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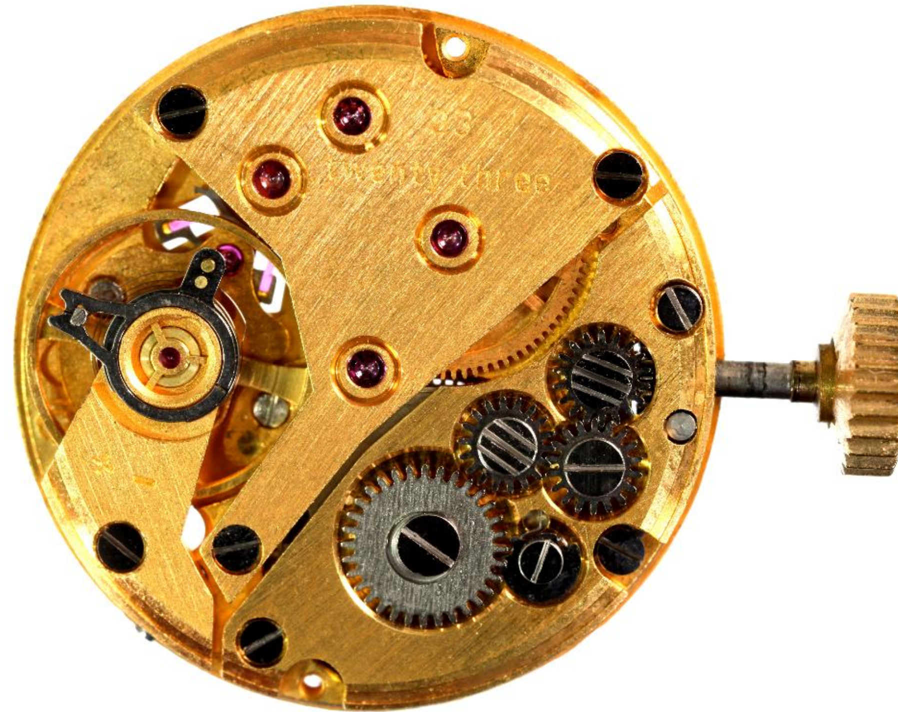

IFRS 17 Transition Resource Group meeting #2

The IASB staff proposal to amend IFRS 17

Francesco Nagari, Deloitte Global IFRS Insurance Leader | 9 May 2018

Agenda

- Introduction
- Background of the TRG papers and summary output of the TRG discussion
- Next steps

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Introduction

- The purpose of the TRG on IFRS 17 is to:
  - Invite discussion and analysis of potential stakeholder issues arising from implementation of IFRS 17;
  - Provide a public forum for stakeholders to learn about the new requirements from IFRS 17; and
  - Help the IASB determine whether additional action is needed to support the implementation of IFRS 17, such as providing clarification or issuing other guidance
- This was the second meeting where submissions to the TRG were discussed and it covered a number of areas. Discussion on coverage units dominated the meeting.
- The IASB staff proposed an amendment to IFRS 17 to address the coverage units issues raised to the TRG. The IASB will deliberate on this proposed amendment in the coming IASB meetings.

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Determining the quantity of benefits for identifying coverage units

Background

- The estimation of total coverage units (CU's) and their allocation to each part of the coverage period is necessary to depict the transfer of insurance service
- This determines the release of the contractual service margin (CSM) during the period and affects the recognition of insurance revenue and profit
- For a group of insurance contracts, the total number of coverage units depends on each contract's quantity of benefits provided and expected duration of coverage
- Following on from the February TRG meeting, the submissions include the following observations of the TRG members:
  - CU's reflect the likelihood of insured events occurring only to the extent it affects contracts' expected duration; and
  - CU's do not reflect the probability of insured events occurring to the extent it affects expected claim amounts

Key question:
What is the definition of "quantity of benefits" in IFRS 17:B119(a)?

