measurement of a reference portfolio of assets. Then the entity would eliminate any factors that are not relevant to the insurance contracts (but is not required to adjust for differences in liquidity characteristics of the insurance contracts and the reference portfolio).

[3] This is where a liquid risk-free yield curve is adjusted to reflect the differences between the liquidity characteristics of the financial instruments that underlie the rates observed in the market and the liquidity characteristics of the insurance contracts.

disaggregated between profit or loss and other comprehensive income is discussed in paragraphs 98 to 99.

<u>Risk adjustment</u>

23 Incorporating an explicit risk adjustment will provide relevant information to users of financial statements because the users will be able to evaluate the entity's view of the economic impact imposed by the non-financial risk associated with the entity's insurance contracts. In addition, any subsequent changes in estimates of the risk adjustment will provide users with useful information relating to any change in the entity's views relating to non-financial risk.

24 The risk adjustment includes the degree of diversification benefit when determining the compensation that the entity requires for bearing the risk.

<u>Current measurement</u>

25 EFRAG is of the view that the use of current updated estimates at the end of each reporting period for the fulfilment cash flows provides relevant information about the entity's contractual obligations and rights by reflecting information about the amounts, timing and uncertainty of the cash flows generated by those obligations and rights. Updated estimates also provide relevant information because these take into consideration current developments which may impact the fulfilment cash flows. Therefore, the users of financial statements can better assess the predictability of cash flows and can also better assess the adequacy of the liability.

<u>Contractual service margin</u>

26 The contractual service margin is determined on initial recognition of a group of insurance contracts as the amount that eliminates any gains arising at that time because services have not yet been provided.

27 EFRAG is of the view that the contractual service margin provides relevant information because it provides a transparent view of the expected but unearned profit that the entity considers that it will make from the insurance contracts over the coverage period. If entities need to change the fulfilment cash flows which relate to future periods (IFRS 17 specifies what relates to future services), the contractual service margin is adjusted to reflect this change. This updating to reflect the current conditions provides relevant information.

28 In addition, the contractual service margin provides relevant information because it enables users to consider the allocation of the unearned profit over the reporting periods included in the coverage period.

29 EFRAG's analysis on the release pattern of the contractual service margin to profit or loss is explained in paragraphs 79 to 81 below.

Questions for EFRAG TEG

30 Do you have any comments from paragraph 7 to 29? Please explain.

Separating components from an insurance contract

31 Insurance contracts may combine different types of insurance coverage, thereby grouping different insurance risks into one legal insurance contract. It is argued by some that the Standard should permit the separation of different insurance risks contained in a single insurance contract.

32 Under IFRS 17, an entity has to apply IFRS 9 to determine whether there is an embedded derivative to be separated. An entity also has to separate from a host insurance contract an investment component only if it is distinct and also any promise to transfer to a policyholder distinct goods and services (other than insurance contract services). IFRS 17 is then applied to the remaining components.

33 EFRAG considers that entities would usually design contracts in a way that reflects their substance. Therefore, a contract with the legal form of a single contract would generally be considered on its own to be a single contract in substance. In addition, the lowest unit of account that is used in IFRS 17 is the contract that includes all insurance components.

Different insurance accounting models

34 IFRS 17 defines the principles for the measurement of insurance contracts as assessed above. Those principles are modified or simplified for:

(a) contracts with direct participation features;

(b) reinsurance contracts held;

(c) investment contracts with discretionary participation features; and

(d) contracts where the premium allocation approach is applied.

Contracts with direct participation features

Distinction between contracts with and without direct participation features

35 IFRS 17 distinguishes between insurance contracts with and without direct participation features.

36 Contracts with direct participation features are substantially investment-related contracts. Insurance contracts with direct participation features are insurance contracts for which, on inception:

(a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;

(b) the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items; and

(c) 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.

37 EFRAG assesses that a specific treatment is justified for these contracts with direct participation features because:

(a) of the different nature of the fee in these contracts, i.e., the returns to the entity from a pool of underlying items should be viewed as the compensation that the entity charges the policyholder for service provided by the insurance contract, rather than as a share of returns from an unrelated investment. Therefore, a different treatment represents the nature of the contractual arrangement. These contracts are creating an obligation to pay policyholders an amount that is linked to returns and value of specified underlying items, minus a variable fee for service; and.

(b) the entity is often constrained when exercising its control over the underlying items because (i) the quantum of underlying items is determined entirely by the premiums paid by the policyholder; (ii) the entity is usually expected to manage the policyholder's invested premiums for the benefit of the policyholders, acting for them in a fiduciary capacity; and (iii) some aspects of the entity's management of the underlying items might be specified in the contract[4].

[4] EFRAG notes that the term contract used here can also mean by law or regulation as per paragraph 2 of IFRS 17.

38 Any changes in the fair value of the underlying items will cause a change in the amount of the fee that the entity will receive. EFRAG considers that this change in amount of the fee relates to the future because the entity continues to manage the investments for the benefit of the policyholder over the coverage period. Therefore, EFRAG considers it relevant that any changes to the fee should adjust the contractual service margin and be recognised in profit or loss as the investment services are provided over the coverage period.

39 For contracts without direct participation features, at least one of the criteria is not met in order to be classified as contracts with direct participation features. EFRAG assesses that for contracts without direct participation features, the nature of the profit is different from contracts with direct participation features. For contracts without direct participation features, the profit from investment activities arises from the difference between (i) the gains (or losses) from the investments and (ii) the change in the insurance contract liability depicted by the insurance finance income or expenses including the gains (or losses) the entity passes to the policyholder through any indirect participation mechanism. Therefore, the approach to determining profit from financing activities for contracts without direct participation reflects the separate accounting for the investment portfolio and the group of insurance contracts, regardless of any participation mechanism in the insurance contracts. This approach is consistent with the following: (i) the entity controls the cash flows of the investments; and (ii) in most cases, retains the obligation to pay the policyholders the amounts that are determined by contract regardless of the returns of the investments.

40 Some have argued that the scope of the variable fee approach needs to be adapted to accommodate circumstances in which customary business practices are not enforceable from a legal point of view. They argued that these contracts were similar in terms of economics and asset/liability management to those contracts that apply the variable fee approach. EFRAG assesses that (i) the contract[5] needs to specify the fee, i.e. the relationship between underlying items and the amounts payable to the policyholders; and (ii) such contracts cannot be regarded as in effect providing asset management services if the contractual terms do not specify a clearly identified pool of underlying items. Therefore, EFRAG considers that relevance is not negatively impacted.

