

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

## **IFRS 17 *Insurance Contracts*** **Issues raised by the insurance industry**

### **Objective**

- 1 The objective of this paper is to seek the views of EFRAG TEG on the issues raised by the insurance industry and how these issues should be raised in the draft endorsement advice to be recommended by EFRAG TEG to the EFRAG Board.

### **Background**

- 2 Insurers that provided responses to the full and simplified case studies provided a combination of evidence (quantitative and qualitative) and views on the effects of IFRS 17 *Insurance Contracts* and its acceptability in its current form. The CFO Forum presented its members' analysis of the key findings/concerns from the case study to the EFRAG Board on 3 July. This presentation was made available to EFRAG TEG as agenda paper 05-05 for the meeting on 5 July 2018<sup>1</sup>.
- 3 The EFRAG Board requested an analysis of the issues for consideration at a future meeting. Accordingly, the EFRAG Secretariat has prepared analyses of the issues which are attached to this paper. The analyses summarise the relevant requirements of IFRS 17 and include evidence from the case studies.

### **List of issues**

- 4 The list of issues raised in the presentation to the EFRAG Board are:
  - (a) Measurement:
    - (i) Acquisition cash flows;
    - (ii) CSM amortisation;
    - (iii) Discount rates
    - (iv) Multi-component contracts;
    - (v) Reinsurance;
    - (vi) Scope of hedging adjustment;
    - (vii) Scope of the VFA vs General Model and PAA;

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<sup>1</sup> The CFO Forum has since written to the President of the EFRAG Board and to the Chairman of the IASB calling for IFRS 17 (and IFRS 9) to be re-opened to address the CFO's Forum's concerns prior to endorsement.

- (viii) Transition;
  - (b) Operational complexity:
    - (i) Business combinations;
    - (ii) Level of aggregation;
    - (iii) Presentational issues;
  - (c) Other implementation challenges:
    - (i) Pressure on implementation timeline.
- 5 The CFO Forum also raised the issue of costs. This will be the subject of a separate paper.

#### **Evidence from the case studies**

- 6 The evidence from the case studies must be read in the light of the fact that case study participants made their best endeavours, but without fully developed systems to support their work. This required the use of shortcuts and approximations, given the time available. Further, the accounting policies used in the case studies and the IFRS 17 options selected may change as further analysis and information becomes available.
- 7 In the analysis, the evidence from the case study is derived from the full case study unless specifically mentioned that the evidence came from the simplified case study. The evidence from the case study included in this paper is necessarily summarised and therefore not comprehensive (but is intended to be representative).

#### **Questions for EFRAG TEG**

- 8 Does EFRAG TEG agree with the EFRAG Secretariat analysis, especially the aspects of the endorsement criteria that would be affected by the issues raised?
- 9 Does EFRAG TEG have other comments on the analysis before presentation to the EFRAG Board?

## MEASUREMENT

### 1. Acquisition cashflows

#### CFO Forum Presentation

##### *Description of issue and evidence*

- 10 Acquisition cash flows on new business that is expected to renew cannot be allocated to future periods. This is inconsistent with other industries which capitalise acquisition costs over multiple contracts. This was particularly evidenced in the testing of P&C contracts.

##### *Implications*

- 11 This results in incorrect matching of income and expenses over time. The implications are intensified if the inability to allocate acquisition costs to future periods results in contracts being onerous in accounting (but not in economic reality).

## IFRS 17

#### *Requirements*

##### *Definition of acquisition costs*

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

##### *IFRS 17, paragraphs 27, 38*

- 13 Acquisition cash flows are initially capitalised (unless the entity elects to recognise them immediately in profit or loss under the PAA). They are included in the CSM of a group of contracts to which they relate when that group is recognised.

#### *Basis for Conclusions*

##### *IFRS 17, paragraph BC176*

- 14 The IASB concluded that such an asset either does not exist or relates to future cash flows that are included in the measurement of the contract. The Board noted that an entity typically charges the policyholder a price the entity regards as sufficient to compensate it for undertaking the obligation to pay for insured losses and for the cost of originating the contracts. Thus, a faithful representation of the remaining obligation to pay for insured losses should not include the part of the premium intended to compensate for the cost of originating the contracts.

## Findings from the case study

- 15 Number of respondents addressing the issue: 2.
- 16 Of the comments received:
- (a) One respondent illustrated the impact of the treatment of acquisition costs relying 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) One 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 calculations for its portfolio (for reasons of confidentiality, the impact is reported in percentages).

Acquisition costs allocated to	A. New clients only	B. Renewals only	A+B New business (new clients and renewals together)
Pretax profit	(75%) negative	175% (positive)	100% (overall positive)

Explanation: 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 partly to new clients and partly renewals, the allocation to new clients becomes 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.

### EFRAG Secretariat analysis

- 17 The EFRAG Secretariat acknowledges that, from a commercial perspective, an insurer's decision to pay a certain level of acquisition costs might take into account its expectation of contract renewals. The EFRAG Secretariat also acknowledges that some contracts will be treated as onerous due to the allocation of acquisition costs to them.
- 18 Some insurers have raised concerns about the different treatment of similar costs under IFRS 17 compared to the treatment in IFRS 15 *Revenue from Contracts with Customers*. The following differences between the two Standards are noted:
- The scope and definition of acquisition costs under the two Standards differ, with IFRS 17 including a wider range of expenses compared to IFRS 15<sup>2</sup>.
  - Expenses capitalised under IFRS 15 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.
  - Contract costs under IFRS 15 are subject to annual impairment testing whereas, under IFRS 17, recoverability is dealt with by the onerous calculation for the groups of insurance contracts.

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<sup>2</sup> For contract costs, IFRS 15 refers to incremental costs compared to costs that are directly attributable under IFRS 17. IFRS 17 also includes costs not directly attributable to individual contracts or groups of insurance contracts within a portfolio e.g. cash flows related to both successful and unsuccessful acquisition activities which is not the case under IFRS 15.

## *IFRS 17 issues*

- (d) The unit of account for IFRS 15 is an individual contract or performance obligation whereas for IFRS 17 it is a group of insurance contracts.
- 19 The EFRAG Secretariat notes that eliminating the differences between IFRS 15 and IFRS 17 would require significant changes. IFRS 15 treats these costs as a separate unit of account but IFRS 17 treats them as a cash flow of the of group of insurance contracts. The acquisition costs are dependent on the underlying business and viewing them as a separate 'unit of account' would create knock-on effects.
- 20 The EFRAG Secretariat notes that considering behavioural estimates of renewals cannot be seen in isolation from the type of acquisition cash flows that are deferred. The costs deferred under IFRS 15 are specific and incremental to a particular contract, while under IFRS 17 they are directly attributable to a portfolio of contracts. The narrower scope of costs deferred under IFRS 15 goes hand-in-hand with the recognition of a separate asset. Considering behavioural estimates of renewals under the IFRS 17 model would require extending the contract boundary beyond the contractual contract boundary and thus require recognition of fulfilment cash flows over the expected renewal period.
- 21 The EFRAG Secretariat notes expensing the acquisition costs either immediately or over the contract period contributes to prudence.
- 22 Based on the above considerations, the EFRAG Secretariat considers that IFRS 17's treatment of acquisition costs will contribute positively to the technical endorsement criteria (relevance, reliability, understandability, comparability and prudence).

## 2. CSM Amortisation

### CFO Forum Presentation

#### *Description of issue and evidence*

- 23 The requirements on coverage units to be used for the CSM amortisation are not appropriate for all types of contracts. A key issue is that the CSM (of which the initial amount is impacted by investment spreads) cannot be amortised over the period in which investment services are provided. This issue was mainly identified in the testing for savings and participating contracts. It is acknowledged that this is a topic under discussion by the IASB for contracts in scope of the VFA. However, the issue is equally relevant for the general measurement model.

#### *Implications*

- 24 Profit recognition over the life of the contract is not appropriate. For certain contracts, profit recognition is strongly frontloaded or backloaded. For example, on a simple annuity contract profit is not appropriately recognised in the accumulation and deferral phases.

### IFRS 17

#### *Requirements*

##### *IFRS 17, paragraph B119*

- 25 The CSM for a group of insurance contracts is recognised in profit or loss in each period to reflect the services provided under the group of insurance contracts in that period.

#### *Basis for Conclusions*

##### *IFRS 17, paragraph BC279*

- 26 The amount is determined by identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage duration.

### Findings from the case study

- 27 Number of respondents addressing the issue: 7.
- 28 For 10 of the 26 portfolios tested under the General Model, concerns were raised that investment services should be considered in CSM amortisation by 7 respondents. Of these 10 portfolios, 8 were annuity products, the remainder was an indirect participating contract as well as a savings type product. One respondent calculated the CSM release based on actual insurance cash flows as suggested by the TRG, i.e. CSM release only during the insurance coverage period of the annuities. In this case more than 60% of the CSM was released over years 25-30 of a 30-year annuity contract.
- 29 One respondent to the simplified case study explained that for some products the insurance risk is provided over a shorter period than the contract duration, potentially resulting in 'upfronting' the CSM release.
- 30 Respondents expressed support for the proposed IASB amendment to IFRS 17 to include investment services when allocating CSM under the VFA.