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Determining the quantity of benefits for identifying coverage units

Summary of discussion (1/4)

The staff analysis on insurance contracts with and without investment components

1. Sources of profit are more than the CSM release. They also include the release of non-financial risk adjustment and experience adjustments
2. The period during which an entity bears insurance risk is not necessarily equal to the insurance coverage period
3. When contracts in the group provide different types/amounts of benefits, there is a need for a method to account for such diversity and how the benefits change over the term of the coverage period
4. Lapse assumptions are considered in determining the CUs because they affect the expected coverage duration
5. The estimation of CUs is not an accounting policy but involves judgment in determining the provision of service in a systematic and rational way

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Determining the quantity of benefits for identifying coverage units

Summary of discussion (2/4)

- The staff view on the principles in measuring the quantity of benefits for insurance contracts without investment components was as follows:
  - An amount of CSM has to be recognised in each period when insurance coverage services are provided by contracts in the group
  - The benefit is provided even when the entity stands ready but does not expect a claim to occur

- Possible methods of estimating quantity of benefits include:
  - Maximum amount of cover available in each period; and
  - Amount entity expects to policyholder to be able to validly claim in each period.

- The following methods were considered not to meet the objective:
  - Methods based on the performance of entity's assets;
  - Methods resulting in no allocation of CSM to periods when the entity is standing ready to meet a valid claim;
  - Methods based on premiums, unless they can be demonstrated to be a reasonable proxy for services provided by the entity in each period; and
  - Methods based on expected cash flows, unless they can be demonstrated to be a reasonable proxy for services provided by the entity in each period.

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Determining the quantity of benefits for identifying coverage units

Summary of discussion (3/4)

- The staff view on the principles in measuring the quantity of benefits for insurance contracts with investment components was as follows:
  - The main consideration is whether any CU's should be allocated to the provision of investment service
  - The staff view is that for variable fee approach (VFA) contracts, insurance contracts provide both insurance and investment service, hence CSM recognition and the CU's should reflect the provision of both services
  - Whereas, for insurance contracts with investment components that are not VFA contracts, the service provided to the policyholder does not include investment service and therefore the quantity of benefits provided should exclude the investment components

- The TRG members noted the following:
  - The principles produced by the staff to be useful in identifying the quantity of benefits provided by the variety of contracts
  - However, it was noted that the analysis of examples is very facts-specific and there is a risk in extrapolating from them the application of the principles to similar, but slightly different scenarios

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Determining the quantity of benefits for identifying coverage units

Summary of discussion (4/4)

- The TRG members noted the following (cont'd):
  - The methods identified by the staff are not the only methods of determining the quantity of benefits. Other methods may also be in line with the principles and meet the objective
  - The method of estimation of the quantity of benefits provided by the contract is not a choice, and different methods may be appropriate to different facts and circumstances
- There was a general support for referring the matter to the IASB Board to consider including provision of investment services in the definition of coverage period and coverage units for VFA contracts
- Several TRG members did not agree with the IASB staff view that insurance contracts with investment components accounted for under the general model (also known as indirect participating contracts) provide no investment services
- Many TRG members were concerned with the different treatment of VFA and non-VFA indirect participating contracts, when economically they may be similar
- The IASB staff will present this issue to the Board

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Determining the risk adjustment for non-financial risk in a group of entities

Background

- IFRS 17:37 sets outs the requirements that an entity shall reflect the compensation it requires for bearing uncertainty about the amount and timing of cash flows that arises from non-financial risk
- This should also reflect the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk
- The submission looks at the level of aggregation for determining the risk adjustment for non-financial risk:
  - In the individual financial statements of entities that are part of a consolidated group (i.e. parent and subsidiary entities that issue insurance contracts);and
  - In the consolidated financial statements of a group of entities.
- The submission asks whether it is possible to have a different amount of risk adjustment determined in the individual financial statements of the entity issuing insurance contracts that is part of the group and the consolidated financial statements