41 Based on the above, EFRAG considers that the different measurement requirements between contracts with and without direct participation features provide relevant information about the differences in the nature of the entity's income or rewards from the contracts.

<u>Granularity of assessment</u>

42 In assessing the criteria for the variable fee approach, an entity assesses the variability of the amounts to be paid to the policyholder over the duration of the insurance contract. EFRAG considers that this leads to relevant information as the assessment is made in respect to that particular policyholder and not to another policyholder in the same group of insurance contracts.

Unlocking of CSM for the changes in non-underlying cash flows for contracts with direct participation features

43 Paragraph B113(b) of IFRS 17 requires adjusting the CSM for a change in the effect of the time value of money and financial risks not arising from underlying items.

[5] Applying paragraph 2 of IFRS 17, contract terms include all terms in a contract, explicit or implied. Implied terms in a contract include those imposed by law or regulation.

44 Some have indicated that there are contracts with direct participation features but which contain a material amount of cash flows which are non-participating and not covered by underlying items, for e.g., variable annuities with guarantees that are not covered by underlying items. The assets backing the liabilities covering the non-participating features are non-underlying items. The investment result from these assets are recognised in profit or loss based on IFRS 9. This results in an accounting mismatch in profit or loss because the interest accretion on the liabilities covering the non-participating features decreases the CSM while the investment result on the assets backing non-participating features is recognised in profit or loss.

45 EFRAG assesses the accounting treatment leads to relevant information as these changes relate to future service.

Contracts that change nature over time

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

47 EFRAG assesses this reduces the complexity of the standard and thus does not reduce relevant information.

Reinsurance contracts held

48 Reinsurance contracts held are discussed separately in paragraphs 53 to 67 below.

Investment contracts with discretionary participation features

49 Investment contracts with discretionary participation features are not insurance contracts as they do not transfer significant insurance risk. These contracts are scoped into IFRS 17 and treated as if they are insurance contracts only to the extent they are issued by an entity that also issues insurance contracts. The general requirements for measuring insurance contracts are modified for investment contracts with discretionary participation features.

50 EFRAG assesses that the changes to the general measurement requirements provides relevant and useful information for users as these contracts and insurance contracts, that specify a link to returns on underlying items, are sometimes linked to the same underlying pool of assets. Also, there are some characteristics in these contracts which are similar to insurance contracts, e.g., long maturities, recurring premiums.

Premium allocation approach

51 The premium allocation approach is an optional simplification of the IFRS 17 principles and can be applied in circumstances where the entity expects such a simplification would produce a measurement that is not materially different than a measurement following the general requirements or when the coverage period is one-year or less.

52 EFRAG assesses that the eligibility criteria ensure that the relevance of the information is not materially reduced compared to the general measurement requirements.

Reinsurance contracts held

General assessment

53 IFRS 17 modifies the requirements of the general model for reinsurance contracts held. The "contractual service margin" on initial recognition does not represent unearned profit but instead a net cost or net gain on the purchase of the reinsurance.

54 IFRS 17 treats insurance contracts issued and reinsurance contracts held as separate contracts with different counterparties. Based on the EFRAG user outreach in 2018, some specialist users indicated that reinsurance and insurance were not considered as separate businesses and the net effect was considered. However, EFRAG assesses that the separate treatment wunder IFRS 17 reflects the right and obligations of different contractual positions.

55 It is argued by some that, from an economic perspective, reinsurance contracts held are highly dependent on the underlying insurance contracts. Those holding this view argue in favour of a symmetrical accounting treatment for both initial and subsequent measurement of the insurance liability and the reinsurance asset or having similar amounts for both the insurance liability and the reinsurance asset to avoid any accounting mismatches.

56 EFRAG acknowledges the high interdependence between a reinsurance contract held and the underlying insurance contract(s). Nevertheless, EFRAG only partly agrees with the view that measurement for both types of contracts in accordance with IFRS 17 results solely in accounting mismatches.

57 In EFRAG's view, the extent to which a reinsurance contract provides symmetry would depend on the residual economic mismatches that exist between the underlying insurance contracts and the reinsurance contract. The following are examples of residual economic mismatches:

(a) Reinsurance contracts come in many forms. For example, proportional contracts (which reinsure a proportion of the underlying risks) can be divided between those providing coverage for a quota share (for example, an entity reinsuring 50% of all underlying risks) or providing coverage up to certain fixed limit (so called surplus treaties). As a result, some of the risk in the underlying contracts is not reinsured; and

(b) The terms of the reinsurance contract held and the underlying insurance contracts may differ including any timing differences between the two. For example, the reinsurer may exclude particular risks from coverage such as terrorist attacks or natural disasters or the duration of the reinsurance contract may differ from the underlying insurance contracts.

Reinsurance contracts do not qualify as contracts with direct participation features

58 In accordance with paragraph B109 of IFRS 17, reinsurance contracts issued and held do not qualify as contracts with direct participation features. For reinsurance contracts held this is because the entity and the reinsurer do not share in the returns on underlying items. For reinsurance contracts issued this because 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 service provided by the insurance contract does not apply to reinsurance contracts issued. Some have argued that for reinsurance contracts held this creates a mismatch with the underlying insurance contracts, when these are measured as contracts with direct participation features.

59 In EFRAG's simplified case study, it was mentioned that the scope of the variable fee approach should be extended to reinsurance contracts. From the results of the extensive case study, some of the respondents indicated that some reinsurance

contracts would be eligible for the variable fee approach. These respondents mentioned that volatility would arise in the ceding insurer's financial statements when the variable fee approach contracts are reinsured.

60 For an entity that holds reinsurance contracts, EFRAG assesses that, applying the variable fee criteria, the entity would be the policyholder and EFRAG is not aware that the policyholder and the reinsurer share in the returns on underlying items. Therefore, EFRAG does not consider that the variable fee criteria would be met. Furthermore, EFRAG considers that a reinsurance contract held should be accounted for separately from the underlying contracts issued as explained in paragraph 54 above.

61 For reinsurance contracts issued, EFRAG considers that some of these contracts may meet the variable fee criteria. However, EFRAG does not consider these types of reinsurance contracts issued to be substantially investment-related contracts as these reinsurance contracts compensate another entity for claims arising from one or more insurance contracts issued by that entity.

62 Therefore, considering the above, on balance, EFRAG considers that relevance is not negatively impacted for reinsurance contracts that do not qualify as contracts with direct participation features.

