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IFRS 17 *Insurance Contracts* **Interaction with IFRS 9 and IFRS 15**

Objective

- 1 The objective of this paper is to highlight the interaction of IFRS 17 *Insurance Contracts* with:
 - (a) IFRS 9 *Financial Instruments* (Part A); and
 - (b) IFRS 15 *Revenue from Contracts with Customers* (Part B).

Introduction

- 2 IFRS 17 is effective from 1 January 2021. An insurer can choose to apply IFRS 17 before that date but only if it also applies IFRS 9.
- 3 The paper considers components of IFRS 9 and IFRS 15 that are relevant to the endorsement of IFRS 17. Where relevant, findings from the case studies and the user outreach are integrated in the paper. Additional information from the extensive case study is included in Appendix I.
- 4 This paper is based on the following as the most likely scenarios:
 - (a) entities have deferred IFRS 9 and will implement IFRS 9 together with IFRS 17.
 - (b) Unless stated otherwise, the discussion regards the General Model and the Premium Allocation Approach (PAA) as having the same outcome, as either there is no material difference between the two or the insurance contracts liability matures in the short-term.

A - INTERACTION OF IFRS 17 WITH IFRS 9

- 5 This part comprises:
- (a) Overview;
 - (b) Measurement;
 - (c) Asset liability management; and
 - (d) Transition.

Overview

- 6 As a result of applying IFRS 9, financial assets are measured at either amortised cost or fair value. When financial assets are measured at fair value, gains and losses are recognised either in profit or loss (fair value through profit or loss), or in other comprehensive income (fair value through other comprehensive income (OCI)).
- 7 IFRS 17 requires insurers to discount their insurance contract liabilities using a current interest rate and the effect of changes in that interest rate can be reported in profit or loss. Thus, the income and expenses reported in profit or loss, as a result of changes in current interest rates, are expected to offset, to the extent the insurance liabilities are economically matched with the relating assets, the volatility in profit or loss that may arise from financial assets accounted for at fair value through profit or loss.
- 8 IFRS 9 allows all entities, including insurers to elect to measure financial assets at fair value through profit or loss where this addresses an accounting mismatch. This is important as insurers typically seek to minimise accounting mismatches¹.

Measurement

- 9 Generally, measurement possibilities of financial assets and insurance liabilities could be illustrated as follows:

Financial assets (in accordance with IFRS 9)	Insurance liabilities (in accordance with IFRS 17)
<ul style="list-style-type: none"> • Amortised cost (if it passes both the business model and the SPPI test) • FVPL • FVOCI (with recycling – debt instruments) • FVOCI (without recycling – equity instruments) 	Fulfilment value (a current value measurement)

- 10 When applying IFRS 17, changes that relate to future insurance coverage are recognised by adjusting the contractual service margin (CSM)² and changes that relate to past insurance coverage will be recognised in profit or loss. As a result, upon recognition in profit or loss, measuring assets backing insurance contracts at fair value and measuring insurance obligations using current estimates consistent with relevant market information reduces accounting mismatches.

¹ Defined as differences arising if the values of assets and liabilities respond differently to changes in economic conditions.

² This will be recognised in profit or loss only over time.

- 11 Both IFRS 9 and IFRS 17 include options to reduce accounting mismatches. Whereas IFRS 9 allows entities to elect to measure financial assets at fair value through profit or loss where this addresses an accounting mismatch, IFRS 17 allows entities to make an accounting policy choice between:
- (a) including insurance finance income or expense for the period in profit or loss; or
 - (b) disaggregating finance income or expense between profit or loss and OCI.

Evidence from case studies and economic study

- 12 Under the extensive case study, respondents were asked to identify the related assets of the portfolios included and how these are accounted for today and under IFRS 17/IFRS 9. Some respondents indicated the measurement bases they are using (see paragraph 19 of Appendix I).
- 13 Half of the respondents did not know whether IFRS 17 would result in a change in investment strategy. The remaining respondents had split views about the issue.
- 14 Respondents to the simplified case study were divided as to whether IFRS 17 would affect their current investment strategy. It was noted that economically risks are unchanged by the introduction of IFRS 17, but the accounting would make these risks more visible than today. For those that expected an impact, it was due to the desire to reduce capital requirements under Solvency II as well as any volatility in profit or loss for accounting purposes.
- 15 In the economic study commissioned by EFRAG it has also been noted that:
- (a) Although there is considerable discussion about insurers moving away from debt securities towards new asset classes and/or equity, the aggregate data from EIOPA on the investments of EU insurers do not show a significant movement out of the debt securities at the EU wide level.
 - (b) The majority of stakeholders interviewed (i.e. supervisory authorities, insurers and external investors) agree that IFRS 17 alone will not impact the asset allocation of insurance undertakings, as this activity is more driven by risk management and/or asset/liability management.
 - (c) However, industry stakeholders expressed the view that the combined effect of applying IFRS 17 and IFRS 9 may have an impact on asset allocation.

EFRAG Secretariat analysis

- 16 Based on the assets identified in the case studies there will be few changes in the balance sheet structurally and from an accounting perspective³ under IFRS 17 and IFRS 9. However, for the income statement the EFRAG Secretariat assesses that, when measuring the insurance liability in a way that is consistent with observable market information:
- (a) For financial assets at fair value through profit or loss, the income and expenses reported in profit or loss under IFRS 17 as a result of changes in current interest rates are expected to offset, at least to some extent, the volatility in profit or loss that may arise from financial assets accounted for at fair value through profit or loss under IFRS 9.
 - (b) For financial assets at amortised cost, the insurer can elect the fair value option under IFRS 9 in order to reduce accounting mismatches.
 - (c) For financial assets at fair value through OCI, the insurer can either:

³ However, some respondents indicated that complex bonds and equity-like instruments may be classified and measured differently under IFRS 9.