**EFRAG Secretariat analysis**

- 31 The IASB is proposing to amend IFRS 17 to clarify that, for VFA contracts, the services provided include investment services because of the explanation in paragraph B101 that these “are insurance contracts that are substantially investment-related service contracts ... which ... promises an investment return based on underlying items”. IFRS 17 has a clear principle that provides relevant information that the allocation of the CSM to profit or loss is recognised in accordance with the services to be received by the customer.
- 32 However, for non-VFA contracts, it is not clear when and how any investment service provided should be identified and included in ‘services provided’ for the purpose of determining the pattern of CSM release. In some cases, the insurer may consider the service to include investment services, but the policyholder would not necessarily regard it as such. For example, with the purchase of a deferred annuity, the insurer will need to carefully manage the investment to ensure it can honour its obligations under the annuity contract, however, the policyholder is not concerned about the intervening period, but only the outcome, i.e. the receipt of the annuity as agreed.
- 33 The EFRAG Secretariat acknowledges that, for some products, an insurer receives and invests premiums before the start of the insurance coverage period in accordance with the business model but, under IFRS 17 may not recognise any revenue during this period. In such a case, the EFRAG Secretariat considers that the insurer’s investment activity is not a service provided to the policyholder. An analogy can be made with IFRS 15’s guidance on activities that are necessary to fulfil a contract but do not transfer a service to the customer.
- 34 The EFRAG Secretariat does not support an extension of the investment services concept to non-VFA contracts as, it is questionable whether there is a clear link between the promise to the policyholder and the provision of an investment service. To do so would imply a linkage that does or may not exist. If no specific investment service to the policyholder can be identified, including investment activity in determining the CSM release pattern does not lead to relevant information.
- 35 The EFRAG Secretariat questions whether any “true” profit pattern can be known. Often respondents compare the outcome under IFRS 17 to the profit pattern under current GAAP(s) and question the need to change that pattern. However, currently the patterns are not comparable given the significant differences in current practices. IFRS 17 sets out an overall principle that (in the view of the EFRAG Secretariat) will contribute to relevance and comparability while also requiring the use of judgement to adapt to specific fact patterns.
- 36 Based on the above considerations, the EFRAG Secretariat considers that IFRS 17’s requirements on CSM amortisation will contribute positively to the technical endorsement criteria.

### 3. Discount rates

#### CFO Forum Presentation

##### *Description of issue and evidence*

- 37 The use of a locked in discount rate for the CSM in the general model. The impact of assumption updates is absorbed in the CSM at the locked-in rate. The BEL is measured at the current rate. The difference between the locked-in and the current rate is reflected in the P&L and will significantly distort the current period result.
- 38 In the situation where the BEL component of the insurance liability is an asset and the CSM component is a liability, inconsistencies arise due to the different discount rates for BEL (current rate) and CSM (locked-in rate).
- 39 There is currently uncertainty regarding whether changes in asset mix will result in changes to the discount rate when the discount rate is determined top down using actual assets as a reference portfolio.

##### *Implications*

- 40 For the issue referred to in paragraph 37 above, the result is significantly distorted by the discount rate components of the impact of assumption changes that are otherwise absorbed in the CSM.
- 41 For the issue referred to in paragraph 38 above, the P&L and/or OCI is distorted by the use of different discount rates for different components of the insurance liability. This is particularly exacerbated when the BEL component is an asset.
- 42 In the situation referred to in paragraph 39 above, an interpretation of the reference portfolio that appropriately reflects the asset/liability matching strategy is key to avoid significant levels of spurious volatility.

#### IFRS 17

##### *Requirements*

###### *IFRS 17, paragraphs 36, 44, B72(b)*

- 43 The discount rates applied to the estimates of the future cash flows shall reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts; be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity; and (c) exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance
- 44 For insurance contracts under the general model, the carrying amount of the CSM of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for (among others): interest accreted on the carrying amount of the CSM measured at the discount rates determined at the date of initial recognition of a group of contracts,

##### *Basis for Conclusions*

###### *IFRS 17, paragraph BC201*

- 45 To the extent that the cash flows that arise from the contracts are expected not to vary with returns on underlying items, the appropriate discount rate should exclude any factors that influence the underlying items that are irrelevant to the contracts. Such factors include risks that are not present in the contracts but are present in the financial instrument for which the market prices are observed. Thus, the discount



rate should not capture all of the characteristics of those assets, even if the entity views those assets as backing those contracts.

### Findings from the case study

- 46 Number of respondents addressing the issue: 5. Of those participants:
- (a) One respondent estimated the pro-forma P&L impact of an annuitant mortality assumption change for 2017 under IFRS 17 (the actual improvement in life expectancy was less than originally expected). Assuming the use of modified or full retrospective approach and given differences in discount rate, about a quarter of the amount would have been recognised in P&L.
  - (b) Another respondent estimated that when testing sensitivity of results to changes in longevity (also for annuity products), a significant amount would be recognised in insurance finance expense given the larger impact on the liability compared to the CSM (in a decreasing interest rate environment). This is when not using the OCI option for interest rate changes.
  - (c) One respondent reflected the impact of changes to the risk-free interest rate on the balance sheet of an Asian business where the BEL is in an asset position. The equity balance increased by 22% or decreased by 19% with a 1% increase or decrease in the risk-free rate respectively.
  - (d) Another respondent expressed the concern above and referred to sensitivity of its annuity portfolios where a 50bps change in asset spread change (with no change to the reference portfolio or the discount rate) would result in a 671% negative change to profit before tax.
  - (e) One respondent commented that a 12% difference in the net finance result was due to the calculating interest on the CSM at the locked-in rate and that this does not reflect the financial performance of the insurance contracts.

### EFRAG Secretariat analysis

- 47 The EFRAG Secretariat notes that the issue of locked-in versus current rates for the CSM (both in the interest accretion and when updating for changes in estimates) impacts relevance and prudence. The CSM is a “cost-based” deferral that avoids a day 1 gain and provides a mechanism to allocate profit over the insurance coverage period. There are also other considerations.
- 48 In the extreme example where only interest rates change (with no other changes), the CSM and related amortisation would change if the CSM is accreted at current rates. This does not appear to provide relevant information or to be prudent.
- 49 However, as explained in (a) and (b) above, respondents expressed concern about the (in their view) anomalous result when a change to a technical assumption could impact the profit or loss due to different interest rates being used for the fulfilment cash flows and the CSM.
- 50 A further consideration is the operational complexity of having to use a historic rate for some parts for one of the models and the related costs. No information was provided on the impact on costs by the case study respondents.
- 51 The EFRAG Secretariat considers that the technical arguments for use of a locked-in rate or a current rate are finely balanced – both approaches have pros and cons. The EFRAG Secretariat also considers that a high-quality standard should select one approach or the other. However, given the significance of the issue, any amendments to change the standard would not be simple and the EFRAG Secretariat would welcome further analysis.

## 4. Multi-component contracts

### CFO Forum Presentation

#### *Description of issue and evidence*

- 52 Certain contracts exposing the issuer to credit risk that are in substance loans (for example equity release mortgages in the UK) contain a small insurance element which causes the entire contract to be subject to insurance accounting under IFRS 17.

#### *Implications*

- 53 Including these products in the scope of IFRS 17 is inconsistent with the treatment of similar products in other industries.

### IFRS 17

#### *Requirements*

##### *Definition of insurance contract*

- 54 An insurance contract is a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future

##### *IFRS 17, paragraph 10, 11*

- 55 An insurance contract may contain one or more components that would be within the scope of another Standard if they were separate contracts. For example, an insurance contract may include an investment component or a service component (or both). An investment component is separated from a host insurance contract only if that investment component is distinct.

#### *Basis for Conclusions*

##### *IFRS 17, paragraphs BC10, BC11, BC108*

- 56 If the IASB extended the scope of existing IFRS Standards to include insurance contracts, an insurer would need to identify investment components within each premium that it receives. The IASB decided that it would be difficult for an entity to routinely separate components of an insurance contract and setting requirements to do so would result in complexity. Such separation would also ignore interdependencies between components, with the result that the sum of the values of the components may not always equal the value of the contract as a whole, even on initial recognition.
- 57 Overall, applying generally applicable IFRS Standards would provide useful information for users of financial statements and would be relatively easy to apply to insurance contracts for which there is no significant variability in outcomes and no significant investment component. This is because, in those cases, the issues arising with IFRS 15 and IFRS 9 would not occur. However, simply applying generally applicable Standards would be difficult and would produce information of limited relevance for other types of insurance contracts. In contrast, the model required by IFRS 17 can be applied to all types of insurance contracts.