<u>Intragroup reinsurance</u>

63 Intragroup reinsurance is discussed in the prudence section.

<u>Reinsurance contracts held — recovery of losses on underlying insurance contracts</u>

64 When the entity recognises a loss on initial recognition of an onerous group of underlying insurance contracts, or on addition of onerous contracts to that group, the entity will determine the amount of a loss recovered from a reinsurance contract held and recognise it as income.

65 EFRAG considers that this requirement aims at reducing accounting mismatches between reinsurance contracts held and the related underlying contracts as the entity has the right to recover some or all the claims that contribute to these losses.

66 Furthermore, the loss-recovery calculation based on total expected reinsurance recoveries would be consistent with the general measurement requirements of IFRS 17 that are comprehensively based on expectations about future cash flows.

67 Therefore, for the reasons explained above, EFRAG considers that this requirement provides useful and relevant information.

Questions for EFRAG TEG

68 Do you have any comments from paragraph 31 to 67? Please explain.

Level of aggregation

69 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

Sharing of risks

70 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

Treatment of investment component

71 IFRS 17 requires any differences between expected and actual amounts of the investment component payable in the period to be recognised in the contractual service margin for contracts under the general model. A detailed description of this issue is provided in the Reliability section in paragraphs 173 to 174 below.

72 EFRAG has been made aware that the application of this requirement is complex. EFRAG acknowledges the complexity of the requirement but notes that

accelerations or delays in payment of investment components are inherent to insurance business models. EFRAG does not consider as useful information, for example, the recognition of a gain for a delay in repaying an investment component accompanied by a loss that adjusts the contractual service margin for the expected later repayment. EFRAG assesses that accounting for the net effect of expected and actual amounts of the investment component in the contractual service margin brings relevant information as it smooths the effect over time and consequently avoids an immediately impact in profit or loss leading to volatility. EFRAG concludes that the complexity is balanced by the relevance of the resulting information in line with the insurance business models.

Risk mitigation

73 IFRS 17 provides a risk mitigation approach for contracts with direct participation features. In order to apply this approach an entity must have a previously documented risk-management objective and strategy for using derivatives and reinsurance contracts held to mitigate financial risk arising from insurance contracts. In the absence of this specific risk mitigation, the changes in the effect of financial risk on the entity's share of the underlying items would be recognised in the contractual service margin. However, the change in the fair value of the derivative or change in the financial risk of the reinsurance contracts held used to mitigate this financial risk would be recognised in profit or loss giving rise to an accounting mismatch. Therefore, EFRAG assesses that the risk mitigation approach for contracts with direct participation features addresses a particular set of accounting mismatches.

74 In addition, the risk mitigation option can be used when the entity uses financial instruments at fair value through profit or loss other than derivatives. EFRAG is of the view this leads to relevant information as it reduces accounting mismatches.

75 Risk mitigation at transition is discussed in paragraph 121 below.

Contractual service margin

Current rate versus locked-in rate to accrete the contractual service margin

76 IFRS 17 requires that, for insurance contracts without direct participation features, the contractual service margin is accreted using the discount rate that was determined at initial recognition of a group of contracts. In contrast, for contracts with direct participation features, the effect of changes in the entity's share of underlying items, which comprises both the effect of the passage of time and the change in the fair value of the underlying items, is recognised in the contractual service margin. As a result, the contractual service margin is remeasured at each reporting period and consequently based on current discount rates.

77 Some argue that insurance contracts without direct participation features should also use current rates to accrete the contractual service margin because using locked-in rates is not responsive to changes in economic conditions in the way that the fulfilment cash flows is. Changes in the value of future cash flows, following changes to market conditions, are recognised immediately through changes in the fulfilment cash flows. However, these changes in value also give rise to changes in the value of future margins which should give rise to a recalibration of the contractual service margin. However, due to use of a mixture of locked-in and current measurement approaches, this gives rise to an accounting mismatch and therefore artificial volatility in shareholder equity and total comprehensive income.

78 EFRAG does not agree with this view because:

(a) the contractual service margin does not represent future cash flows; it represents the unearned profit in the contract, measured at the point of initial recognition and adjusted only for specified amounts;

(b) accreting interest for a period at a current rate without also remeasuring the contractual service margin at the start of the period would create an internally inconsistent measurement of the contractual service margin; and

(c) of the different economics of these contracts without direct participation features compared to the contracts with direct participation features for reasons explained in paragraphs 35 to 41 above.

Pattern of release of the contractual service margin

79 IFRS 17 requires an entity to systematically recognise the contractual service margin in profit or loss over the coverage period thereby reflecting the provision of coverage as required by the contract. In order to determine the provision of coverage, an entity identifies the number of coverage units in a group which are determined as the quantity of benefits provided by the contracts in the group and its expected coverage duration. This is applicable for both contracts with and without direct participation features.

<u>Contracts without direct participation features</u>

80 For insurance contracts without direct participation features, the coverage units consider the quantity of benefits and expected period of investment-return service, if any, in addition to insurance coverage. EFRAG considers this leading to relevant information as contracts accounted for in accordance with the general model may provide both insurance and investment services.

<u>Contracts with direct participation features</u>

81 For insurance contracts with direct participation features, the coverage units consider quantity of benefits and expected period of both insurance coverage and investment-related service. EFRAG considers that this represents the mixture of services provided under these contracts as these contracts are substantially investment-related service contracts and hence agrees that the allocation of the contractual service in accordance with the period of investment-related services results in relevant information.

Contract boundaries

82 Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premium or in which the entity has a substantive obligation to provide the policyholder with services.

Contract boundary of contracts with annual repricing mechanisms

83 The contract boundary ends when the insurer has the practical ability to reassess the risks of the underlying insurance contract or the portfolio that contains that insurance contract and as a result can set a price or level of benefits that fully reflects the risk of that portfolio. As a consequence, when an insurer uses annual repricing mechanisms that are closely related to the underlying risks, the cash flows resulting from the renewal terms are not part of the boundary of the existing insurance contract but belong to a new insurance contract instead. EFRAG assesses that accounting for this change as a new contract leads to relevant information because it reflects the changed economics of the contracts.

84 When the contract includes an option to add insurance coverage at a future date, EFRAG notes that if that option is not a separate contract and the terms are not guaranteed by the entity, the cash flows arising from the option might be either within or outside of the contract boundary, depending on whether the insurer has the practical ability to set a price that fully reflects the reassessed risks.

85 EFRAG assesses that an entity is no longer bound by the existing contract at the point at which the contract confers on the entity the practical ability to reassess the risk presented by a policyholder. Therefore, only including cash flows in the contract boundary if they arise from substantive rights and obligations that exist during a reporting period provides relevant information.