- (i) elect the fair value option under IFRS 9 in order to reduce accounting mismatches; or
 - (ii) elect the option under IFRS 17 to disaggregate financial income or expense between profit or loss and OCI.
- 17 Given the few responses, the EFRAG Secretariat has little evidence of equity instruments that were carried at cost⁴ and the only available evidence points to bonds being classified as Available-for-Sale (AFS) under IAS 39 *Financial Instruments: Recognition and Measurement*. From the economic study commissioned by EFRAG the EFRAG Secretariat notes that although a significant shift in investments in bonds is not expected, the measurement category might change due to the SPPI test under IFRS 9. As noted in paragraph 19 of Appendix I, some respondents to the extensive case study noted that they are currently classifying assets as AFS under IAS 39. For further discussion on equity instruments carried at FVOCI under IFRS 9, refer to paragraphs 39-42 and 57-60 below.
- 18 In summary, the EFRAG Secretariat notes that although IFRS 17 in itself is not expected to change the investment strategy of insurers, the combined application of IFRS 17 and IFRS 9 might have such an impact.

Asset liability management

- 19 The degree to which matching insurance liabilities and assets backing those liabilities can be successfully matched depends on a number of factors:
- (a) The use of a dedicated fund of assets or a general fund of assets;
 - (b) The existence of economic mismatches between the assets and the liabilities; and
 - (c) The existence of accounting mismatches between the assets and the liabilities.

The use of a dedicated fund or a general fund of assets

- 20 Some insurers invest in a dedicated fund where a direct link exist between the assets and the liabilities whilst others make use of a general fund where there is no direct link between the assets backing the liabilities.

Evidence from case studies

- 21 The case studies showed:
- (a) In the extensive case study that, of the nineteen portfolios⁵, eleven were funded through a general fund of assets, while eight were funded through a general fund of assets.
 - (b) in the simplified case study that half of the respondents held assets that back specific liabilities whilst the other half generally held assets in a general fund.

EFRAG Secretariat analysis

- 22 The EFRAG Secretariat notes that one of the conditions for applying the Variable Fee Approach (VFA) is that the contractual terms should specify that the policyholder participates in a share of a clearly identified pool of underlying items. Consequently, the EFRAG Secretariat envisages that a dedicated fund of assets will be more prevalent for portfolios accounted for under the VFA than the General Model. Therefore, EFRAG Secretariat acknowledges that using a dedicated fund of assets allows the insurer to align the characteristics of the assets more closely to

⁴ Although one respondent commented that illiquid investments may be measured at cost.

⁵ For life insurance portfolios where sufficient information was received.

the portfolio of insurance liabilities that it supports, thereby limiting the degree of mismatches. In contrast, when relying on a general fund of assets, the assets in such a general fund support several portfolios of insurance liabilities each with different characteristics. In such a case, it is there will be more mismatches between the assets and the insurance liabilities.

Economic mismatches

- 23 Insurance entities typically seek to match the characteristics of their assets with their liabilities to minimise economic mismatches⁶ between the two. Economic matching depends on several factors (for example, the availability of assets of sufficient duration, the uncertainty as to when pay-outs on insurance contracts will be required, and the insurer’s desire to generate higher returns).

Evidence from the case studies

- 24 From the extensive case study respondents provided information on the following economic mismatches:
- (a) Currency mismatches;
 - (b) Eurozone mismatches⁷; and
 - (c) Duration mismatches.
- 25 For three portfolios currency mismatches were quantified. For one portfolio, backed by a dedicated fund, the mismatch was small. The two other portfolios backed by a general fund showed much bigger differences, however no conclusions can be drawn as information on the size of the general fund compared to the tested portfolio was not received.
- 26 For 13 portfolios Eurozone mismatches were reported, and for only three of these, quantitative information was provided.
- 27 As an illustration of the potential effect of eurozone mismatches, consider the following market interest rates:

Euro Member State	Interest on 30-year government bonds⁸
France	1.63%
Germany	1.10%
Italy	3.52%
Spain	2.58%

- 28 Many of these Eurozone mismatches were significant. In particular, respondents used qualifications such as “most”, “majority” or “mainly” to indicate whether their assets were held in the same jurisdiction as the corresponding liabilities.
- 29 The portfolios that were backed by a general fund of assets showed a significant average duration mismatch of 20%. In contrast, portfolios that were backed by a dedicated fund of assets showed a much smaller average duration mismatch of 4%.
- 30 Based on whether the portfolios were accounted for in accordance with the General Model or the VFA, no other particular trend information could be derived.

⁶ Defined as differences arising if the values of assets and liabilities respond differently to changes in economic conditions.

⁷ Eurozone mismatches refers to mismatches that arise when assets and liabilities are held in the same currency, but the jurisdictions of the assets held and liabilities issued differ (such as assets held and insurance contracts issued in differing countries of the Eurozone).

⁸ As at 11 September 2018.

EFRAG Secretariat analysis

- 31 The EFRAG Secretariat observed in paragraph 22 that economic mismatches are more prevalent in cases where portfolios are backed by a general fund as opposed to a dedicated fund. As a clear link between insurance liabilities and underlying assets is not needed under the General Model, it is more difficult to align the characteristics of the assets and the insurance liabilities in order to mitigate volatility. For the Eurozone mismatches, the EFRAG Secretariat obtained evidence that there is significant variability.
- 32 Although the VFA could be applied in cases where entities do not hold the underlying assets, the EFRAG Secretariat is of the view that in such cases another economic mismatch arises as changes in assumptions of the IFRS 17 liability will be recognised in profit or loss over time without the recognition of similar changes in assets.
- 33 Consequently, the EFRAG Secretariat is of the view that the mismatches identified above do not arise solely from the application of IFRS 17 and IFRS 9 but are economic in nature.