### Findings from the case study

- 58 Number of respondents addressing the issue: 2
- 59 Under current accounting, for the selected portfolios:
- (a) Nine respondents did not separate any components.

- (b) Two respondents separate guaranteed benefits and options under annuity contracts.
- 60 Of the nine respondents that do not separate contracts currently:
- (a) Two respondents are considering the need to separate hybrid contracts, riders on participating contracts and some guarantees on annuity contracts.
  - (b) Two respondents specifically noted the issue with regards to equity release mortgages. However, these loans were not part of their selected portfolios for the case study.
  - (c) Another respondent also raised concerns with regards to policy loans which will be deemed closely related to the insurance host contract under IFRS 17 but these loans were not part of their selected portfolios.

### **EFRAG Secretariat analysis**

- 61 The EFRAG Secretariat notes that the definition of:
- (a) an insurance contract is a principle-based definition which did not change with the introduction of IFRS 17; and
  - (b) the notion of “distinct” under IFRS 17 is consistent with IFRS 15 *Revenue from Contracts with Customers*.
- 62 The EFRAG Secretariat considers that the issue arises in part because, unlike in IFRS 4, entities are no longer permitted to separate (‘unbundle’) an embedded derivative that confers the insurance risk from an overall contract (unless the components are distinct). The EFRAG Secretariat acknowledges that IFRS 4’s greater flexibility in this area enables some entities to account for products such as equity release mortgages more simply than applying IFRS 17 (especially if the unbundled component was assessed to be immaterial).
- 63 The EFRAG Secretariat assesses that reintroducing an unbundling option would be a significant change, which would hinder comparability and add complexity. While IFRS 4 is very flexible in this area, a new unbundling solution would probably need to be much more tightly defined to meet the overall objectives of IFRS 17.
- 64 Further, the EFRAG Secretariat notes that IFRS 17 applies to all insurance contracts, whether the issuer is an insurer or not. The application of the ‘significant insurance risk’ principle to distinguish insurance contracts from financial instruments or IFRS 15 contracts should contribute to comparability. The EFRAG Secretariat assesses that contracts with significant insurance risk are dissimilar to contracts without such risk. Scoping out particular contracts would be arbitrary and could add complexity.
- 65 Based on the above considerations, the EFRAG Secretariat considers that IFRS 17’s scope and unbundling requirements contribute positively to the technical endorsement criteria.

## 5. Reinsurance

### CFO Forum Presentation

#### *Description of issue and evidence*

- 66 The approach to reinsurance gives rise to several accounting mismatches. Examples include:
- (a) For an underlying contract that is onerous, a cedant has to recognize a loss component through P/L whereas the relief from a corresponding reinsurance contract held has to be deferred over the coverage period
  - (b) Reinsurance held cannot be accounted for under the VFA model, even if the VFA model is applied to the underlying insurance contracts
  - (c) Contract boundaries for reinsurance are inconsistent with those of the underlying insurance contracts, meaning that the reinsurance accounting requires including an estimate of underlying insurance business that is not yet written/recognised

#### *Implications*

- 67 The inconsistencies between insurance and reinsurance accounting creates a number of accounting mismatches, meaning that the financial statements do not appropriately reflect the net risk position after reinsurance and, as a consequence, a distorted profit recognition pattern.

### IFRS 17

#### *Requirements*

##### *IFRS 17, paragraphs 47, 60, 69, B109*

- 68 An entity shall recognise a loss in profit or loss for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for the group being equal to the fulfilment cash flows and the contractual service margin of the group being zero.
- 69 Reinsurance contracts held are to be measured by applying the general model.
- 70 An entity may use the PAA (adapted to reflect the features of reinsurance contracts held that differ from insurance contracts issued for example the generation of expenses or reduction in expenses rather than revenue) to simplify the measurement of a group of reinsurance contracts held.
- 71 Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purposes of IFRS 17.

#### *Basis for Conclusions*

##### *IFRS 17, paragraphs BC298, BC299, BC311, BC313*

- 72 IFRS 17 requires a reinsurance contract held to be accounted for separately from the underlying insurance contracts to which it relates. This is because an entity that holds a reinsurance contract does not normally have a right to reduce the amounts it owes to the underlying policyholder by amounts it expects to receive from the reinsurer. The IASB acknowledged that separate accounting for the reinsurance contracts and their underlying insurance contracts might create mismatches that some regard as purely accounting, for example on the timing of recognition, the measurement of the reinsurance contracts and the recognition of profit. However, the IASB concluded that accounting for a reinsurance contract held separately from the underlying insurance contracts gives a faithful representation of the entity's rights and obligations and the related income and expenses from both contracts.

- 73 The amount paid for reinsurance coverage by the entity can be viewed as payment for:
- (a) the reinsurer's share of the expected present value of the cash flows generated by the underlying insurance contract(s). That amount includes an adjustment for the risk that the reinsurer may dispute coverage or fail to satisfy its obligations under the reinsurance contract held.
  - (b) a CSM that makes the initial measurement of the reinsurance asset equal to the premium paid. This margin depends on the pricing of the reinsurance contract held and, consequently, may differ from the contractual service margin arising for the underlying insurance contract(s).
- 74 The IASB concluded that the contractual service margin for the underlying group of insurance contracts should not be negative. However, IFRS 17 requires entities to instead recognise the negative difference over the coverage period of the group of reinsurance contracts held. The IASB was persuaded by the view that the apparent gain at initial recognition represents a reduction in the cost of purchasing reinsurance, and that it would be appropriate for an entity to recognise that reduction in cost over the coverage period as services are received.
- 75 In the IASB's view, measuring the group of reinsurance contracts held on the basis of the premium the entity receives for the underlying contracts when that premium does not directly affect the cash flows arising from the group of reinsurance contracts held would be contrary to viewing the group of reinsurance contracts held and the underlying contracts as separate contracts. Such a measurement approach would also not reflect the economics of the group of reinsurance contracts the entity holds - that the expense of purchasing the group of reinsurance contracts (that should be recognised over the coverage period) equals the whole of the consideration paid for the group of reinsurance contracts.

#### **Findings from the case study**

- 76 Number of respondents addressing the issue: 10
- 77 Of the respondents providing information:
- (a) Four respondents provided qualitative and quantitative input. Of these four:
    - (i) Two respondents provided an example relating to protection business that is onerous and becoming profitable after considering external reinsurance. These respondents described that direct protection was written in collaboration of reinsurance partners for that reason.
    - (ii) One respondent provided an example relating to a savings fund that was proportionally reinsured for 10%.
    - (iii) One respondent supported the exclusion of reinsurance assumed from the VFA. However, for intercompany purposes the respondent deemed it beneficial for reinsurance assumed to mirror the mechanics of the underlying business.
  - (b) Five other respondents from the full case study and one respondent from the simplified case study provided qualitative comments on the inability to use the VFA for reinsurance assumed and reinsurance held.
- 78 For reinsurance contracts held, five respondents mentioned the accounting mismatch, and raised concerns about the effect of intragroup reinsurance.

## EFRAG Secretariat analysis

- 79 The EFRAG Secretariat is sympathetic to the concerns about IFRS 17's accounting outcomes in cases when the effect of reinsurance is that the primary insurer is clearly in a net risk position. The rebalance and understandability of the reported information would be enhanced by showing the extent to which the risks have been offloaded to a third party. However, such a net risk position may exist when relying on some proportional reinsurance contracts (i.e. quota share treaties where the reinsurer covers a fixed proportion of every risk accepted by the direct insurer, no retention limits are applied), but does not arise when using other reinsurance contracts such as:
- (a) Proportional, surplus treaty (i.e. the reinsurer only reinsures that portion of risk that exceeds the retention limit of the direct insurer); or
  - (b) Non-proportional reinsurance such as an excess of loss or stop loss reinsurance contracts.

### *Reinsurance assumed*

- 80 When a reinsurer issues contracts that offset the risks/cash flows of direct participation contracts as defined in IFRS 17, the EFRAG Secretariat sees no principle against accounting for these contracts under the VFA. However,
- (a) The EFRAG Secretariat has been informed that such contracts do not exist today, or are very rare;
  - (b) As contracts with direct participation contracts are basically pass-through contracts to the policyholder, a demonstration of the cash flows between the reinsurer, the direct insurer and the ultimate policyholder is required; and
  - (c) Further complexities of combining investment risk and insurance risk together need to be addressed (see below).
- 81 The EFRAG Secretariat acknowledges that an accounting mismatch can arise when an underlying contract is onerous and the cedant is required to recognise a loss component in profit or loss while the relief from a corresponding reinsurance contract held is deferred over the coverage period.