Contract boundary of reinsurance contracts held

86 IFRS 17 requires insurance and reinsurance contracts held to be treated as separate contracts. This implies that, in contrast to current practices, the contract boundary of reinsurance contracts held is determined independently of the underlying insurance contracts. As a result, the contract boundary of reinsurance contracts held may be shorter or longer than the underlying insurance contracts.

87 EFRAG notes that situations may occur where contract boundaries differ between reinsurance contracts held and the underlying insurance contracts. For example, reinsurance contracts held may be repriced on a more frequent basis than the underlying insurance contracts. EFRAG notes that both rights and obligations need to be considered when assessing the boundary of a contract. EFRAG assesses that determining the contract boundary of insurance and related reinsurance contracts separately provides relevant information as it reflects the different conditions of insurance contracts issued and reinsurance contracts held.

Questions for EFRAG TEG

88 Do you have any comments from paragraph 69 to 87? Please explain.

Presentation on the statement of comprehensive income

89 IFRS 17 distinguishes two ways that entities earn profits from insurance contracts:

(a) the insurance service result, which comprises insurance revenue and insurance service expenses (e.g. incurred claims) and depicts the profit earned from providing insurance coverage; and

(b) insurance finance income or expenses.

90 The insurance revenue includes the release of the risk adjustment and the contractual service margin. EFRAG considers that this provides relevant information as it depicts the transfer of promised services at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. The analysis on the release pattern of the contractual service margin is in paragraphs 79 to 81.

91 EFRAG is of the view that the insurance service result will provide useful information for users. This is because it will reflect insurance contract services that have already been provided and therefore will reflect profit on an earned basis for each reporting period.

92 The insurance revenue and incurred claims excludes any investment components because these represents amounts payable to the policyholder, in all circumstances, regardless of whether an insured event occurs. EFRAG considers that, since the insurance revenue and incurred claims relates to insurance services, excluding the investment component provides relevant information.

93 IFRS 17 requires a gross presentation of the insurance service result, i.e. insurance revenue and insurance service expenses are presented separately. EFRAG assesses this as adding relevant information as it provides users of financial statements more granular information about the insurance service result.

94 For contracts without direct participation contracts, the insurance finance income or expenses arises from the effect of the time value of money and of financial risk and

changes to these as well. EFRAG considers that this financial result will provide relevant information because it depicts the effects of investments and of market interest rates.

95 For contracts with direct participation features, the insurance finance income or expenses would also arise from components stated in paragraph 94 above but excludes some changes relating to these components that would adjust the contractual service margin, i.e. relating to the remeasurement of the fee. EFRAG considers that the remeasurement of the fee which adjusts the contractual service margin provides relevant information because of the different nature of the contracts compared to contracts without direct participation features as explained in paragraphs 35 to 41.

96 A separate presentation of investment income and insurance finance income or expenses is assessed as adding relevant information as it provides users of financial statements more granular information about the net financial result.

97 Under IFRS 17, if insurance contracts are onerous at initial recognition, a loss is recognised in profit or loss for the net outflow for the group of onerous contracts. In addition, there is a reconciliation of any loss components. EFRAG considers that this provides relevant information for users of financial statements as it shows to what extent entities have onerous contracts.

98 When applying IFRS 17, an entity will recognise insurance finance income or expenses. The entity can choose where to present this effect - either in profit or loss or disaggregated between profit or loss and other comprehensive income. This is applicable for both contracts with and without direct participation features. Some reject this and propose that the insurance finance income or expenses should be recognised in profit or loss thus preventing accounting mismatches with finance income from assets measured at fair value through profit or loss.

99 EFRAG does not agree with this view. EFRAG considers that having both options represents two business approaches of European insurers. EFRAG expects that entities will choose the presentation that better reflects the economics of their business. In addition, users of financial statements may find the presentation of insurance finance income or expenses more useful when it is recognised in profit or loss for some contracts or it would be more useful when disaggregating between profit or loss and other comprehensive income for other contracts.

100 As per EFRAG's 2018 user outreach, specialist users indicated that the requirement to split the presentation between underwriting and investing activities, in the statement of comprehensive income, would provide useful information. In addition, most of the specialist and generalist users did not see volatility in profit or loss as a problem as long as it reflects real economic substance and the underlying causes were communicated clearly.

101 Based on the reasons above, EFRAG assesses that, overall, the statement of comprehensive income will provide relevant information on the performance of the insurance business and also provide relevant information on the extent to which profit arises from underwriting and from financial activities.

102 The pattern of release of the contractual service margin is analysed in paragraphs 79 to 81.

Presentation on the statement of financial position

Separate presentation of portfolios that are assets and that are liabilities

103 IFRS 17 requires an entity to present separately in the statement of financial position portfolios of insurance contracts issued that are assets and those that are liabilities.

104 EFRAG understands that the switch between an asset and liability position is not necessarily related to the profitability of the insurance contract, which is assessed over the entire duration of the group of insurance contracts but due to the timing of cash flows.

105 As per EFRAG's user outreach, most users agreed with this separate presentation because the portfolio level would not reduce the loss of useful information. EFRAG agrees with these remarks provided in the EFRAG user outreach and assesses that these requirements would not hinder relevance.

Non-separation of receivables and payables

106 Based on the requirement in paragraph 103 above, there is no separate presentation in the financial position of receivables or payables.

107 Some preparers argue that the principle of IFRS 17 to disclose a portfolio of insurance contracts as a bundle of rights and obligations results in one balance rather than separating out on the balance sheet its components such as premiums receivable or claims payable. They are concerned that the disclosure requirements under IFRS 17 would lead to a loss of credit risk information that users currently have.

108 From EFRAG's user outreach, there were mixed views. Some users did not consider that there should be a separation of receivables/payables as it would not have a big impact on their estimates when building their models. Fewer users were concerned about the less information in the statement of financial position or wanted the separation of receivables/payables.

109 EFRAG has considered the views from users and EFRAG considers that the presentation requirements of IFRS 17 is consistent with its measurement principle i.e. a current estimate of all expected cash flows within the contract boundary. The balance sheet reflects the combination of rights and obligations created by the contract as a whole. Therefore, based on this, EFRAG considers that non-separation of receivables and payables does not impair the relevance of information.

Disclosures

110 The objective of the disclosure requirements is to provide a basis for the users of financial statements to assess the effect of applying IFRS 17 on the entity's financial position, financial performance and cash flows. To meet this objective, IFRS 17 contains a range of qualitative and quantitative disclosure requirements. EFRAG considers that these disclosures would provide information that is most relevant for the circumstances of entities and would emphasise the importance of communication to users of financial statements rather than compliance with detailed and prescriptive disclosure requirements. Disclosures are also assessed under the Understandability section.