Accounting mismatches

- 34 When applying IFRS 17 and IFRS 9 together, accounting mismatches could arise from insurance liabilities measured at a risk-adjusted present value while assets backing the liabilities are measured differently. The EFRAG Secretariat assesses that accounting mismatches can arise in some of the following instances:

VFA - Scope

- 35 Some insurance contracts have returns based on the fair value of specified underlying items, such as bonds. The insurer and its policyholders share those returns, which are affected by market-driven changes in the fair value of the bonds.
- 36 The VFA enables insurers to recognise some changes in insurance contract liabilities due to changes in returns by adjusting the CSM, rather than in profit or loss. Absent such an approach, the General Model will have to be applied where such unearned returns would have to be recognised within profit or loss.

Evidence from case studies

- 37 In its extensive case study, the EFRAG Secretariat noted the following product lines and how they were expected to be accounted for carried under the different approaches.

General Model	VFA	PAA
Annuities	Annuities	Motor
Non-life	Savings / Protection	Other
Protection	Unit linked	
Reinsurance ceded and held	Other	
Savings/Protection		
Unit linked		
Indirect participation		
Other		

EFRAG Secretariat analysis

- 38 In conclusion, entities that qualify and apply the VFA and manage their assets and liabilities together in order to reduce economic mismatches can reduce mismatches significantly. However remaining mismatches are still present when the General Model are to be applied.

Equity instruments at fair value through OCI without recycling

- 39 IFRS 9 allows for equity instruments to be carried at fair value through OCI. However, the amount in OCI will never be recycled in profit or loss apart from dividends received. If these instruments back insurance liabilities an accounting mismatch can arise as over time the changes in the insurance liabilities will be recognised in profit or loss whereas the changes to any equity instruments backing those liabilities will never be recycled through profit or loss.

Evidence from case studies

- 40 Respondents in the extensive case study indicated their proposed accounting for equity instruments in paragraph 19 of Appendix I.
- 41 As part of evidence received, concerns have been raised by insurers that in the case of contracts with participation features, the share of profit of the shareholder is recognised in profit or loss over the total contract term, while for equity instruments at FVOCI the investment income will never be recognised in profit or loss. The lack of recycling is therefore perceived to create an accounting mismatch with the measurement of insurance liabilities.

EFRAG Secretariat analysis

- 42 The EFRAG Secretariat notes that the share of profit for the shareholders will be recognised in P&L over the period via the release of CSM to profit or loss.
- 43 Furthermore, the option to measure equity instruments at fair value through OCI is an option and not a requirement under IFRS 9. However, the EFRAG Secretariat notes that the reason for exercising this choice is to mitigate the volatility of the effect of strategic investments within the income statement. Nonetheless, the EFRAG Secretariat is of the view that if those assets are backing insurance liabilities, entities could choose to measure such instruments at fair value through profit or loss as opposed to OCI to reduce any perceived opportunity for an accounting mismatch that could arise.

Risk mitigation option in IFRS 17 and hedge accounting

- 44 The concerns relate to the risk mitigation option in IFRS 17 only deals with contracts under the VFA and derivatives as hedging instruments.
- 45 As with other industries, accounting mismatches may arise where a hedging instrument and hedged item are not measured consistently.

Evidence from case studies

- 46 Respondents indicated that derivatives are not the only method of hedging, other hedging instruments include mortality bonds or investments in special funds, but how these are accounted for were not discussed.
- 47 The EFRAG Secretariat notes that hedge accounting under IFRS 9 could be used as a measure to mitigate risk. However, when respondents to the extensive case study were asked if they intend to apply hedge accounting almost all respondents indicated that they do not intend to apply hedge accounting due to the following reasons:
- (a) When derivatives are part of the underlying items, the change in the fair value of the derivatives will offset (partly or fully) the cost of the guarantees, leading to reduced changes in the fulfilment cash flows. This offset is not perfect, i.e. some mismatches still remain depending on the methods used;
 - (b) Currently, hedging (including economic hedging) is applied on a macro basis, i.e. derivatives backing VFA contracts are not allocated to the same backing-assets of insurance-portfolios since IFRS 4 does not require such granularity.

- (c) The vast majority of assets backing insurance contracts (including hedging derivatives) are held at FVPL with fair value movements going through the income statement are matched against movements in the insurance liabilities which are measured using current economic assumptions. This will continue after implementing IFRS 9 and IFRS 17;
- (d) For the life business the hedging strategies focus on the Solvency II surplus. This includes hedges of items which are on the Solvency II balance sheet, but not on the IFRS 17 balance sheet.
- (e) Hedge accounting requires the hedged item to be separately identifiable and reliably measurable which is not possible where investment and insurance components of an insurance contract are highly interrelated.
- (f) Policyholder behaviour and other future expectations (e.g. lapses, surrenders, new business sales, and mortality) are intertwined with the impact of financial market variables. It is not evident how these items could be excluded from the hedging relationship.