### *Reinsurance ceded*

- 82 While being sympathetic to the "netting"- idea for particular reinsurance contracts held, the EFRAG Secretariat notes that such "netting" does not remove the need for identification of onerous contracts. In case only 40% of the risks is being reinsured, the remaining 60% may still be onerous.
- 83 In addition, a reinsurance contract only covers downside risk. When one of the risks covered is investment risk, issues arise such as:
- (a) Is the premium paid to the reinsurer reduced when the underlying assets provide a return above initial estimates; or
  - (b) Can an insurance claim be compensated with a higher than expected investment return of the underlying assets, or is there discretion, and who initiates this discretion, the insurer or the reinsurer?
- 84 The EFRAG Secretariat acknowledges that the IFRS 17 requirements are an important change to the netting practices that prevail today in several local GAAPs. The EFRAG Secretariat notes however that resolving the above issues could create additional complexity and might increase the costs of implementation.
- 85 Based on the above considerations, the EFRAG Secretariat considers that certain aspects of IFRS 17's requirements may detract from the technical endorsement criteria of relevance, reliability and understandability.

## 6. Scope of hedging adjustment

### CFO Forum Presentation

#### *Description of issue and evidence*

- 86 Whilst IFRS 17 includes a specific hedging adjustment, its use is limited to specific circumstances:
- (a) It is only available for contracts in scope of the VFA
  - (b) It cannot be applied retrospectively on from the date of initial application
  - (c) It can only be used when derivatives are used as hedging instrument
- 87 This was highlighted as part of the testing for a material book of business with guarantees that are hedged.

#### *Implications*

- 88 The inability to use the hedge adjustment outside the narrowly defined scope will result in accounting mismatches if the fair value changes on hedging instruments are not recognised in the same category (P&L, OCI or CSM) as the changes on the hedged items). This will significantly distort the net result and create misalignment between accounting results and risk management. Paradoxically, a perfect hedge would cause a comparatively higher income statement volatility than a partial hedge.

## IFRS 17

### *Requirements*

- 89 Hedge accounting is primarily within the scope of IFRS 9 *Financial Instruments* but IFRS 17 provides an optional risk mitigation accounting solution for VFA contracts.

#### *IFRS 17, paragraphs B115, B116*

- 90 An insurer may choose not to recognise a change in the contractual service margin to reflect some or all of the changes in the effect of financial risk on the entity's share of the underlying items or the fulfilment cash flows if the entity has a previously documented risk-management objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts and, in applying that objective and strategy:
- (a) the entity uses a derivative to mitigate the financial risk arising from the insurance contracts.
  - (b) an economic offset exists between the insurance contracts and the derivative, ie the values of the insurance contracts and the derivative generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated. An entity shall not consider accounting measurement differences in assessing the economic offset.
  - (c) credit risk does not dominate the economic offset.

#### *IFRS 17, paragraphs BC250 – BC255*

- 91 Amounts payable to policyholders create risks for an entity, particularly if the amounts payable are independent of the amounts that the entity receives from investments; for example, if the insurance contract includes guarantees. An entity is also at risk from possible changes in its share of the fair value returns on underlying items. An entity may purchase derivatives to mitigate such risks. When applying IFRS 9, such derivatives are measured at fair value.
- 92 For contracts without direct participation features, the CSM is not adjusted for the changes in fulfilment cash flows the derivatives are intended to mitigate. Hence,

both the change in the carrying amount of fulfilment cash flows and the change in the value of the derivative will be income statement. If the entity chooses to recognise all insurance finance income or expenses in profit or loss, there will be no accounting mismatch between the recognition of the change in the value of the derivative and the recognition of the change in the carrying amount of the insurance contract.

- 93 For contracts with direct participation features the CSM would be adjusted for the changes in the fulfilment cash flows, including changes that the derivatives are intended to mitigate. Consequently, the change in the value of the derivative would be recognised in profit or loss, but, unless the group of insurance contracts was onerous, there would be no equivalent change in the carrying amount to recognise, creating an accounting mismatch.
- 94 A similar accounting mismatch arises if the entity uses derivatives to mitigate risk arising from its share of the fair value return on underlying items.
- 95 The IASB concluded that, to avoid such accounting mismatches created by the VFA, an entity should be allowed not to adjust the contractual service margin for the changes in the fulfilment cash flows and the entity's share in the fair value return on the underlying items that the derivatives are intended to mitigate.
- 96 Such an option reduces the comparability of the measurement of insurance contracts because the contractual service margin will be adjusted by a different amount depending on whether, and the extent to which, an entity chooses to apply this approach. To limit the reduction in comparability, the Board decided that an entity may make this choice only to the extent that, in accordance with a previously documented risk management objective and strategy for using derivatives to mitigate financial market risk arising from those fulfilment cash flows

*IFRS 17, paragraph BC393*

- 97 Paragraph B115 of IFRS 17 permits entities not to recognise a change in the contractual service margin for changes in fulfilment cash flows and the entity's share in the fair value returns on underlying items for which an entity uses derivatives to mitigate their financial risk. However, an entity applying this option is required to document its risk management objective and the strategy for mitigating the risk before doing so. This documentation requirement is analogous to the documentation requirements for hedge accounting in IFRS 9. Consistent with the transition requirements for hedge accounting in IFRS 9, the Board concluded that retrospective application of the risk mitigation treatment would give rise to the risk of hindsight. In particular, the Board was concerned that documentation after the event could enable entities to choose the risk mitigation relationships to which it would apply this option, particularly because the application of this approach is optional. Consequently, IFRS 17, consistent with the transition requirements for hedge accounting in IFRS 9, requires prospective application of the risk mitigation option from the date of initial application of the Standard.

**Findings from the case study**

- 98 Number of respondents addressing the issue: 1.
- 99 One respondent made an estimate of the impact of IFRS 17's prohibition on retrospective application of the optional risk mitigation solution for VFA contracts. However, as the respondent did not provide estimates for the size of its portfolios, it is difficult to assess whether the impact is material.
- 100 Only one respondent expressed an intention to apply hedge accounting, whereas 7 stated that they did not expect to apply hedge accounting. One respondent noted they would consider whether to use hedge accounting.



- 101 Reasons for not using hedge accounting are that derivatives are not generally used. Instead instruments such as mortality bonds or investments in special funds are used.

**EFRAG Secretariat analysis**

- 102 The EFRAG Secretariat acknowledges the issues raised in relation to hedge accounting but notes that many of the fact patterns provided in the case study demonstrate the need for a solution under the dynamic risk management (DRM) approach as being developed by the IASB as part of a separate project. The EFRAG Secretariat considers that the lack of DRM solution today does not detract from IFRS 17's ability to meet the technical endorsement criteria.
- 103 The EFRAG Secretariat has sympathy with the concern on IFRS 17's prohibition on retrospective application of the optional risk mitigation solution for VFA contracts. However, the EFRAG Secretariat assesses that permitting or requiring retrospective application might increase relevance (because it enables entities to more fully report the effect of certain risk management strategies in place at transition to IFRS 17) but could raise concerns over reliability (because entities might be able to 'cherry-pick' the hedging relationships to include in the designation at transition). The EFRAG Secretariat notes that, although IFRS 9's transition provisions include a notion of 'continuing hedge relationships', hedging designations are generally prospective).
- 104 The EFRAG Secretariat expects that this issue will affect the relevance and reliability criteria of the standard.

## 7. Scope of the VFA model vs General model and PAA

### CFO Forum Presentation

#### *Description of issue and evidence*

105 The testing has shown that the results are very different depending on the measurement model applied, whilst there is a continuum in the nature of insurance products. There are several elements in the VFA model that deal more appropriately with specific elements of insurance products but these are not available under the general model or premium allocation approach. These include the alignment between liability discount rates with (accounting for) asset returns and the transitional amount in OCI.

#### *Implications*

106 The result is that insurance contracts that are economically similar will be accounted for very differently, which does not reflect economic reality. The significant differences between the models create 'cliff effects' that are very dependent on the interpretation of the scope definitions of the different models.

## IFRS 17

### *Requirements*

#### *Definitions*

- 107 **VFA:** An insurance contract for which, at 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.
- 108 **PAA:** An entity may simplify the measurement of a group of insurance contracts using the PAA if, at the inception of the group:
- (a) the entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced applying the general; model; or
  - (b) the coverage period of each contract in the group (including coverage arising from all premiums within the contract boundary determined at that date is one year or less.

### *Basis for Conclusions*

#### *VFA: IFRS 17, paragraphs BC231, BC239, BC241*

- 109 The VFA was developed for contracts that create an obligation to pay policyholders an amount equal in value to specified underlying items, minus a variable fee for service. These contracts are distinguished from those where the entity controls the cash flows of the investments, even when the entity is required to act in a fiduciary capacity for the policyholder.
- 110 The IASB concluded that for many insurance contracts it is appropriate to depict the gains and losses on any investment portfolio related to the contracts in the same way as gains and losses on an investment portfolio unrelated to insurance contracts.