Questions for EFRAG TEG

111 Do you have any comments from paragraph 89 to 110? Please explain.

Transition requirements

Existence of three transition approaches

112 At transition, entities are required to apply IFRS 17 retrospectively unless impracticable. The full retrospective approach recognises and measures insurance contracts as if IFRS 17 had always been applied. When impracticable, entities can choose between applying either the modified retrospective approach or the fair value approach using IFRS 13 *Fair Value Measurement*.

113 As per EFRAG's user outreach in 2018, some specialist users were not sure of the impact of the different transition approaches, e.g., concerns that people would choose the option they want in terms of opening balances and window dressing, not necessarily choosing what is most appropriate. In EFRAG's 2019 user outreach, some users indicated that it was unclear how transition was managed and therefore when the numbers will normalise going forward. Some users also preferred the use of only one transition approach and not three.

114 EFRAG considers that each of the above transition approaches can provide relevant information depending on the information available because entities are implementing IFRS 17 from different starting points and users will be informed of the effect of the transition method chosen and the movement of the figures going forward as each transition method is disclosed separately for the contractual service margin and insurance revenue. Whenever practicable, entities would use the full retrospective approach that provides the most complete and consistent information. The EFRAG extensive case study showed that all three approaches would be used in practice.

115 Under the fair value approach, the fair value of liabilities at the date of transition is defined (in accordance with IFRS 13). The fair value is therefore driven by the relationship between two willing market participants and is determined by reference to the rate of return required by such market participants. As a result, when calculating the fair value, it would include a compensation that the market participant would require for taking on the obligation.

116 Overall, taking the above reasons into consideration, on balance, EFRAG is of the view that the existence of three transition requirements does not result in a lack of relevant information.

Modified retrospective approach

<u>Specific transition modification and reliefs</u>

117 The assessments that would have been made at inception or initial recognition whether an investment contract meets the definition of an investment contract with discretionary participation features are extended. The extension permits an entity to make this assessment using information available at the transition date (rather than at inception or initial recognition).

118 If an entity does not have reasonable and supportable information to identify whether the reinsurance contract held was acquired before or at the same time that the insurance contracts were issued, the entity would assume that the reinsurance contract held was acquired after the insurance contracts were issued.

119 In applying the modified retrospective approach an entity would determine the contractual service margin, loss component and amounts related to insurance finance income or expenses at the transition date as if the entity had not prepared any interim financial statements before the transition date.

120 EFRAG considers the above changes to the modified retrospective approach as leading to relevant information as they allow to achieve the closest outcome to retrospective application without undue cost or effort.

<u>Applying the risk mitigation option retrospectively/ at transition date</u>

121 The risk mitigation option cannot be applied retrospectively. EFRAG assesses this reduces the relevance of the information as it distorts the CSM balance at transition.

Business combinations

122 For insurance contracts issued and reinsurance contracts held acquired in a business combination, the consideration paid or received (i.e. the fair value of the contracts at the date of the acquisition) is used as a proxy for the premiums received.

123 Based on the results of its case study, EFRAG understands that the fair value of a portfolio of insurance contracts typically ranges between 70%-90% of the present value of future shareholder transfers for life insurance.

124 EFRAG notes that the consideration paid can either be lower (in which case it results in a bargain purchase), higher (in which case goodwill is created) or equal than the present value of future shareholder transfers.

125 In those cases where the acquirer makes a bargain purchase, EFRAG assesses that the acquirer continues the obligation of the acquiree to provide services to the policyholders, but not to the same extent as the acquiree. This may be due different expectations from the acquirers' perspective in insurance and/or financial variables that affect the insurance business, compared to the acquiree's perspectives for those same variables. As a result, EFRAG considers that accounting for an immediate gain in profit or loss for a bargain purchase and a lower future contractual service margin results in relevant information.

Questions for EFRAG TEG

126 Do you have any comments from paragraph 112 to 125? Please explain.

Conclusion about the relevance of information resulting from IFRS 17

127 With regard to the scope, the choice to apply IFRS 17 or IFRS 9 to loans that meet the definition of insurance contracts provides relevant information because entities would apply the same Standard to similar contracts that it issues.

128 The general measurement requirements are assessed to lead to relevant information as the rights and obligations that arise from insurance contracts are considered. Also, the measurement captures a full range of foreseeable outcomes and their probabilities. Finally, time value of money is being considered through the use of discounting. The treatment of acquisition costs in cases where renewals of insurance contracts are considered by the insurer is assessed to lead to relevant information.

129 The general measurement requirements are modified or simplified for:

(a) Contracts with direct participation features: These contracts are assessed to be of an economical different nature due to the different nature of the fee in these contracts and therefore conditions to apply the approach for contracts with direct participation features are assessed to lead to relevant information;

(b) Investment contracts with discretionary participation features: the measurement is assessed to provide relevant information as these are accounted for under IFRS 17 if the entity also issues insurance contracts. These investment contracts often have similar characteristics to insurance contracts; and

(c) Premium allocation approach: the reduction in relevance is considered not to be material and is balanced by the simplification it represents for preparers.

130 For reinsurance contracts held that are used to recover losses from the underlying contracts, EFRAG considers that this provides relevant information as it aims at reducing accounting mismatches. EFRAG also considers that relevance is not negatively impacted for reinsurance contracts that do not qualify as contracts with direct participation features.

131 The level of aggregation requirements [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS].

132 The treatment of investment components is considered to be complex, but that complexity is balanced by the relevance of the resulting information in line with the insurance business models.

133 The risk mitigation approach of IFRS 17 addresses adequately particular accounting mismatches for contracts with direct participation features when derivatives and reinsurance contracts held are used. However, in those cases where the risk mitigation approach cannot be applied retrospectively it reduces the relevance of the information.

134 On the assessment on the contractual service margin, this is treated as a residual. For contracts without direct participation features accreting this residual at a locked in rate provides relevant information as the contractual service margin does not represent future cash flows. In contrast, contracts with direct participation features have different economics compared to contracts without direct participation features. Therefore, for such more investment-like contracts, a treatment similar to the use of current discount rates is assessed to be appropriate.

135 The release pattern of the contractual service margin for contracts without direct participation features is considered to lead to relevant information. When an insurer provides both insurance coverage and investment services for contracts without direct participation features EFRAG assesses the release of the contractual service margin should reflect this thus providing relevant information.