EFRAG Secretariat analysis

- 48 The EFRAG Secretariat acknowledges that insurers applying the VFA for contracts with direct participation features that use derivatives to manage financial risks are permitted, but not required, to apply IFRS 17's 'risk mitigation solution'. Using this solution, the effects of changes in the effect of financial risks that would otherwise adjust the CSM under the VFA approach are instead recognised in profit or loss. One of the conditions for applying this option is to document the risk management objective and the strategy for mitigating the risk. This is similar to IFRS 9's documentation requirement to be eligible for hedge accounting⁹.
- 49 Therefore, the EFRAG Secretariat notes that the recognition of changes in that financial risk in profit or loss partially offsets the effect of fair value changes in the relevant derivatives that are recognised in profit or loss and reduces potential accounting mismatches.
- 50 Under the General Model, changes in the effect of financial risk do not impact the CSM but is recognised in profit or loss immediately and it is therefore not clear what remaining accounting mismatch remains in respect of risk mitigating derivatives.
- 51 The EFRAG Secretariat has not been provided with further information as to the accounting mismatches that may arise (under the VFA or General Model) when non-derivatives are used for risk mitigation purposes.

Option for the presentation of changes in financial assumptions

- 52 Changes in insurance contract liabilities may be the consequence of changes in financial assumptions (i.e. discount rates and other financial variables). When applying IFRS 17, an insurer will recognise the effect of some changes in financial assumptions in the period in which the changes occur. However, the insurer will choose whether to present this effect:
 - (a) in profit or loss, or
 - (b) disaggregated between profit or loss and OCI.
- 53 The choice will be made individually for each portfolio of insurance contracts. The flexibility in the presentation of the effects of changes in financial assumptions provided by IFRS 17 will allow an insurer to align the accounting treatment of each

⁹ However, hedge accounting under IFRS 9 is also subject to other more onerous eligibility criteria that do not apply to IFRS 17's risk mitigation solution.

portfolio of insurance contracts with the accounting treatment of the assets that back that portfolio.

Evidence from case studies

- 54 In the extensive case study, some respondents accounted for their insurance finance income or expense through profit or loss under IFRS 17. The remaining 60% chose the disaggregation between OCI and profit or loss.
- 55 No general conclusions could be drawn from the extensive case study on the impact on volatility of combining IFRS 9 and IFRS 17. Respondents did not distinguish, when measuring sensitivities, between the accounting and the economic mismatches impacting their balance sheets. The most common economic mismatch was the Eurozone mismatch as described above. In addition, an overall high sensitivity to equity risk was reported, even while there was a low to very low level of investments in equity instruments.

EFRAG Secretariat analysis

- 56 The EFRAG Secretariat expects that insurers will choose the option that minimises accounting mismatches between investment income from financial assets and insurance finance expenses from insurance contract liabilities. For example, if an insurer mainly holds financial assets at fair value through profit or loss, it is expected that the insurer would present all changes in insurance contract liabilities from financial assumptions in profit or loss. The changes in financial assumptions might impact assets and will then be partially offset by a similar impact on the insurance liabilities with a reduced overall effect on profit or loss.

Transition

OCI under the fair value approach

- 57 At transition, under the fair value approach, entities have the option of setting OCI on the insurance liabilities to nil as per paragraph C24(b) of IFRS 17. This option is not available to assets accounted for at fair value through OCI under IFRS 9. Therefore, the EFRAG Secretariat acknowledges that setting OCI on the liabilities to nil at transition, whilst maintaining the historical OCI on related assets has an asymmetric impact on equity at transition and the results going forward.

Evidence from case studies

- 58 In the extensive case study, it was noted that of the 14 portfolios under the fair value transition approach, respondents indicated the following with regards to the option of setting OCI to nil:
- (a) For 21% of the portfolios OCI will be equal to the cumulative amount recognised in OCI from the underlying items.
 - (b) For 14% portfolios the OCI will be set at nil as they are not restricted by IFRS 17 paragraph C24(c) from applying the option. Also, the selected portfolios were measured under the general model.
 - (c) For the remaining selected portfolios, no information was provided on the treatment of OCI at transition.

EFRAG Secretariat analysis

- 59 The EFRAG Secretariat acknowledges that a major factor in the classification of financial assets in accordance with IFRS 9 is an insurer's business model. The application of IFRS 17 would not of itself have been likely to have resulted in a change in an insurer's business model in accordance with IFRS 9. However, the IASB acknowledged that there is a relationship between how entities manage their financial assets and their insurance contract liabilities. Therefore, to reduce the risk of accounting mismatches arising, the IASB decided to allow an insurer to reassess

its business models on the initial application of IFRS 17 if they have previously applied IFRS 9.

- 60 The EFRAG Secretariat is therefore of the view that the lack of an option to set OCI to nil at transition for assets classified at FVOCI is not an issue arising from IFRS 17 as entities are permitted to reassess their business models in order to reduce accounting mismatches. The transitional requirements for financial asset accounting are addressed in IFRS 9. The EFRAG Secretariat also notes that entities are permitted but not required to set the OCI to nil therefore the mismatch will arise from the management decision of whether to exercise the option in IFRS 17.

Comparative information

- 61 In contrast to IFRS 17 which requires one year of comparative information, IFRS 9 permits, but does not require, an insurer to restate prior periods if it is possible without using hindsight. When an insurer does not restate prior periods (either as a matter of choice or because restatement without use of hindsight is not possible), the financial statements in which IFRS 17 is first applied will include restated comparative information for insurance contracts but the associated financial assets will be reported in accordance with IAS 39.

EFRAG Secretariat analysis

- 62 The EFRAG Secretariat notes that the misalignment of presenting comparative financial information for financial assets and insurance liabilities under IFRS 9 and IFRS 17 is subject to a choice. The EFRAG Secretariat acknowledges that hindsight should not be applied in providing comparative information for financial assets. However, entities that want to align their comparative information still have the ability to do so without the use of hindsight (as the comparative year is still in the future) and are permitted to do so.

Question for EFRAG TEG

- 63 Does EFRAG TEG have comments on the analysis?