*PAA: IFRS 17, paragraphs BC291*

- 111 The IASB views the PAA as a simplification of those general requirements. To simplify its application, the IASB also decided to provide guidance that an entity could assume, without further investigation, that the approach provides a reasonable approximation of the general requirements of IFRS 17 if the coverage period of each contract in the group is one year or less.

**Findings from the case study**

- 112 Number of respondents addressing the issue: 7.
- 113 The reasons provided for not being able to use the VFA where the entity considered that the VFA would have been appropriate were that:
- (a) The insurance contract contained a constructive obligation rather than a contractual obligation. It was acknowledged that that the link to underlying items was not enforceable. It was also noted that the insurance contract only relates to contracts issued within a specific jurisdiction.
  - (b) A substantial portion of the amount paid to policyholders does not vary with a change in the fair value of the underlying items.
  - (c) Assets were held in a general fund rather than being identifiable underlying items.
- 114 Three respondents explained why, in their view, the general model does not reflect their business model. Only one of the three respondents provided detailed information on the relevant portfolio and quantified the impact.
- 115 Four respondents did not provide quantified evidence to support their view that the CSM pattern under the general model does not reflect their business model. Another four respondents did not provide any information.

**EFRAG Secretariat analysis**

- 116 The EFRAG Secretariat acknowledges that scoping decisions need to be made when an accounting standard includes multiple models and that this inevitably has the effect that contracts on different points on a continuum are accounted for differently. A cliff effect will only arise with the PAA in the case of a contract with a term of one year or less and can be avoided by not adopting the PAA.
- 117 If the scope of the VFA were to be amended this would move the “cliff” rather than eliminating it. Further, if the scope were to be extended to contracts that do not specify a clear link between the payments to policyholders and the returns on an identifiable pool of assets it is unclear how the VFA would operate (because the VFA involves deferring a specified amount of investment gain/loss into the CSM). This is especially problematic when the assets in concern are held in a general fund.
- 118 The EFRAG Secretariat considers that IFRS 17’s requirements on eligibility for the VFA and PAA approaches are reasonable and will contribute positively to the technical endorsement criteria (in particular relevance, understandability and comparability).

## 8. Transition

### CFO Forum Presentation

#### *Description of issue and evidence*

- 119 Applying the fully retrospective approach to transition is expected to be impossible in many cases due to the need for detailed historical data for long historic periods.
- 120 The modified retrospective approach is very restrictive and will not provide the simplifications that make retrospective application possible in practice.
- 121 The option to set OCI to nil under the fair value approach is not available to assets accounted at fair value through OCI.

#### *Implications*

- 122 If the modified retrospective method is not improved, insurers will be forced into the fair value approach for many portfolios. Whilst the fair value approach is a helpful practical expedient in some cases, it may not provide an appropriate profit recognition pattern in all cases. Depending on the final interpretation of the fair value, this could be the case for portfolios with significant in-force and significant new business.
- 123 Setting OCI on the liabilities to nil at transition, whilst maintaining the historical OCI on related assets will distort equity at transition and results going forward significantly.

### IFRS 17 and IFRS 13

#### *Requirements*

##### *IFRS 17, Appendix C*

- 124 An entity shall apply IFRS 17 retrospectively unless impracticable.
- 125 If, and only if, it is impracticable for an entity to retrospectively apply IFRS 17 for a group of insurance contracts, an entity shall apply the following approaches:
- (a) the modified retrospective approach; or
  - (b) the fair value approach.

##### Modified retrospective approach

- 126 The objective of the modified retrospective approach is to achieve the closest outcome to retrospective application possible using reasonable and supportable information available without undue cost or effort. In applying this approach, an entity shall:
- (a) use reasonable and supportable information. If the entity cannot obtain necessary reasonable and supportable information, it shall apply the fair value approach.
  - (b) maximise the use of information that would have been used to apply a fully retrospective approach, that is available without undue cost or effort.
- 127 Permitted modifications are:
- (a) assessments of insurance contracts or groups of insurance contracts that would have been made at the date of inception or initial recognition;
  - (b) amounts related to the contractual service margin or loss component for insurance contracts without direct participation features;

## IFRS 17 issues

- (c) amounts related to the contractual service margin or loss component for insurance contracts with direct participation features; and
- (d) insurance finance income or expenses.

### Fair value approach

- 128 To apply the fair value approach, an entity shall determine the CSM or loss component of the liability for remaining coverage at the transition date as the difference between the fair value of a group of insurance contracts at that date and the fulfilment cash flows measured at that date. Fair value is determined in accordance with IFRS 13 Fair Value Measurement.

### *IFRS 13, paragraph 9, 41*

- 129 Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
- 130 When applying a present value technique an entity might take into account either of the following:
- (a) the future cash outflows that a market participant would expect to incur in fulfilling the obligation, including the compensation that a market participant would require for taking on the obligation.
  - (b) the amount that a market participant would receive to enter into or issue an identical liability or equity instrument, using the assumptions that market participants would use when pricing the identical item (eg having the same credit characteristics) in the principal (or most advantageous) market for issuing a liability or an equity instrument with the same contractual terms.

### *IFRS 17, paragraphs C18, C24*

- 131 In applying the fair value approach, if an entity chooses to disaggregate insurance finance income or expenses between profit or loss and OCI, it is permitted to determine the cumulative amount of insurance finance income or expenses recognised in OCI at the transition date:
- (a) retrospectively – but only if it has reasonable and supportable information to do so; or
  - (b) as nil – unless (c) applies; and
  - (c) for insurance contracts with direct participation features, as equal to the cumulative amount recognised in other comprehensive income from the underlying items.
- 132 A similar provision for setting OCI to zero is available for the modified retrospective approach.

### **Findings from the case study**

- 133 Number of respondents addressing the issue: 3 (for the restrictive use of the modified retrospective approach) and 1 (for the option to set OCI to nil under the fair value approach).
- 134 Of the 40 portfolios where information on transition was provided:
- (a) 9 used the full retrospective approach
  - (b) 13 used the modified retrospective approach
  - (c) 14 used the fair value approach
  - (d) 4 applied the PAA

- 135 For the remaining portfolios, the effects on transition were not quantified.
- 136 For the liabilities at transition:
- (a) Full retrospective 5.5%
  - (b) Modified retrospective 63.2%
  - (c) Fair value 30.5%
  - (d) PAA 0.8%
- 137 One respondent adjusted the modified retrospective approach but gave no details about the adjustments.
- 138 The case study provides the following insights into the difficulties in applying the requirements of the modified retrospective approach:
- (a) One respondent identified the following concerns:
    - (i) The requirement to split portfolios by profitability group (onerous, no significant possibility of becoming onerous, other) is likely to mean that they need to identify cash flows at a lower level than the portfolio level (i.e. individual contract or sub-groups within portfolios). This significantly increases the granularity of the data required.
    - (ii) The production of transition figures by annual cohort is potentially significantly more onerous than if cohorts can be grouped together.
    - (iii) Given the long duration of contracts, the identification of all actual cash flows between the date of initial recognition and the transition (or earlier) date will prove to be very difficult.
    - (iv) The simplifications in respect of loss components should be consistent between the VFA and general model.

This respondent provided suggested changes to address these concerns.
  - (b) One respondent noted that the modified retrospective approach would require taking into account the past margins, therefore it would not reflect a simple prospective vision of the insurance contracts profitability. This respondent considered the valuation of such past margins to be extremely heavy to perform precisely, looking at the reduced time available to implement IFRS 17.
  - (c) Another respondent considered the data requirements for the modified retrospective approach similarly onerous to those required for the fully retrospective approach, particularly the requirement for historic cash flow information.
  - (d) Another respondent is still investigating whether this approach provides sufficient simplifications to make it operationally feasible.
- 139 The major reason for not using the full retrospective approach was the lack of available historical data, especially in older systems.
- 140 Of the 14 portfolios measured under the fair value approach, respondents indicated the following with regards to the option of setting OCI to nil:
- (a) For 3 portfolios OCI will be equal to the cumulative amount recognised in OCI from the underlying items.
  - (b) For 2 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**

- 141 The EFRAG Secretariat acknowledges that several case study participants have raised concerns about the operationality of the modified retrospective approach. However, it is difficult to identify the specific problem(s) and/or their severity and it also unclear how this approach could be improved.
- 142 The EFRAG Secretariat also acknowledges the practical challenges of the fair value transition model, and that its outcome could differ materially from the full or modified retrospective approach. However, it is not clear to the EFRAG Secretariat why this approach should result in a systematically 'low' CSM.
- 143 In the circumstances the EFRAG Secretariat proposes that the concerns raised should be described in the DEA and a question to constituents should be added to seek further insights on the practical challenges of applying the modified retrospective approach.
- 144 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. The transitional requirements for financial asset accounting are addressed in IFRS 9.