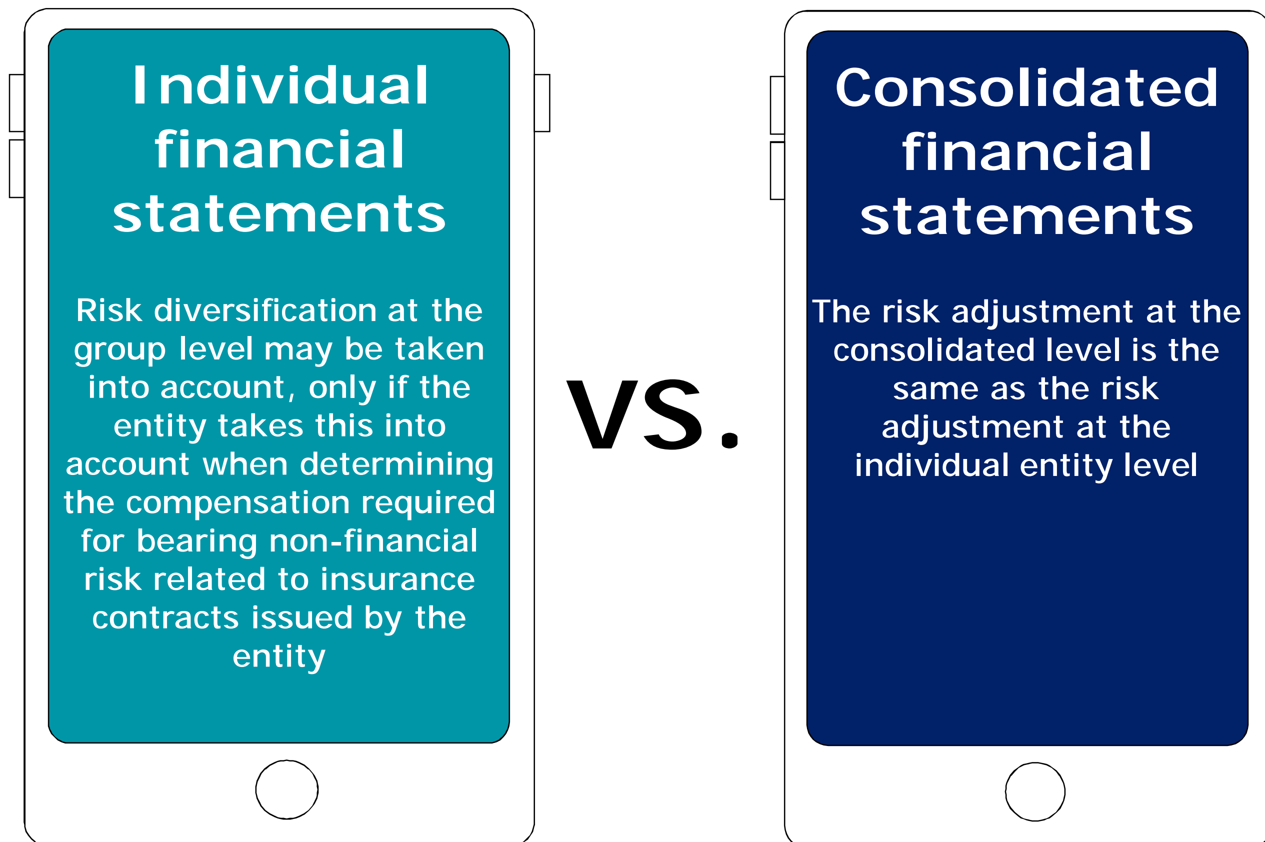
Key question:

At which level is the risk adjustment for non-financial risk is required to be determined?

Determining the risk adjustment for non-financial risk in a group of entities

Summary of Discussion (1/2)

- The staff view was that there is only one risk adjustment and this amount reflects the single decision that is made by the entity that is party to the contract



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Determining the risk adjustment for non-financial risk in a group of entities

Summary of Discussion (2/2)

- The TRG members agreed that the determination of risk adjustment is not an accounting policy, but reflects the actual compensation the entity requires for bearing uncertainty
- Views were split on whether the amount the entity would 'charge' in IFRS 17:B87 refers to pricing of insurance contracts or to the issuer's cost for uncertainty, and accordingly, whether the risk adjustment relates to the single decision made by the issuer of the contract at its inception
- TRG members however agreed that the focus is on the "compensation" the entity requires, which may be evidenced by the capital required to be carried, instead of premiums charged
- The TRG members were split on the level at which the risk adjustment for non-financial risk is determined in the consolidated financial statements. Many preferred a more flexible approach and were uncomfortable with the staff view that for the same group of insurance contracts the risk adjustment is always the same, regardless of the level of consolidation for financial reporting purposes
- References were made to the Australian market where the risk adjustment is already reported and varies at different reporting levels
- In particular, the TRG members read differently the reference to the 'entity' in the definition, with some taking it to mean 'reporting entity' and others – 'an issuing entity party to the contact'