B - INTERACTION OF IFRS 17 WITH IFRS 15

- 64 This part comprises:
- (a) Overview
 - (b) Separating components from an insurance contract;
 - (c) Unit of account;
 - (d) Fixed fee contracts; and
 - (e) Insurance acquisition cash flows.

Overview

- 65 IFRS 15 specifies the accounting treatment for all revenue arising from contracts with customers. Under IFRS 17, consistent with IFRS 15, an insurer depicts revenue for the transfer of promised coverage and other services at an amount that reflects the consideration to which the insurer expects to be entitled in exchange for the services. This means that the insurer:
- (a) excludes from insurance revenue any investment components; and
 - (b) recognises insurance revenue in each period as it satisfies the performance obligations in the insurance contracts.
- 66 Both Standards require that the statement of financial position reports the related asset or liability, and the statement(s) of financial performance reports the progress towards satisfaction of the performance obligations in the contracts:
- (a) IFRS 15 establishes the amount of revenue to be recognised each period and adjusts the contract asset or contract liability at the start of the period by the amount of revenue recognised to measure the contract asset or contract liability at the end of the period; and
 - (b) IFRS 17 requires a measurement model that establishes the carrying amount of the asset or liability for the group of insurance contracts at the start and end of the reporting period. The amount of insurance revenue presented is determined by reference to these two measurements.

Separating components from an insurance contract

- 67 Under IFRS 17 an insurer should separate performance obligations to provide goods and non-insurance services from the host contract, regardless of whether the host contract is within the scope of IFRS 17 or of IFRS 15. Accordingly, IFRS 17 requires entities to separate only the goods and services that are distinct from the provision of insurance coverage, in a consistent manner to IFRS 15. IFRS 17 requires an insurer to allocate the cash inflows of an insurance contract between the host insurance contract and the distinct good or non-insurance service, based on the stand-alone selling price of the components, consistent with IFRS 15.

Evidence from case studies

- 68 In the extensive case study, no evidence of separation of goods and services under current practice were noted.
- 69 Respondents to the simplified case study noted that unbundling were generally not used today, and no change is expected under IFRS 17.

EFRAG Secretariat analysis

- 70 Based on the result of the case studies the separation of components did not appear to be significant in the past and there is no evidence that that will change in nature.

Unit of account

- 71 For recognition and measurement requirements (including release of CSM), the unit of account is a group, but IFRS 17 allows that estimation of fulfilment cash flows can be done at a higher level of aggregation than a group or a portfolio. A group of insurance contracts may comprise a single contract.
- 72 IFRS 15 specifies the accounting of an individual contract with a customer as the unit of account, as a practical expedient an insurer may apply IFRS 15 to a portfolio of contracts (or performance obligations) with similar characteristics if the insurer reasonably expects that the effects on the financial statements of applying IFRS 15 to the portfolio would not differ materially from applying IFRS 15 to the individual contracts (or performance obligations) within that portfolio. When accounting for a portfolio, an insurer shall use estimates and assumptions that reflect the size and composition of the portfolio.

EFRAG Secretariat analysis

- 73 Although the EFRAG Secretariat did not ask for evidence on the impact of the unit of account between the two Standards, the EFRAG Secretariat notes that, in some cases, the unit of account under both IFRS 15 and IFRS 17 is the same.

Fixed fee contracts

- 74 Some contracts meet the definition of an insurance contract but have as their primary purpose the provision of services for a fixed fee. An entity (including insurers) may choose to apply IFRS 15 instead of IFRS 17 to such contracts that it issues if, and only if, specified conditions are met. The insurer may make that choice contract by contract, but the choice for each contract is irrevocable. The conditions are:
 - (a) the insurer does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer;
 - (b) the contract compensates the customer by providing services, rather than by making cash payments to the customer; and
 - (c) the insurance risk transferred by the contract arises primarily from the customer’s use of services rather than from uncertainty over the cost of those services.

EFRAG Secretariat analysis

- 75 The EFRAG Secretariat notes that the choice in IFRS 17 for fixed fee contracts allows insurers to select the one that they prefer, contributing to the positive interaction of applying the two Standards together.

Insurance acquisition cash flows

- 76 The definitions of insurance acquisition cash flows and contract costs under the two standards are as follows:

Insurance acquisition cash flows under IFRS 17	Contract costs under IFRS 15
Insurance acquisition cash flows arise from the costs of selling, underwriting and starting a group of insurance contracts that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual	Contract costs are the incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) and are recognised as an asset if the insurer expects to recover them.

Insurance acquisition cash flows under IFRS 17	Contract costs under IFRS 15
contracts or groups of insurance contracts within the portfolio.	

77 The following differences between the IFRS 15 and IFRS 17 in respect of acquisition costs were noted:

- (a) The scope and definition of acquisition costs under the two Standards differ, with IFRS 17 including a wider range of costs compared to IFRS 15; and
- (b) Costs capitalised under IFRS 15 relate to only those bids that were successful and are subject to amortisation on a systematic basis over a period that can include expected renewals of the existing contract. Under IFRS 17, the acquisition costs reduce the CSM at inception and are effectively recognised through the amortisation of the CSM over the coverage period as established by the contract boundary.
- (c) Contract costs under IFRS 15 are subject to annual impairment testing whereas, under IFRS 17, recoverability is dealt with by the determination of onerous groups of insurance contracts.