## OPERATIONAL COMPLEXITY

### 9. Business combinations

#### CFO Forum Presentation

##### *Description of issue and evidence*

145 There are several elements in accounting for insurance business combinations that add significantly to complexity, including:

- (a) the requirement to assess classification at the acquisition date instead of the original inception date
- (b) the treatment of claims in payment at the acquisition date

##### *Implications*

146 This will result in a significantly different accounting treatment between the group and subsidiary financial statements. This adds significant unnecessary complexity and costs, particularly for GI business which may require GMM capability only if a future acquisition takes place.

## IFRS 17

#### *Requirements*

##### *IFRS 17, paragraph B5, B93, B94*

- 147 Some insurance contracts cover events that have already occurred but the financial effect of which is still uncertain. An example is an insurance contract that provides coverage against an adverse development of an event that has already occurred. In such contracts, the insured event is the determination of the ultimate cost of those claims.
- 148 When an entity acquires insurance contracts issued or reinsurance contracts held in a transfer of insurance contracts that do not form a business or in a business combination, the entity shall apply the level of aggregation requirements to identify the groups of contracts acquired, as if it had entered into the contracts on the date of the transaction.
- 149 An entity shall use the consideration received or paid for the contracts as a proxy for the premiums received. The consideration received or paid for the contracts excludes the consideration received or paid for any other assets and liabilities acquired in the same transaction. In a business combination, the consideration received or paid is the fair value of the contracts at that date.

#### *Basis for Conclusions*

##### *IFRS 17, paragraph BC323, B326, B327*

- 150 The entity determines the CSM in a way that reflects the consideration paid for the contracts.
- 151 The IASB considered how the amount of the fulfilment cash flows could differ from the amount of the consideration received, i.e. the fair value. For transfers of insurance contracts, the most likely cause of the difference is that the fair value would include the risk of non-performance by the entity. The IASB concluded that, for contracts in a liability position acquired in a transfer, the immediate recognition of a loss faithfully represents the entity's assumption of an obligation it expects to fulfil but for which it received a lower price because of the risk that it might not be able to fulfil the obligation.



- 152 For a business combination, the Board concluded that the most likely reason that fulfilment cash flows differ from the fair value is that the acquirer may have been willing to pay more for the contracts because of other synergies that might arise as the contracts are fulfilled. Consequently, the recognition of that difference as an adjustment to the gain on the business combination or goodwill is consistent with the accounting for similar effects in a business combination.

### **Findings from the case study**

- 153 Number of respondents addressing the issue: 1 (from the simplified case study).
- 154 Regarding the issue in paragraph 145(a), there were qualitative comments from one respondent to the simplified case study. This respondent indicated that IFRS 17 has amended IFRS 3 paragraph 17 to remove an important exception that currently exists where insurance contracts are currently classified based on the factors at the inception date rather than acquisition date. The removal of this exception could result in a different contract classification (e.g. investment rather than insurance) between Group and solo entity accounts, where factors have changed since inception. In addition, due to the different dates of initial recognition between the Group and solo entity, this will result in a different CSM between these two.
- 155 Regarding the issue in paragraph 145(b), one respondent noted that the requirement reduced comparability and reduced understandability. No further explanation was provided.

### **EFRAG Secretariat analysis**

#### *Regarding the issue in paragraph 145(a):127(a):*

- 156 The EFRAG Secretariat notes that the requirement to assess classification at the acquisition date and not at the inception date is consistent with the requirements in IFRS 3 *Business Combinations*.
- 157 There was an exception under IFRS 3 because at that time, the IFRS 3 guidance was developed in phase I of the IASB's project on insurance contracts and the IASB decided not to pre-empt phase II of the IASB's project on insurance contracts. Therefore, the EFRAG Secretariat considers that this exception was only a temporary one.
- 158 In addition, the requirement to assess classification at the acquisition date would increase comparability between insurance entities and non-insurance entities that have undertaken business combinations since there will be consistent accounting.

#### *Regarding the issue in paragraph 145(b):*

- 159 As no detailed information was provided in the case studies nor in the presentation by the CFO Forum, the issue cannot be analysed without further information from the insurer(s) who raised this.
- 160 At this stage, pending any further information, the EFRAG Secretariat assesses that the requirements in concern relate to well-established principles of business combination accounting and do not detract from IFRS 17's ability to meet the technical endorsement criteria.

## 10. Level of aggregation

### CFO Forum Presentation

#### *Description of issue and evidence*

- 161 The prohibition to aggregate contracts that are issued more than one year apart is unduly complex. We believe that it should be replaced by a principle according to which the insurer determines based on its internal business and risk management the way it defines its cohorts. This determination should reflect mutualisation effects when they exist. In addition, the second profitability bucket (no significant possibility of becoming onerous) is highly subjective and adds to the complexity.
- 162 On the contrary, the requirement to - in principle – group contracts in their entirety prohibits the insurer to group components of an insurance contracts (e.g. the host contract and individual riders) in line with how the business and risks are managed in some cases.

#### *Implications*

- 163 The standard's requirements on level of aggregation, including the annual cohorts, are too prescriptive and detailed, leading to an excessive level of granularity, major implementation challenges, as well as undue costs.
- 164 The inability to group components of an insurance contract by relevant risks means contract aggregation will not reflect how the business and risks are managed.
- 165 The requirement to report on an underwriting year basis (including analysis of change) is not aligned with management of reserves which is on an accident year basis.

## IFRS 17

### *Requirements*

#### *IFRS 17, paragraphs 14, 16, 18, 22*

- 166 An entity shall identify portfolios of insurance contracts. A portfolio comprises contracts subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together. Contracts in different product lines (for example single premium fixed annuities compared with regular term life assurance) would not be expected to have similar risks and hence would be expected to be in different portfolios.
- 167 An entity shall divide a portfolio of insurance contracts issued into a minimum of:
- (a) a group of contracts that are onerous at initial recognition, if any (for contracts issued to which an entity applies the PAA, the entity shall assume no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise);
  - (b) a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and
  - (c) a group of the remaining contracts in the portfolio, if any.
- 168 An entity shall not include contracts issued more than one year apart in the same group.
- 169 There is no paragraph in IFRS 17 that addresses separating insurance components of an insurance contract. That is, the lowest level of the unit of account used in IFRS 17 is a contract, or a host insurance contract after separating non-insurance components (when relevant).

*Basis for Conclusions*

*IFRS 17, paragraphs BC119 to BC139*

- 170 BC119: The decisions about grouping in IFRS 17 were driven by considerations about reporting profits and losses in appropriate reporting periods.
- 171 BC120: The level of aggregation is also relevant to the recognition of the contractual service margin in profit or loss. ... An entity should systematically recognise the remaining contractual service margin in profit or loss over the current and remaining coverage period to reflect the remaining transfer of services to be provided by the insurance contracts.
- 172 BC130: Some stakeholders nonetheless expressed the view that separating contracts that have no significant possibility of becoming onerous from other contracts that are not onerous was burdensome and unnecessary. The Board, however, concluded that in the absence of such a requirement, should the likelihood of losses increase, IFRS 17 would fail to require timely recognition of contracts that become onerous.
- 173 BC137: The Board considered whether there were any alternatives to using a one-year issuing period to constrain the duration of groups. However, the Board considered that any principle-based approach that satisfied the Board's objective would require the reintroduction of a test for similar profitability, which was rejected as being operationally burdensome. The Board acknowledged that using a one-year issuing period was an operational simplification given for cost-benefit reasons.
- 174 BC136: The Board noted that the decisions outlined in paragraph 167 above could lead to perpetual open portfolios. The Board was concerned that this could lead to a loss of information about the development of profitability over time, could result in the contractual service margin persisting beyond the duration of contracts in the group, and consequently could result in profits not being recognised in the correct periods. Consequently, in addition to dividing contracts into the groups, the Board decided to prohibit entities from including contracts issued more than one year apart in the same group. The Board observed that such grouping was important to ensure that trends in the profitability of a portfolio of contracts were reflected in the financial statements on a timely basis.
- 175 BC138: The Board considered whether prohibiting groups from including contracts issued more than one year apart would create an artificial divide for contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group. However, the Board concluded that applying the requirements of IFRS 17 to determine the fulfilment cash flows for groups of such contracts provides an appropriate depiction of the results of such contracts. The Board acknowledged that, for contracts that fully share risks, the groups together will give the same results as a single combined risk-sharing portfolio ... the Board noted that the requirements specify the amounts to be reported, not the methodology to be used to arrive at those amounts. Therefore, it may not be necessary for an entity to restrict groups in this way to achieve the same accounting outcome in some circumstances.