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Combination of insurance contracts

Background

- IFRS 17:9 sets out requirements on combining a set or series of insurance contracts with the same or related counterparty that may achieve or be designed to achieve an overall commercial effect
- The discussion continues from the issue raised at the February TRG meeting which considered what circumstances would lead to separation of one legal contract into several insurance contracts for the purposes of applying IFRS 17
- The paper considered the following factors that could indicate that a set or series of insurance contracts are in substance a single contract

01 the contracts are priced as a single risk

02 the lapse of one contract changes the rights and obligations of the other contract(s)

03 measuring the contracts separately would result in one/some of the contract(s) being onerous whereas when measured as a whole the contract is profitable

Key question: When would it be necessary to treat a set or series of insurance contracts as a whole applying IFRS 17:9?

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Combination of insurance contracts

Summary of discussion

- The staff highlighted the following in their analysis:
  - Entering the contracts at the same time with the same counterparty is not sufficient to conclude that they should be combined
  - Presence of a discount by itself is not a decisive factor
  - The inability to measure one component without considering the other is an important consideration e.g. when there is interdependency of risks and cash flows or contracts lapse together
  - Contractual rights and obligations are different when considered individually and together. This could be an indication of separate contracts designed to achieve an overall commercial effect

- TRG members generally agreed with the staff analysis and agreed that no single factor is considered to be determinative thus calling for significant judgement and careful consideration of all relevant facts and circumstances

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Cash flows within the contract boundary

Background

- IFRS 17:B64 requires an assessment of whether at the renewal date an entity has the practical ability to set a price that fully reflects the risks in the contract or portfolio. The entity shall consider all the risks that it would consider when underwriting equivalent contracts on the renewal date for the remaining coverage
- The paper raised two issues:
  - ü Whether IFRS 17 requires constraints or limitations, other than those arising from the terms of an insurance contract, to be considered in assessing the entity's practical ability to reassess and reprice the risks/level of benefits for a particular policyholder (or the portfolio of insurance contracts); and
  - ü How to determine the contract boundary of insurance contracts that includes an option to add insurance coverage at a future date (where the entity is obligated to provide additional coverage if the policy holder exercises the option)

Key questions:

a. What is the practical ability to set a price at a future date that fully reflects the risks of a contract or portfolio from that date as described by IFRS 17:34?; and

b. How do options that add insurance coverage affect the contract boundary?

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Cash flows within the contract boundary

Summary of discussion (1/3)

Sources of constraints on an entity's practical ability to reprice risks at the renewal date

- Examples considered were commercial pressures and reputational risks. There was also a discussion as to whether market competition can be considered to be a constraint
- The staff highlighted the following in their analysis:
  - Constraints are irrelevant to the contract boundary assessment if they equally apply to new and existing policyholders in the same market;
  - Legal and regulatory constraints need to be considered because they affect the entity’s substantive rights and obligations, unless they relate to terms that have no commercial substance; and
  - In analysing pricing constraints, the entity needs to consider whether it is also prevented from changing the level of benefits, either for a contract or a portfolio as a whole
- TRG members agreed with the staff view that constraints on the entity’s practical ability to reprice can only exist, if they apply solely to existing contracts. Analysing commercial considerations requires the exercise of judgement in determining which of them would result in a constraint

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Cash flows within the contract boundary

Summary of discussion (2/3)

Impact of options to add insurance coverage on the contract boundary

- The discussion distinguishes between additional coverage options with the premium agreed at inception of the base contract (without the ability to change) and options with premium not agreed until such options are exercised.
- The following views were submitted:

View	Description
A	• The additional coverage option is a feature of the insurance contract with the resulting cash flows included in the contract boundary at initial recognition • The measurement of the group of insurance contracts reflects the entity's estimate of policyholder behaviour
B	• The option is outside the contract boundary of the original contract until it is exercised • When the policyholder exercises the option the entity would either (i) change the estimate of the fulfilment cash flows of the original contract or (ii) treat the entire contract as a new contract

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Cash flows within the contract boundary

Summary of discussion (3/3)

Impact of options to add insurance coverage on the contract boundary

- The staff view was as follows:
  - The original contract includes the additional coverage option, unless it is required to be separated, from the date of initial recognition
  - The cash flows from the option are within the contractual boundary of the original contract up to the point that the entity is able to fully reprice the whole contract
  - Where the additional premium from the option is guaranteed by the entity, all the cash flows are within the contractual boundary of the original contract
  - However, if this option premium is determined only on its exercise, all the subsequent cash flows relating to both the base contract and the option are outside the original contract's boundary (resulting in a new contract), if at that point the entity is able to reprice the whole contract to fully reflect policyholder risks
  - If the entity cannot reprice the whole contract, then the cash flows from the option would be within the boundary of the original contract

- TRG members emphasized that the focus of this assessment should be the entity's present substantive obligation, with its end indicating the contract boundary

- Some TRG members argued that future coverage option is outside of the contract boundary and does not contain a present substantive obligation for the entity if there is no practical constraints on its future premium, even if the entity cannot reprice the whole contract

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Boundary of reinsurance contracts held with repricing mechanisms

Background

- The measurement of a group of insurance contracts includes all the cash flows **within the contract boundary** that arise from the **entity's substantive contractual rights and obligations**
- In the Feb 2018 TRG meeting, it was observed that cash flows within the boundary of a reinsurance contract held arise from the **substantive right** to **receive services from the reinsurer** and **substantive obligation** to **pay amounts to the reinsurer**
- This submission provides the following fact pattern when the reinsurer has the right to reprice the remaining coverage prospectively:
  - The reinsurer can choose not to exercise its repricing right and the cedant is committed to continue paying premiums to reinsurer; and
  - The reinsurer can choose to exercise the right to reprice and the cedant has the right to terminate.

Key question:
How should the boundary of a reinsurance contract held be determined when the reinsurer has the right to reprice the remaining coverage prospectively?

Boundary of reinsurance contracts held with repricing mechanisms

Summary of discussion

The submission presented two views:

A The cedant has a substantive obligation to pay premiums to the reinsurer for the full duration of the underlying contracts

B The contract boundary should end at the first point at which the reinsurer has the right to change the premium rates

- The staff supported view A because in determining the contractual boundary a cedant needs to consider the end of both its substantive rights and substantive obligations
- The reinsurer's right to terminate coverage, being outside the cedant's control, is ignored, and the cedant has an unavoidable obligation to pay premiums continuing for the entire term of the contract held
- The cedant reflects its expectations about the amount and timing of future cash flows, including the probability of the reinsurer repricing the contract
- TRG members agreed with IASB's staff view that both substantive rights and obligations should be considered, however noted this paper illustrated a limited scope example

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Implementation challenges outreach report

Background

- This submission looks at the implementation concerns associated with the following three topics, the accounting aspects of which were discussed at the February TRG meeting:
  - Presentation of groups of insurance contracts in the statement of financial position and the need to present separately groups of contracts that are assets and groups of contracts that are liabilities.
  - The need to track premiums received for a group of insurance contracts in order to record the liability for remaining coverage on application of the PAA
  - Subsequent treatment of insurance contracts acquired in their settlement period

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Implementation challenges outreach report

Summary of discussion

Level of aggregation for presentation in the statement of financial position

- IFRS 17:78 requires separate presentation of groups of insurance contracts issued that are assets and those that are liabilities in the statement of financial position
- The group overall balance would further need to be disaggregated in the footnotes disclosing the balance of the liability for remaining coverage and that of the liability for incurred claims
- This would require tracking actual cash movements at the group of insurance contracts level, including the identification of premiums received and claims incurred and may present a significant implementation challenge for some entities requiring change to their information systems
- It is noted that the challenge of identifying claims incurred at the group of insurance contract level maybe more relevant to non-life contracts, which tend to have long settlement periods
- Several TRG members from insurance companies confirmed that the issue of aggregating cash flows at a group level in order to determine whether it is a net asset or a net liability is one of the top three concerns for implementation. The cost involved in obtaining this information, does not, in the view of these TRG members, justify the benefit