Evidence from case studies

78 The evidence obtained from the extensive case study included the following:

- (a) A respondent illustrated the impact of the treatment of acquisition costs on a property and casualty portfolio. The respondent found limited losses on onerous contracts, while demonstrating an overall profit on the line of business (the results were based on a combination of two portfolios). The respondent noted that the pricing reflects expected renewals.
- (b) A respondent described the situation for property and casualty business where acquisition costs are unconditionally paid, i.e. without any claw-back clause if the contract is not renewed after the first year. The respondent notes there are strong historical records of persistence of the contracts (i.e. many of the policyholders continue the contract beyond the first year). Hence, the respondent argues that the economic duration of the contracts is longer than the contract boundary as defined in IFRS 17. This respondent quantified the difference between assigning the acquisition costs to new clients only, or to new clients and renewals. The respondent found that attributing acquisition costs to new clients only can lead to more onerous contracts. Further, this respondent noted that renewals can indirectly impact pricing as profitability assumptions are based on the expectation that contracts will be renewed over several years.

This respondent provided the following effect of IFRS 17 for its portfolio

Acquisition costs allocated to	A. New clients only	B. Renewals only	A+B New business (new clients and renewals together)
Pre-tax profit	-21,4 mio Euro	+50.0 mio Euro	+29.8 mio Euro

The respondent explained that when acquisition costs are allocated to the new business in their entirety (new clients and renewals together), the portfolio is overall profitable. However, when the acquisition costs are allocated between new clients and renewals, the allocation to new clients makes their contracts onerous. Also, what can be drawn from this example is that the major part of the acquisition costs is attributed to renewals of the contracts from a commercial perspective.

79 In the simplified case study:

- (a) Some respondents indicated that the IFRS 17 requirements do not reflect either the long-term business model of insurers or the economic reality of transactions as this requirement would likely result in onerous contracts. They stated that there are high acquisition costs relating to the first premiums payment, however, they expect that the business will renew thereby recuperating the initial acquisition costs.
- (b) A respondent stated that due to the CSM being released over a very long period of time for annuity business, IFRS 17 would cause a significant mismatch between the expenses being incurred and the CSM being released to pay for those expenses.
- (c) Another respondent indicated that since this requirement would lead to onerous contracts, this respondent would expect some changes in products and product trends.

EFRAG Secretariat analysis

80 The EFRAG Secretariat notes that some contracts could become onerous as a result of the allocation of acquisition costs. The EFRAG Secretariat also acknowledges that:

- (a) some insurers have raised concerns about the different treatment of similar costs under IFRS 17 compared to the treatment in IFRS 15 due to the differences as highlighted in paragraph 77; and
- (b) from a commercial perspective, an insurer's decision to incur a certain level of acquisition costs can incorporate a number of factors including its expectation of contract renewals.

81 The EFRAG Secretariat also notes that CSM release does not provide the cash flows to pay for expenses. Acquisition costs also reduces CSM at initial recognition and so do not impact the profit or loss directly but by reducing the amount of CSM released over the coverage period. Other ongoing expenses included in the fulfilment cash flows will not impact the profit or loss as the payment of these will reduce the insurance liability. The EFRAG Secretariat acknowledges that if there are other types of expenses a mismatch may occur, but further details are required to conclude on such examples.

Question for EFRAG TEG

82 Does EFRAG TEG have comments on the analysis?

Appendix I: Extracts from the answers to the extensive case study

Question 26

1 For each portfolio selected:

- (a) **Define the economic characteristics of the liabilities (duration, transactional currency, jurisdiction issued, fixed or variable guarantees, options included, etc);**
- (b) **Taking into account the fund where the assets are held, identify the economic characteristics of the covering assets (duration, transactional currency, jurisdiction located, fixed or variable interest rates, options included, sensitivity to re-allocation, etc).**

2 Economic mismatches mainly arose from:

- (a) Currency mismatches;
- (b) Duration mismatches; and
- (c) Eurozone mismatches - Mismatches due to the fact that liabilities were issued in a jurisdiction other than the jurisdiction in which the assets are being held.

Currency mismatches

- 3** For three portfolios currency mismatches were quantified. For one portfolio, backed by a dedicated fund, the assets were for more than 95% held in the same currency as the liabilities. Two other portfolios were backed by a general fund and showed much bigger differences in currency mismatch. However, by its nature, a general fund backs more than one portfolio of liabilities and as no information was received on the size of the portfolio compared to the general fund no conclusions can be drawn from the size of these mismatches.

Duration mismatches

- 4** Respondents provided duration mismatches for 19 portfolios.

Portfolios funded by a general fund of assets:

- 5** Eleven of the nineteen portfolios were funded through a general fund of assets, with an average duration mismatch of 20%. This percentage represents both situations where assets held had a longer duration than the liabilities (5 portfolios) and vice versa (6 portfolios).
- 6** Two portfolios were accounted for in accordance with the General model. For one portfolio the duration of the general fund was more than double the duration of the liabilities, for the other portfolio the duration of the assets was slightly shorter than the liabilities held.
- 7** Five portfolios were accounted for in accordance with the VFA. For two of these portfolios the duration of the assets was about 59% longer than the liabilities. For three of the portfolios the duration of the assets was shorter than the liabilities. The average of the duration shortfall was 16%, which was due to one portfolio only.
- 8** Four portfolios were accounted for in accordance with the PAA. For two of the portfolios the duration of the assets was shorter than the liabilities with an average of 12%. For the two other portfolios the duration of the assets was longer than the liabilities with an average of 32%.

Portfolios funded by a dedicated fund of assets:

- 9** Eight of the nineteen portfolios were funded through a dedicated fund of assets, with an average duration mismatch of 4%. This percentage represents both situations

where assets held had a longer duration than the liabilities (3 portfolios) and vice versa (5 portfolios).