136 The issues that EFRAG is aware of in relation to the contract boundary do not limit the relevance of the resulting information as cash flows within a contract boundary reflect the substantive rights and obligations that exist.

137 The statement of comprehensive income is expected to provide relevant information on the performance of the insurance business and distinguishes performance between underwriting activities and financial activities.

138 The requirement for separate presentation of contracts in an asset position and contracts in a liability position on the statement of financial position is assessed not to hinder relevant information. Regarding non-separate presentation of receivables/payables, the combination of rights and obligations should be reflected as a whole. Therefore, EFRAG assesses that this non-separation provides relevant information.

139 The disclosure requirements would provide information that is most relevant for the circumstances of entities.

140 The transition requirements consider the situation where an insurer has all, partly or an insufficient amount of information available to apply the Standard retrospectively. In addressing each of these situations, the transition requirements are assessed to lead to relevant information, considering the extent of the information available for each particular group of insurance contracts at transition. The changes to the modified retrospective approach are leading to relevant information as they allow to achieve the closest outcome to retrospective application without undue cost or effort.

141 EFRAG's overall assessment is to be finalised.

Questions for EFRAG TEG

142 Do you have any comments on the conclusion section from paragraph 127 to141? Please explain.

Reliability

143 EFRAG also considered the reliability of the information that will be provided by applying IFRS 17. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

144 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

145 In its assessment of reliability, many of the aspects addressed in the relevance section also affect reliability. These issues are not repeated. As a result, EFRAG has identified the following topics as being the most significant to the assessment of reliability:

(a) Measurement of insurance contracts;

(b) Discount rates;

(c) Treatment of acquisition costs;

(d) Premium allocation approach;

(e) Different insurance accounting models;

(f) Reinsurance contracts held;

(g) Level of aggregation;

(h) Risk mitigation;

(i) Separating components from an insurance contract;

(j) Treatment of investment component;

(k) Sharing of risks;

(l) Contractual service margin;

(m) Transition requirements; and

(n) Disclosures on the release of the contractual service margin.

Measurement of insurance contracts

146 Measurement of insurance liabilities in IFRS 17 requires judgement in estimating the fulfilment value of an insurance contract. Judgement and interpretation may be required including accounting policy choices which may affect the reliability of information. EFRAG acknowledges that judgement is inherent in the insurance business and in the complexity of the products and as a result, it is inherent in the measurement of insurance contracts. Therefore, EFRAG considers that estimating future cash flows would not lead to reduced reliability.

147 In addition, EFRAG considers that reliability would not be reduced because entities have experience in applying judgement when applying other IFRS Standards and in managing their business.

148 Also, IFRS 17 is a new standard and as a certain market practice will develop over time, this would increase the reliability of information.

Discount rates

149 IFRS 17 requires entities to discount cash flows. Under IFRS 17, discount rates include only relevant factors, i.e. factors that arise from the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance

contracts. When such discount rates are not directly observable in the market, an entity uses estimates.

150 IFRS 17 does not require a particular estimation technique for determining discount rates. However, in applying an estimation technique, an entity (i) maximises the use of observable inputs, (ii) reflects current market conditions from the perspective of a market participant, and (iii) uses judgement in assessing the degree of similarity between the features of the insurance contracts being measured and the features of the instrument for which observable market prices are available and adjust those prices to reflect the differences between them.

151 An entity may determine the appropriate discount rates using either a top-down (where the entity does not need to make an adjustment for differences in liquidity characteristics between the reference portfolio and the insurance contracts) or a bottom-up approach (where liquidity characteristics are considered). In principle, EFRAG considered that the discount rate reflecting the liquidity characteristics of the group of insurance contracts being measured reflect the nature of the liabilities. However, EFRAG acknowledges that for the top-down approach, it would be difficult to determine a liquidity premium in isolation, however, EFRAG expects that a reference portfolio would typically have liquidity characteristics closer to the liquidity characteristics of the group of insurance contracts compared to highly liquid, high-quality bonds. Therefore, EFRAG considers that both approaches to determine the discount rate provide reliable information within the bounds of cost.

152 In assessing the reliability of the use of discount rates, EFRAG notes that:

(a) observable rates may not be available for particular markets or for very long durations, requiring the use of particular estimation techniques;

(b) dealing with estimates and uncertainty is inherent to the insurance business and the use of professional judgement is inherent to that; and

(c) an entity is required to disclose information about significant judgements and changes in judgements, including the approach used in determining the discount rates. Also, the yield curve(s) used to discount cash flows that do not vary based on the return on underlying items are to be disclosed.

Treatment of acquisition costs

153 EFRAG notes that entities are required to allocate, on a systematic and rational basis, insurance acquisition cash flows that are directly attributable to a group of insurance contracts to that group and to any groups that include contracts that are expected to arise from renewals of the contracts in that group. EFRAG also notes that entities should assess the recoverability of an asset for insurance acquisition cash flows if facts and circumstances indicate the asset may be impaired.

154 EFRAG acknowledges that such allocation and recoverability assessment require the use of judgement to be exercised especially the expectation with regards to the renewals of contracts. Under IFRS 17, the directly attributable overheads are allocated to groups of insurance contracts based on a systematic and rational basis and so EFRAG assesses that the allocation of the acquisition costs in the same way provides a reliable measurement of directly attributable costs.

155 An entity has to make expectations about the expected renewals of contracts and EFRAG assesses that this judgement is inherent in the insurance business because the entity pays the acquisition cost, e.g. commissions, in the expectation of it being recovered via renewals. Therefore, EFRAG considers that the entity has taken into considerations the extent of the renewals and this information would also be used when assessing recoverability of the acquisition cash flow asset.

156 EFRAG also notes that in order to help users of financial statements assess such judgement exercised, extensive disclosure is required for the asset recognised which arise from the expected renewals and for the recognition and reversal of impairment losses.

157 Therefore, EFRAG considers that such judgement would not reduce reliability.

Premium allocation approach

158 EFRAG considers that the measurement under the premium allocation approach provides information that is reliable because the information is expected to provide a reasonable approximation of the general requirements.

Different insurance accounting models

Scope of contracts with direct participation features

159 EFRAG assesses the reliability of the conditions that determine the scope of the approach available to contracts with direct participation features in the following paragraphs. Reinsurance contracts not eligible for the variable fee approach are discussed under relevance in paragraphs 58 to 62.

<u>Participation in a clearly identified pool of assets</u>

160 The requirement that contracts with direct participation features relates to a clearly identified pool of underlying items ensures that the link between the insurance contract liability and the associated assets is contractually[6] determined and enforceable. This provides reliable information because the contract specifies a determinable amount.