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Implementation challenges outreach report
Summary of discussion

Challenges in identifying premium received

- The challenge of tracking premiums received may be **less relevant** to **life contracts with investment components** where the coverage does not typically begin until the premium is received.
- For other contracts, **whether tracking premiums** received for the purpose of measuring the **liability for remaining coverage under the PAA** or for the purpose of presentation in the **statement of financial position**, the implementation challenges are similar
- The IASB staff proposed to issue **additional supporting material**, but pointed out that IFRS 17 specifies the **amounts to be reported** and **not the methodology of determining** them
- Under existing practice, entities present gross amounts of **premiums due to be received** (sometimes on an accrual, rather than invoiced basis) and an amount of unearned premiums and regard these as **important performance metrics** that under IFRS 17 **may either be lost or become alternative performance measures**

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Implementation challenges outreach report

Summary of discussion

Treatment of contracts acquired during the settlement period

- For contracts acquired in their settlement period, the insured event is the determination of the ultimate cost of the claim
- Therefore, the settlement period for the issuer becomes the coverage period for the acquirer, and the liability for incurred claims of the issuer becomes the liability for remaining coverage of the acquirer
- The implementation concerns arise from having to treat differently insurance contracts issued directly from those acquired, notably:
  - The acquirer potentially having to apply the general model to acquired contracts; when had they been the issuer they may have applied the PAA
  - The acquirer having to recognise revenue for the acquired contracts in their settlement period; when they would not do so for similar contracts issued directly
- For performance presentation, while accepting the need to record changes in initial expectations in the insurance service result, many TRG members questioned the validity of recording insurance revenue for such contracts

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Reporting on other questions submitted

Background and summary of discussion

- For this TRG meeting 11 submissions were received and did not feature in a fully fledged paper out of the total 23 submissions received after 2 January 2018

- The staff will consider publishing educational materials on these topics in the future to further support implementation
  - S13 - Modifications to retrospective application
  - S14 – Projected return on assets
  - S28 - Insurance contract with direct participation features – adjustment to CSM
  - S29 - Discount rates used in the allocation of insurance finance income or expense in P&L
  - S32 - Issued adverse loss cover and contracts acquired in their settlement period
  - S35 - Level of aggregation – no significant possibility of becoming onerous
  - S37 - Projected economic conditions
  - S38 - Reflecting minimum guarantees
  - S40 - Discount rate for reinsurance contracts held
  - S41 - Coverage units for reinsurance contracts held
  - S42 - Risk of non-performance of the issuer of a reinsurance contract

- One paper will be considered through other than TRG process
  - S33 – Scope of IFRS 17: Does IFRS 17 apply to certain types of contracts typically issued by non-insurance entities

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Next steps

IASB

- The IASB will receive a public debriefing on the TRG at its meeting. The discussion should lead to a decision on the amendment to IFRS 17 that the staff proposed during the May TRG meeting (coverage unit amendment)
- The next TRG meeting will be held on 26 September 2018 in the new IASB office in London
- The deadline for submissions of issues and comments is 20 July 2018, with earlier submissions allowing for earlier publication of agenda papers.

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- 'IFRS in Focus – IFRS 17 TRG Meeting, 2 May 2018' will be published soon

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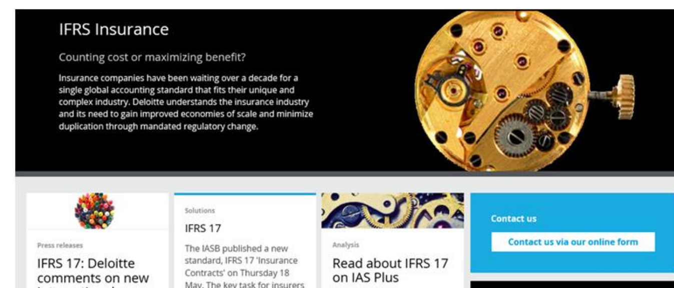

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