- 10 Four portfolios were accounted for in accordance with the General model. For three portfolios the duration of the assets was longer than the duration of the liabilities with an average of 23%, for the other portfolio the duration of the assets was shorter than the liabilities held with 9%.
- 11 Three portfolios were accounted for in accordance with the VA. For all three portfolios the duration of the assets was shorter than the liabilities with an average of 22%
- 12 One portfolio was accounted for in accordance with the PAA. That portfolio showed a duration shortfall of 22% indicating that the corresponding assets are in duration 22% shorter than the liabilities.

Eurozone mismatches

- 13 For 13 portfolios Eurozone mismatches were reported, of which three were reported in a quantitative way, the remaining ten in a qualitative way.
 - (a) Quantitative input: between 63% and 93% of the assets were of the same jurisdiction as where the liabilities were issued.
 - (b) Qualitative input: respondents noted that “most” or the “majority” of their assets were held in the Eurozone or in the EU whereas the liabilities were almost entirely issued in a single jurisdiction in the EU. One respondent noted that the assets were “mainly” of the same jurisdiction as where the liabilities were issued.
- 14 Other respondents did not specify the jurisdictions where liabilities and supporting assets were held.
- 15 In the above analysis, no difference could be found whether the assets were held in a dedicated fund or a general fund.

Other comments received

- 16 More than half of the respondents indicated that hedging strategies such as derivatives are in place to mitigate mismatches identified.

Question 27

- 17 **For each portfolio selected:**
 - (a) **Identify the asset-types that correspond to those liabilities and how these are accounted for today and under IFRS 17;**
 - (b) **Identify whether these assets are held in:**
 - (c) **A general fund;**
 - (d) **A dedicated asset fund.**
 - (e) **When using a general fund, explain the methodology used to allocate assets to the corresponding liabilities;**
 - (f) **Explain how the asset portfolios differ from the EIOPA reference portfolios to calculate volatility adjustments;**
 - (g) **Clarify whether during the life of the insurance liabilities you apply asset reallocation, if so, between which asset types. Quantify the effect.**
 - (h) **If you apply hedge accounting under IFRS 17 in this case study, quantify the impact of hedge accounting on the accounting mismatch.**

Asset types and how these are accounted for

- 18 In relation to asset-types, accounting mismatches could arise from insurance liabilities measured at a risk adjusted present value while assets backing the liabilities are being measured at in one of the following ways:
- (a) amortised cost;
 - (b) fair value through profit or loss;
 - (c) fair value through OCI; and
 - (d) in accordance with other IFRSs (such as assets measured at costs less accumulated depreciation)

- 19 For the selected portfolios, respondents were asked to identify the asset-types that correspond to those liabilities and how these are accounted for today and under IFRS 17/IFRS 9. Respondents had the following remarks:

- (a) Respondents indicated that they are using the following measurement bases;

Asset types	Accounted for today	Accounted for under IFRS 9 and IFRS 17
Bonds	AFS (some respondents)	FVOCI
Loans	Amortised cost (one respondent)	FVPL
Equities	AFS (some respondents)	FVPL or FVOCI
Derivatives	FVPL (one respondent)	FVPL
Illiquid instruments	AFS or cost (one respondent)	FVPL or cost
UCITS ¹⁰	AFS (one respondent)	FVPL

- (b) Apart from the above, some respondents only provided their current measurement basis for their assets and did not indicate how this will change with the introduction of IFRS 9 and IFRS 17.
- (i) A few of the respondents indicated that apart from their one portfolio where most asset types are measured as available-for-sale investments, all these asset types are measured at FVPL: debt, equities, unit trusts, real estate, deposits, cash, loans, derivatives.
 - (ii) The other respondents noted that their government bonds are currently treated as available for sale investments.

General fund vs dedicated fund

- 20 In relation to funds where assets are held, accounting mismatches are more prevalent where assets are held in a general fund as opposed to a dedicated fund. The respondents that answered the question for their selected portfolios indicated that assets were predominantly held as follows:
- (a) In a dedicated fund, 21 portfolios; and
 - (b) in a general fund, 26 portfolios.

¹⁰ Undertakings for Collective Investment in Transferable Securities.

Difference with EIOPA reference portfolio for volatility adjustment

- 21 Some respondents indicated the difference between the EIOPA reference portfolio and their portfolios. In general the difference resulted in holding more assets in the same jurisdiction as where the liabilities were issued, thereby overall reducing the economic mismatch between the two.
- (a) A few respondents noted that the main difference is the higher rate of government bonds in the respective jurisdictions than allowed by EIOPA;
 - (b) A few respondents noted the portfolio had a higher composition of assets from their jurisdiction;
 - (c) Another respondent indicated that differences arises in terms of how much of the assets were held in government bonds compared to corporate bonds, which affected the size of the spread that contributes to the mismatch.
- 22 Other respondents noted they do not apply a volatility adjustment or mentioned to use that they use a matching adjustment instead.

Asset reallocations

- 23 The frequent reallocation of assets could lead to asset portfolios which may not match the insurance liabilities, increasing economic mismatches.
- (a) In general respondents indicated that no material asset reallocations occurred. Respondents provided the following remarks:
 - (i) The proportion invested in equity and property would be reduced if necessary to ensure the solvency position of the funds was not compromised. One respondent indicated that it is not possible to quantify the effect of asset reallocations;
 - (ii) The total asset pool is managed to match the insurance liability cash flows, manage the credit risk and optimise regulatory capital; and
 - (iii) Reallocations between similar assets are exceptional.
 - (b) A few respondents did not specifically indicate whether asset reallocations took place but explained their investment strategy. These respondents deemed it not possible to quantify the effect of asset reallocations.