**Findings from the case study**

*Level of aggregation*

- 176 Number of respondents addressing one or more aspects of these issues: 9
- 177 Some of the respondents did not find material differences between the pattern of CSM release using annual cohorts and the equivalent pattern using only coverage units for specific portfolios (savings, unit-linked portfolios, fully or significantly mutualised contracts). One respondent applied the coverage units method to a fully mutualised portfolio in which the profit margin declined with 29% over a 4-year

period and found little difference between using coverage units and cohorts. These respondents argued that the annual cohort requirement adds cost and complexity and is unnecessary to provide a faithful representation.

- 178 However, other respondents demonstrated or acknowledged that the use of annual cohorts does or at least could change the pattern of CSM release. Of those respondents that used coverage units, one noted that their findings were based on a mature portfolio and acknowledged that bundling together all cohorts may not necessarily lead to the same outcome since, as cohorts are spread over time, more differences in the volume of business, its profitability as well as in the percentage of the CSM to be recognised in a given year are observed. Another respondent noted that, even in a mutualised portfolio, material differences were found between using cohorts or coverage units.
- 179 Finally, one respondent used assets under management, sums insured, expected profit/variable fee as coverage units and found significantly different outcomes between the methods used.
- 180 In all these cases no calculations (only the results of the calculation and/or graphic representations) were provided in the case study results.
- 181 Two respondents calculated the impact on their portfolios only for one year which did not illustrate the effect on reported trends.

*Costs relating to the annual cohort requirement*

- 182 Three respondents quantified the costs specifically associated with applying the subdivision of products into subgroups and annual cohorts:

	Millions euros	% costs over total IFRS 17 costs for respondents that quantified	# of respondents who quantified
One-off costs	19.3	between 4% and 23%	3
Ongoing costs	2.4	10%	1

Sharing of risks (also known as mutualisation)

- 183 Most respondents did not provide information about the quantification of risk sharing/intergenerational transfers or indicated they were not able to quantify that effect. Those that provided information showed very minor impacts in 2016 ranging from 0.2% till 1% of the liabilities in the portfolios measured, even when indicating that 100% of risks were being shared.
- 184 The following table provides an overview of the amount of the selected liabilities were subject to risk sharing.

Fully sharing risks	Partially sharing risks	Benefit from intergenerational transfers
478,462	104,410	669,469

- 185 Two respondents provided a description for the term “intergenerational transfer”:
- (a) One respondent defined intergenerational transfer as the transfer of wealth between contracts issued at different points in time.

- (b) Another respondent noted that unrealised gains are used as an intergenerational transfer to support future generations of policyholders.

*Separating components within insurance contracts*

186 The analysis is still to be completed for the full case study.

*Other feedback regarding the level of aggregation*

187 Although current practice does not include the level of aggregation requirements of IFRS 17, it is noteworthy that portfolios under current practice may be more granular than required by IFRS 17. Of the 40 portfolios where information was provided,

- (a) 12 portfolios were smaller than required by IFRS 17;
- (b) 19 portfolios were of a similar size to that required by IFRS 17;
- (c) 9 were larger than the portfolios required by IFRS 17; and
- (d) 11 portfolios were not specified.

188 To the extent that grouping is undertaken under current practice, 45 groups were reported, whereas under IFRS 17 this would increase to 343.

- (a) Five respondents provided grouping details for one year resulting in 26 groups under current accounting and 56 groups under IFRS 17; and
- (b) Four respondents provided grouping details for five years, i.e. over the testing period, resulting in 19 groups under current accounting and 287 groups under IFRS 17.

189 The type of contracts where onerous groups could arise were:

- (a) VFA – unit linked;
- (b) General model – long-term contracts;
- (c) General model – other; and
- (d) PAA motor and other.

**EFRAG Secretariat analysis**

*Level of aggregation*

*Annual cohort requirement*

190 The EFRAG Secretariat refers to the EFRAG Background Papers on *Level of aggregation* and *Release of the CSM*.

191 The EFRAG Secretariat acknowledges that the level of aggregation requirements may not reflect the level at which pricing (as doing so was noted to be too onerous) and risk management of insurance contracts is undertaken. The EFRAG Secretariat also acknowledges that the annual cohort requirement is widely considered to increase the cost and complexity of implementation. However, the EFRAG Secretariat equally notes that the IFRS 17 approach is at a significantly higher level of aggregation than in other areas of IFRS (e.g. IFRS 9 and IFRS 15, which are based on individual contracts). The EFRAG Secretariat considers that the IFRS 17 represents a reasonable compromise between different perspectives.

192 The EFRAG Secretariat considers that providing trend information relating to profitability from one year to the next is a valid objective that contributes to relevance. The EFRAG Secretariat considers that achieving this objective requires some mechanism to ensure closed groups. Without the annual cohort or some alternative mechanism groups would remain open indefinitely, resulting in a continuous re-averaging of the CSM and a loss or obscuring of trend information.

- 193 Some have argued that the trend information can be provided via disclosures. However, EFRAG has consistently taken the view that disclosures are not a substitute for recognition and measurement.
- 194 The EFRAG Secretariat acknowledges that the annual cohort requirement is to some extent arbitrary (but entities can choose to align with the financial reporting year). Further, the annual cohort requirement achieves the objective of providing trend information and enabling comparability across entities and product lines. It should also be noted that the financial statements are not presented on a cohort level but are aggregated in order to provide an overall view of the entity's financial performance and position. Further, limiting the size of the group of insurance contracts (which the annual cohort requirement does) limits the extent to which contracts that become onerous subsequent to initial recognition are shielded by profitable contracts.
- 195 Furthermore, based on the case study results, in some cases, the annual cohorts requirement makes a significant difference in the amounts released to CSM compared to not applying cohorts while in other cases, there may not be a significant difference. Therefore, the EFRAG Secretariat considers that the annual cohort requirement results in relevant information.
- 196 Also, the EFRAG Secretariat considers that IFRS 17 does not prevent the impact of cash flows relating to sharing of risks being included in the fulfilment cash flows. The EFRAG Secretariat acknowledges that an allocation would need to be made to the cohort level if the sharing of risks is determined at a higher level. However, this allocation is again a mechanism to achieve the objective of providing trend information.
- 197 For the above reasons, the EFRAG Secretariat considers that the annual cohort requirement provides relevant information while also acknowledging the trade-offs referred to above.
- 198 While the EFRAG Secretariat acknowledges the concerns expressed about the impact of the annual cohort requirement on complexity and cost, most respondents did not quantify the costs associated with this requirement.

*The second profitability bucket (no significant possibility of becoming onerous)*

- 199 Insurance contracts that are profitable at inception are subdivided into two categories: (i) contracts that have no significant possibility of becoming onerous and (ii) remaining contracts. The EFRAG Secretariat considers that these separate buckets of profitable insurance contracts enable a timely recognition of groups of contracts that become onerous after inception thus reflecting trend information and ensuring early recognition of losses. The determination of the appropriate contractual service margin is a balance between the avoidance of the need to track individual contracts and cross-subsidisation between different levels of profitability of contracts with similar risks (if these buckets were not required). The EFRAG Secretariat further assesses that grouping plays an essential role in the determination of unearned profit and its subsequent allocation to insurance revenue.

*Separating components within insurance contracts*

- 200 The EFRAG Secretariat disagrees with the view that IFRS 17 should permit the separation of different insurance risks contained in a single insurance contract, *except* in cases where two or more insurance contracts are combined for administrative convenience. This is because the cost and complexity of the separation of a single insurance contract into its component is expected to outweigh any resulting increase of relevance of the information. Furthermore, the EFRAG Secretariat considers that entities would usually design contracts in a way that reflects their substance.

## 11. Presentational issues

### CFO Forum Presentation

#### *Description of issue and evidence*

- 201 The standard requires that groups of contracts be presented as asset or liability based on its entirety. In reality, different components, such as claims liabilities to be settled, unearned premiums, receivables/payables, etc are managed separately and administered in different systems. Groups of contracts may frequently switch from an asset to liability position.
- 202 The standard requires premiums and claims to be included in the insurance provision on a cash paid/received basis. In reality, these are reflected on an accrual basis and payments/receipts are managed and administered separately.
- 203 The standard requires, for presentation of revenue only, segregation of non-distinct investment components, even for contracts that do not have a specified account balance or component.
- 204 In several reinsurance contracts, the cedant is obligated to provide funds withheld as collateral. IFRS 17 requires a presentation of reinsurance funds withheld on a net basis, i.e. the insurance contract liability is offset by the funds withheld.

#### *Implications*

- 205 These requirements, that impact only presentation, would require major system changes compared to the current approach, which is a well-established industry practice.
- 206 These changes will also lead to insurance receivables, policy loans and reinsurance collateral (funds withheld) no longer being separately visible in the balance sheet, which is a deterioration in relevance of the financial statements.
- 207 Companies have considered the implications for implementation and maintenance of systems for these requirements and found that the complexity and costs will very significant.