<u>Payment to the policyholder a substantial share of the fair value returns from the underlying items</u>

161 EFRAG assesses that this criterion provides reliable information because it provides a faithful representation to depict an obligation to pay an amount equal to the fair value of the underlying items as the policyholder expects to receive a substantial part of the fair value returns on the underlying items.

<u>Amounts to be paid to the policyholder vary with the change in fair value of the underlying items</u>

162 EFRAG assesses that this criterion provides reliable information because it provides a faithful representation to depict an obligation to pay an amount equal to the fair value of the underlying items as the entity would expect changes in the amount to be paid to vary with the change in fair value of the underlying items.

Reinsurance contracts held

<u>Recovery of losses on underlying insurance contracts</u>

163 An entity is required to determine the amount of a loss recovered from a reinsurance contract held by multiplying the loss recognised on underlying contracts by the percentage of claims on underlying insurance contracts the entity expects to recover from the reinsurance contract held.

164 EFRAG acknowledges that the expected loss-recovery calculation requires judgement and the extent of judgement may depend on the type of reinsurance contracts held. More judgement may be required for reinsurance contracts where there is no one-to-one relationship between the underlying contract and the

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[6] EFRAG notes that the term contractually used here can also mean by law or regulation as per paragraph 2 of IFRS 17.

reinsurance contract held, e.g. where an excess of loss reinsurance contract held covers multiple underlying contracts. However, EFRAG considers this is required, anyway, for the purpose of determining the cash flows in the measurement of the reinsurance contract held. Therefore, EFRAG considers that the judgement used faithfully represents the entity's recovery expectations.

<u>Contract boundary of reinsurance contracts held</u>

165 EFRAG understands that the cash flows within the boundary of the reinsurance contract held arise from the substantive rights and obligations of the primary insurer. The substantive right is to receive services from the reinsurer. The substantive obligation is to pay amounts to the reinsurer. Therefore, a substantive right to receive services from the reinsurer ends when the reinsurer has the practical ability to reassess the risks transferred to the reinsurer and can set a price or level of benefits for the contract to fully reflect the reassessed risk.

166 EFRAG understands that one implication of this is that the boundary of a reinsurance contract held could include cash flows from underlying contracts covered by the reinsurance contract that are expected to be issued in the future. Under IFRS 17, the direct insurance contracts and the reinsurance contracts held of a primary insurer are measured separately.

167 There are some concerns that there may be a reduction in reliability in estimating contracts expected to be written in the future. However, EFRAG considers that the estimation of these contracts would follow the same measurement principles as IFRS 17, i.e., probability-weighted estimate of the present value of cash flows.

Level of aggregation

168 [TO BE COMPLETED BASED ON FUTURE IASB TENTATIVE DECISIONS]

Risk mitigation

169 The risk mitigation option can be used when the entity uses financial instruments at fair value through profit or loss other than derivatives. EFRAG is of the view this leads to reliable information as it reduces accounting mismatches.

Questions for EFRAG TEG

170 Do you have any comments from paragraphs 146 to 169? Please explain.

Separating components from an insurance contract

171 EFRAG assesses that there may be cases where the legal form of a single contract would not reflect the substance of its contractual rights and obligations. For example, an entity selling one legal contract which has several insurance components only for the convenience of the policyholder and the price is the total of the standalone prices for the different insurance components provided. Therefore, EFRAG considers that, in this case, separating the components would faithfully represent the economics of the transactions.

172 However, EFRAG considers that in assessing whether insurance components should be separated reliably, the entity would need to consider the interdependency among the insurance components and whether the components can be priced and sold separately. Judgement may be required in determining the extent of the stand-alone pricing.

Treatment of investment component

173 IFRS 17 requires any differences between expected and actual amounts of the investment component payable in the period to be recognised in the contractual service margin.

174 EFRAG considers that there are cases where an investment component that becomes payable in a period may directly cause changes in estimates of the present value of other future cash flows. For example, an acceleration in the repayment of an investment component because of policyholders who surrender their contracts.

175 The difference between the expected and actual cash flows of the investment component is recognised in the contractual service margin instead of profit or loss. Also, the changes in estimates requires an adjustment to the contractual service margin of a group of insurance contracts for changes in fulfilment cash flows that relate to future service. EFRAG considers that the combined effect of such events adjusting the contractual service margin provides a faithful representation of information because it avoids the recognition of a loss or gain in the current period and a consequential gain or loss in future periods. As a result, the net effect on the contractual service margin would be the effect of the change in timing of the payment of the investment component.

Sharing of risks

176 [TO BE COMPLETED AFTER THE IASB TENTATIVE DECISIONS ON ANNUAL COHORTS]

Contractual service margin

Use of coverage units for the contractual service margin

177 EFRAG acknowledges that the determination of the profit allocated in profit or loss based on the actual service provided over the expected duration and quantity of benefits of the contracts within a portfolio represents the use of significant estimates

178 In assessing the reliability of the information resulting from the application of coverage units in allocating the contractual service margin to profit or loss, EFRAG notes that:

(a) the estimation of coverage units is subject to professional judgement, the reliability of which is similar to other judgements used in applying IFRS 17; and

(b) the coverage units help an entity in reflecting its long-term business model over time as they allow unearned profit to be spread over the contract duration instead of recognising it entirely at day 1.

Coverage units for contracts without direct participation features

179 For insurance contracts without direct participation features, the coverage units consider the quantity of benefits and expected period of investment-return service, if any, in addition to insurance coverage. EFRAG considers this leading to reliable information as contracts accounted for in accordance with the general model may provide both insurance and investment services.

Coverage units for contracts with direct participation features

180 For insurance contracts with direct participation features, the coverage units consider quantity of benefits and expected period of both insurance coverage and investment-related service.

181 These contracts are substantially investment-related contracts, i.e. having more investment-related service compared to insurance service. Therefore, EFRAG assesses that the weighting between insurance and investment would faithfully represent these types of contracts. Furthermore, the entity has to disclose the approach used in determining the weighting which would help users to assess the weighting.

Use of locked-in rate for the contractual service margin

182 IFRS 17 requires that for insurance contracts without direct participation features, the contractual service margin is accreted using the discount rate that was determined at initial recognition of a group of contracts.

183 Some argue that using current rates to accrete the contractual service margin would better reflect the best estimate of unearned profit. EFRAG has assessed the relevance of the use of the locked-in rate from paragraphs 76 to 78 above. The arguments used in that assessment are equally valid when assessing reliability.