Hedge accounting

- 24 Applying hedge accounting under IFRS 9 provides a mechanism to mitigate the effect of accounting mismatches. Almost all respondents indicated that they did not apply hedge accounting for the selected portfolios. However one respondent indicated that they are currently applying hedge accounting for one of their selected portfolios but noted that such a practice was not the key focus for the purpose of the case study. This respondent indicated that hedge accounting is currently applied to cross currency hedges where the foreign bond must pass the solely payments of principal and interest (SPPI) test in order to qualify as a hedge item.

Question 28

- 25 For each portfolio selected:**
- (a) **Quantify any economic mismatch between the insurance liabilities and the corresponding assets;**
 - (b) **Quantify any accounting mismatch between the insurance liabilities and the corresponding assets;**
 - (c) **Please explain what strategy, if any, is used to minimise the existence of the economic mismatch.**

Accounting mismatches

- 26 A majority of respondents did not quantify the effect of accounting mismatches but made the following remarks:
- (a) One respondent performed a sensitivity analysis based on interest rates while another indicated that the quantification was not possible due to the given timeframe.
 - (b) Some respondents noted that no significant accounting mismatches were identified.
 - (c) Other respondents noted that accounting mismatches arise due to:
 - (i) The different treatment of reinsurance contracts and underlying insurance contracts;
 - (ii) The difference in interest rates used for the measurement of assets and liabilities;
 - (iii) The different treatment of liabilities and assets backing those liabilities;
 - (iv) The fact that the risk mitigation option could not be retrospectively applied on transition; and
 - (v) The impact of changes in interest rates on the cost of guarantees is taken to OCI while movements in derivatives used to hedge these guarantees is taken to profit or loss.

Economic mismatches

- 27 Some respondents noted that no major economic mismatches were identified.
- 28 A respondent indicated that the quantification was not possible due to the timeframe for the case study.
- 29 A few respondents noted that an economic mismatch is mainly a consequence of the duration mismatch between assets and liabilities.
- 30 A respondent indicated that a mismatch arise due to either lapse risk or interest rate risk.
- 31 Another respondent noted that volatility can arise when the shareholder chooses to take on credit risk associated with assets backing the annuity business as the IFRS 17 discount rate does not include the element of the asset yield that is considered to relate to credit risk (it only includes a premium for illiquidity over the risk-free rate). The respondent indicated that the direct insurance business is written in collaboration with reinsurance partners. To model the business for the purpose of this case study has been challenging as they do not hold the data to model the portfolios on a gross basis given that their economic exposure is to the net position. This gives rise to a very significant economic mismatch. The respondent also indicated that economic volatility does occur as:
- (a) the value of the future management charges is impacted by investment gains and losses within the fund; and
 - (b) the transfers from the fund is impacted by investment gains and losses within the fund.

Strategy

- 32 Some respondents noted that a strategy is in place aiming at reducing the duration gap through ALM strategy.
- 33 Some respondents utilised hedging techniques but they do not apply hedge accounting.

- 34 Another respondent indicated the following strategies are in place to ensure assets are matched with liabilities:
- (a) Cash flow matching;
 - (b) Rating ensures that assets are suitably secure for meeting liabilities;
 - (c) Appropriate spread to ensure a decent return is earned on assets; and
 - (d) Matching adjustment eligibility and capital treatment.
- 35 Other respondents noted that:
- (a) A strategy that could be used is the active management of credit risk.
 - (b) The overall economic matching on an entity level is used therefore assets are not matched on a single portfolio level.
 - (c) Both Solvency II and national regulations minimise any risk of economic mismatch.
 - (d) The matching adjustment application almost eliminates mismatches.

Question 46

- 36 For each of the portfolios identified, apply IFRS 9 to your financial assets and IFRS 17 to your insurance liabilities. Identify any accounting and economic mismatches relying on the information gathered through steps 4.8 and 4.9.**
- 37 For portfolios under the VFA, generally no mismatches were found. An exception is the mismatch in OCI for assets measured at amortised cost.
- 38 For contracts under the General Model:
- (a) One respondent noted that for their selected portfolios – using the modified retrospective approach on transition - no significant financial or accounting mismatches have arisen. This was because the locked-in rate is similar to the acquisition internal rate of return of the assets. In addition the respondent noted to account for the unrealised gains and losses on the assets and the change in interest rates of the liabilities in OCI.
 - (b) For the general model applied to contracts with a pay-out dependent on financial variables, the major source of potential economic mismatches is the complexity of the systematic allocation of OCI for complex products. Mismatches can occur if the investment result used for policyholder participation significantly deviates from the IFRS 9 investment result (e.g., if equities are measured at amortised cost for policyholder participation rather than at fair value). For the General Model there will be mismatches between the asset and liability sides, driven by the fact that the assets on average have a longer duration than the liabilities and the mixed measurement model on the asset side.
 - (c) One respondent noted that when applying the General Model to a portfolio without direct participation features, they considered that there was an accounting mismatch with the assets as these are accounted for at FVOCI or FVPL.
 - (d) One respondent noted that the General Model reflects asset variation in OCI whereas the liability variation is reflected in P&L.
 - (e) One respondent noted that at this stage it was not possible to draw final conclusions but in their view the accounting policy option of disaggregating insurance finance income or expenses should eliminate the accounting mismatch.

IFRS 17: Interaction with IFRS 9 and IFRS 15

- (f) One respondent who had liabilities solely in country A and held assets in a general fund in other countries identified no economic or accounting mismatches under IFRS 4. Based on that assumption, the respondent noted that under IFRS 17 an economic mismatch would be shown.
- (g) One respondent did not identify accounting mismatches for its non-life portfolio while accounting mismatches were identified for its annuity contracts,. These occurred where assets cannot be fair valued whilst the discount rate must reflect their adjusted fair value yield (leases, insurance contract assets, equity release mortgages).