## IFRS 17

### *Requirements*

#### *Separate presentation of assets and liabilities*

- 208 Premiums and claims (IFRS 17, paragraph 78) are included in the fulfilment cash flows of the insurance contract liability or the liability for incurred claims. Under IFRS 17, paragraph 33, fulfilment cash flows include all the future cash flows within the boundary of each contract in the group. This includes premiums due but not yet received.
- 209 Definition: The liability for incurred claims is the obligation to investigate and pay valid claims for insured events that have already occurred, including events that have occurred but for which claims have not been reported, and other incurred insurance expenses.

#### *Segregation of investment components for presentation*

- 210 Paragraph 83: Insurance revenue depicts the provision of coverage and other services arising from the group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services.
- 211 Paragraph 85: Insurance revenue and insurance service expenses presented in profit or loss shall exclude any investment components.

*Insurance funds withheld*

- 212 Paragraph 63: Estimates of the present value of the future cash flows for the group of reinsurance contracts held shall include the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

*Basis for Conclusions*

*Separate presentation of assets and liabilities*

- 213 BC328: Consistent with the requirement in IAS 1 that an entity not offset assets and liabilities, IFRS 17 prohibits entities from offsetting groups of insurance contracts in an asset position with groups of insurance contracts in a liability position.

*Segregation of investment components for presentation*

- 214 BC108: An investment component is the amount an insurance contract requires the entity to repay to the policyholder even if an insured event does not occur. Many insurance contracts have an implicit or explicit investment component that would, if it were a separate financial instrument, be within the scope of IFRS 9.
- 215 BC109: IFRS 17 requires the cash flows allocated to a separated investment component to be measured on a stand-alone basis as if the entity had issued that investment contract separately. This requirement is consistent with the objective of separation, which is to account for a separated component the way stand-alone contracts with similar characteristics are accounted for. The Board concluded that, in all cases, entities would be able to measure the stand-alone value for an investment component by applying IFRS 9.

**Findings from the case study**

*Separate presentation of assets and liabilities*

- 216 Several respondents raised this issue.
- 217 One respondent quantified estimates of the cost implications of this. This respondent stated that an investment in a three-digit million Euro range would be needed in order to link payment information with cash management systems or to change the mechanics of policy administration systems (i.e., change to cash basis).
- 218 Comments/explanations from the other respondents provided were:
- (a) One respondent confirmed the concerns on tracking groups of insurance contracts if they are in an asset or a liability position, via modelling of their testing.
  - (b) Another respondent indicated that this was an issue. Four respondents provided qualitative comments summarised as follows:
    - (i) This requirement will imply to connect and integrate – at insurance contract group level – administration, technical accounting, actuarial, claims and cash management systems. All these systems are running at different granularity levels and reconciliation of information is granted only at a higher level than the group.
    - (ii) The requirement to present groups of insurance contracts distinguishing those that are assets and those that are liabilities induces the need to duplicate all accounts related to the Insurance contracts liabilities in the Chart of Accounts and to duplicate all posting schemes between the feeder systems and the accounting systems to capture all possible scenarios.

*Separate presentation of receivables and payables*



219 Comments/explanations provided were:

- (a) One respondent indicated, supported by one of the portfolios, that there would be a lack of transparency and undue cost;
- (b) Four respondents indicated that this was an issue and provided qualitative comments explaining the issue summarised as follows:
  - (i) Under IFRS 17, liabilities have to be calculated at the level of group of contracts and have to be netted from receivables due by policyholders from this same group of contracts. The netting has to be done on a cash basis, which is not possible in the timeframe of an accounting closing.
  - (ii) Insurance accounting systems are equipped to know what is due by each client on a given date whilst cash is not managed on a client but on a global basis. In practice, this is because, based on contracts term, it is possible to know in advance when a client has the obligation to pay what it owes to the insurance company but it is not possible to know with certainty in advance when he or she will do so (at least when considering the short timeline of an accounting closing). As a consequence, measuring liabilities on a cash basis is not manageable without drastic IT changes.
  - (iii) Actuarial systems today are not set-up to model data stemming from the cash management systems. Modelling is based on data from the technical feeder systems with no granular link to the cash management systems. Balancing of receivables and payables and reconciliation with the cash management system is dealt with in the general accounting systems. Nevertheless, during the stretched timeline of the closing process of our IFRS consolidated financial statements, this reconciliation is performed at a much less granular level than the group of contracts level.
  - (iv) One of these respondents used for each portfolio an allocation key for receivables and payables, as the IASB staff proposed in its paper preceding the May 2018 TRG meeting. While that might be considered a feasible simplification, they had encountered many short-comings. For example, the change in the weight of a group of contracts measured based on its insurance liabilities changes over the coverage period. As such does the allocation change over time. This respondent stated that this is not reflecting the actual receivables and payables of the group of contracts and would lead to a systematic underestimation of the related receivables and payables for new annual cohorts.

*Separation of the non-distinct investment component of revenue*

220 Comments/explanations provided are as follows:

- (a) One respondent indicated, supported by one of the portfolios, that the split of non-distinct investment components is very detailed and does not reflect the way they look at the business.
- (b) Two respondents indicated that this was an issue. One of these provided comments regarding the complexity and associated costs. That respondent stated that these amounts (in particular the investment component on death or relating to a guaranteed annuity) are not currently available from existing systems and processes and, consequently, new processes will need to be developed.

*Insurance funds withheld*

- 221 One respondent from the simplified case study and one from the full case study mentioned the lack of clarity whether funds withheld should be included in the fulfilment cash flows. It is unclear from the responses whether these comments relate to reinsurance.

**EFRAG Secretariat analysis**

*Separate presentation of assets and liabilities*

- 222 At this stage, the EFRAG Secretariat does not have information regarding the materiality of groups of contracts in an asset position. Based on the responses from the respondents, the issue is whether the indicated cost implications outweigh the benefits. Although the case study did not yield much quantified information, several respondents commented on the cost and systems burdens.
- 223 The EFRAG Secretariat considers that, since the unit of account under IFRS 17 is a group of contracts and therefore already a netting of contracts in an asset or liability position within the group, the usual arguments about the relevance and other endorsement criteria of separate presentation of assets and liabilities may not apply to the same extent. Therefore, the EFRAG Secretariat has sympathy regarding the concerns about the cost of this requirement.

*Separate presentation of receivables and payables*

- 224 Based on the responses, since IFRS 17 does not require separate presentation of receivables and payables, the question will be whether the benefits of not presenting separating receivables and payables outweigh the costs or not.
- 225 The EFRAG Secretariat proposes to ask a question to constituents in the IFRS 17 draft endorsement advice whether not separately presenting receivables and payables would have a detrimental effect for users.

*Segregation of investment components for presentation*

- 226 The EFRAG Secretariat considers that, since the insurance revenue and insurance service expenses relate to insurance services, excluding the investment component separately provides relevant information.
- 227 In addition, determining insurance revenue in this way makes the financial statements more comparable not only between insurance entities but also across industries.

*Insurance funds withheld*

- 228 Based on the responses from the case study, this issue seems to be resulting from a lack of clarity with IFRS 17. Therefore, the EFRAG Secretariat proposes that the affected entities raise the issue at the TRG.
- 229 At this stage, the EFRAG Secretariat is not clear how significant the issue is.

## OTHER IMPLEMENTATION CHALLENGES

### 12. Pressure on implementation timeline

#### CFO Forum Presentation

##### *Description of issue and evidence*

- 230 A number of issues have been identified that put pressure on the implementation timetable, including:
- (a) Industry and auditor consensus on technical interpretation issues will take time to emerge, for example on interim reporting, application of judgement on discount rates, transitional approaches, etc.
  - (b) The discussions in the TRG may lead to further clarifications and amendments; the TRG discussions are not planned to end before the end of 2018.
  - (c) In general, there are insufficient resources within the insurance market, for actuaries, accountants and IT specialists.
  - (d) IT solutions, including those for the calculation of the CSM, are not yet available for purchase.
  - (e) Stakeholder engagement, including with investors and analysts, will only be possible if real accounting impacts with sufficient accuracy are available well in advance of the “go live” date. To achieve that it will be necessary for systems, interpretations, dry runs etc. to have all been completed. Given the complexity of the requirements and the resulting financial information, stakeholder education will be key.

##### *Implications*

- 231 Given our findings we believe the implementation timelines are very challenging

#### Findings from the case study

- 232 Seven respondents addressed this issue.
- (a) The following were suggestions of timeframes to delay IFRS 17 implementation:
    - (i) One year (one respondent);
    - (ii) Two years (two respondents); and
    - (iii) Three years (one respondent).
  - (b) Two respondents recommended a delay in implementing IFRS 17 without suggesting a timeframe.
  - (c) One respondent indicated that first-time application of IFRS 17 in 2021 was realistic, even with some targeted improvements that were listed.

#### EFRAG Secretariat analysis

- 233 The relevance of this issue to the DEA will depend on the overall direction of the DEA. The EFRAG Secretariat proposes that this is discussed at a later date.