184 In addition, for contracts without direct participation features, there can be a link between the liability and the market yield that is used to determine the discount rate. However, there is a no *direct* connection between the liability and the underlying items. Therefore, the argument that the use of a current rate is necessary to avoid accounting mismatches with the assets is not supported by EFRAG. Specifically, EFRAG notes that the relationship between the insurance liability and the assets held by the entity is not static. The variability arises from asset liability management techniques such as the following.

(a) An insurance contract may promise a share of some of the returns on particular assets, but the entity decides not to hold these assets. When the returns from the assets held do not move in line with the promised returns, the resulting economic mismatch will have an impact on the statement of comprehensive income.

(b) Entities hold different types of asset portfolios: (i) dedicated asset portfolios that support specific liability portfolios; (ii) a general fund, the assets of which support different insurance contract liabilities and (iii) surplus assets, which represent the overall excess of assets in relation to insurance liabilities. Individual assets can move between these asset portfolios at the discretion of the entity.

(c) An entity may want to achieve a targeted return on particular assets. When the assets in one of the portfolios described in (b) above do not achieve that return, assets from another portfolio described in (b) above with better prospects can be re-allocated to take their place without derecognition of the original assets.

185 Overall, EFRAG assesses that accreting the contractual service margin at a locked-rate for contracts without direct participation features leads to reliable information.

Questions for EFRAG TEG

186 Do you have any comments from paragraphs 171 to 185? Please explain.

Transition requirements

Transition approaches

187 On transition, entities are required to apply IFRS 17 retrospectively unless impracticable. In the latter case, entities can choose between applying either the modified retrospective approach or the fair value approach.

188 EFRAG assesses that applying the full retrospective approach would result in reliable information because insurance contracts would be identified, recognised and measured as if IFRS 17 had always been applied. It is likely that retrospective application will be practicable for short-term contracts and recently issued long-term contracts.

189 However, on transition it may be impracticable to apply the full retrospective approach. One of the transition approaches that can be applied is the modified retrospective approach.

190 The assessments that would have been made at inception or initial recognition to include the assessment of whether an investment contract meets the definition of an investment contract with discretionary participation features are extended. The extension permits an entity to determine whether an investment contract meets the definition of an investment contract with discretionary participation features using information available at the transition date (rather than at inception or initial recognition).

191 If an entity does not have reasonable and supportable information to identify whether the reinsurance contract held was acquired before or at the same time that the insurance contracts were issued, the entity would assume that the reinsurance contract held was acquired after the insurance contracts were issued.

192 In applying the modified retrospective approach an entity would determine the contractual service margin, loss component and amounts related to insurance finance income or expenses at the transition date as if the entity had not prepared any interim financial statements before the transition date.

193 EFRAG considers the above changes to the modified retrospective approach as leading to reliable information as they allow to achieve the closest outcome to retrospective application without undue cost or effort.

Risk mitigation relating to transition

194 The risk mitigation option cannot be applied retrospectively. EFRAG assesses this reduces the reliability of the information as it distorts the CSM balance at transition.

Disclosures on the release of the contractual service margin

195 IFRS 17 requires disclosing:

(a) quantitative information about when the entity expects to recognise in profit or loss the contractual service margin remaining at the end of a reporting period; and

(b) the approach used to determine the relative weighting of the benefits provided by insurance coverage and investment-return service or investment-related service.

196 EFRAG assesses that this adds to the reliability of the information on the CSM especially as insurance contracts provide both investment and insurance service.

Conclusion about the reliability of information resulting from IFRS 17

197 It is acknowledged that judgement is inherent in the insurance business and therefore in the measurement of insurance contracts. This judgement would not impair reliability. On the treatment of acquisition cash flows, judgement is required for the allocation, expected renewals and impairment testing, however, extensive disclosure would help the users in assessing the judgement used. The premium allocation approach is considered to be a simplification within the bounds of materiality and cost.

198 The criteria of contracts with direct participation features are found to provide reliable information because the link between the insurance contract liability and the associated assets allows to specify a determinable amount. The conditions also provide a faithful representation to depict an obligation to pay an amount equal to the fair value of the underlying items.

199 EFRAG considers that for reinsurance contracts held, there may be a reduction in reliability in estimating contracts expected to be written in the future. However, EFRAG considers that the estimations would be measured using the IFRS 17 principles. Regarding the recovery of losses from reinsurance contracts held, EFRAG acknowledges that judgement is required on the calculation of the expected loss-recovery, however, this is already required when the entity has to determine the cash flows for the reinsurance contracts held for measurement purposes.

200 [LEVEL OF AGGREGATION – TO BE COMPLETED BASED ON FUTURE IASB DECISIONS]

201 The risk mitigation option can be used when the entity uses financial instruments at fair value through profit or loss other than derivatives. EFRAG is of the view this leads to reliable information as it reduces accounting mismatches. The risk mitigation option cannot be applied retrospectively. EFRAG assesses this reduces the reliability of the information as it distorts the CSM balance at transition.

202 In assessing whether insurance components should be separated reliably, the entity would need to consider the interdependency among the insurance components and whether the components can be priced and sold separately.

203 The difference between the expected and actual cash flows of an investment component are recognised in the contractual service margin instead of profit or loss. Also, the changes in estimates relating to the future would adjust the contractual service margin. EFRAG considers that the combined effect of such events adjusting the contractual service margin provides a faithful representation of information because it avoids the recognition of a loss or gain in the current period and a consequential gain or loss in future periods.

204 [SHARING OF RISKS – TO BE COMPLETED BASED ON FUTURE IASB DECISIONS]

205 For insurance contracts without direct participation features, the coverage units consider the quantity of benefits and expected period of investment-return service, if any, in addition to insurance coverage. EFRAG considers this leading to reliable information as contracts accounted for in accordance with the general model may provide both insurance and investment services.

206 For contracts with direct participation contracts, the weighting between insurance and investment would faithfully represent these types of contracts because these are substantially investment-related contracts. Disclosures on the approach used for the weighting would help users to assess the weighting. In terms of accreting the contractual service margin at a locked-in rate for contracts without direct participation features, EFRAG assesses that this leads to reliable information for the same reasons as in the relevance section.

207 Regarding transition approaches, the full retrospective approach would provide reliable information because the contracts are measured as if IFRS 17 had always been applied. EFRAG considers the changes to the modified retrospective approach as leading to reliable information as they allow to achieve the closest outcome to retrospective application without undue cost or effort.

208 **EFRAG's overall assessment is to be finalised.**

Questions for EFRAG TEG

209 Do you have any comments from paragraphs 187 to 208? Please explain.