Insurance alert

IASB meeting on 15 November 2016

Since a variety of viewpoints are discussed at IASB meetings, and it is often difficult to characterise the IASB's tentative conclusions, these summaries may differ in some respects from the actions published in the IASB Observer notes. In addition, tentative conclusions may be changed or modified at future IASB meetings. Decisions of the IASB become final only after completion of a formal ballot to issue a final standard

Highlights

At the November 2016 meeting the IASB voted on a number of sweep issues relating to the proposed insurance contracts standard (the 'draft Standard' or 'IFRS 17').

At the meeting the Staff presented the methodology and findings of the field testing. Key concerns raised by insurers relate to the level of aggregation, transition, and other sweep issues, which led to the revisions proposed by the Staff at this meeting.

The IASB decided to require entities to apply the new Insurance Contracts Standard ('IFRS 17') for annual periods beginning on or after 1 January 2021.

The IASB decided to require disaggregation of a portfolio of insurance contracts at inception into onerous, profitable with no significant risk of becoming onerous, and other profitable contracts. Only contracts issued within the same year at a maximum are allowed to be aggregated. Allocation of the contractual service margin ('CSM') to revenue should be based on coverage units. The Staff will provide additional guidance about the coverage units and the impact of mutualisation on the measurement of insurance contracts in drafting.

The IASB provided a number of additional reliefs on transition to IFRS 17 if the retrospective approach cannot be applied. Either the modified retrospective approach or the fair value approach may be elected for a group of contracts in force on transition (defined in the same way as those for the measurement of the CSM). The modified retrospective approach includes a list of simplifications that can be used individually or in aggregation only when information for the full retrospective approach is not available. Entities have an option to assess eligibility for the variable fee approach ('VFA') at the beginning of the earliest period presented if information at contract inception is not available. Entities are also not required to disaggregate contracts in force on transition based on the annual cohorts.

The IASB decided that for the building block approach ('BBA') the net effect of changes in future estimates and directly related experience adjustments should be recognised in profit or loss rather than in the CSM. In the VFA the same principles as in the BBA should be used for experience adjustments, other than those arising from financial risks that affect the underlying items.

When an entity applies the VFA and mitigates financial risks with derivatives the IASB decided to extend the option to recognise changes in the mitigated financial risks in profit or loss rather than the CSM to all financial risks (such as those related to shareholder's share in the underlying assets) compared to the previous proposal available only for specific financial risks related to the options and guarantees. The IASB confirmed prospective assessment of eligibility on transition and availability of the option only in the VFA and not in the BBA.

The IASB confirmed that there are no remaining questions that they would like the Staff to consider at a future meeting. The Staff will continue drafting IFRS 17 and the IASB expects to issue the standard in March 2017.

Methodology and results of the field testing

At the meeting the Staff presented the methodology and findings of the field testing. The IASB decided to test specific requirements of draft IFRS 17 to understand interpretation and operational difficulties. The six testing areas were aggregation of contracts, scope of the variable fee approach, derivatives used to mitigate financial market risk, determining insurance finance income or expenses recognised in other comprehensive income, recognition of changes in estimates, and transition. Twelve preparers participated in the field testing. Key concerns raised by insurers relate to the level of aggregation, transition, and other sweep issues, which led to the revisions proposed by the Staff at this meeting.

Standard effective date

10 out of 11 Board members voted in favour of 1 January 2021 as the effective date for IFRS 17. An entity may apply IFRS 17 before 1 January 2021, provided that the entity also applies IFRS 9, *Financial Instruments*, and IFRS 15, *Revenue from contracts with customers* ('IFRS 15').

One Board member suggested a 5-year implementation period. He thought this would allow more time for smaller insurers and territories with less sophisticated business to properly implement IFRS 17. He also suggested that delay in implementation of IFRS 17 for up to two years will not bring significant marginal benefits while simultaneous implementation across the world will result in more expensive implementation. A few Board members did not support his proposal for the following reasons:

- Uniform accounting for all insurance contracts is a significant advantage of IFRS 17 and delay of up to two years will make a big difference;
- Based on IFRS 9 implementation experience, a longer implementation period allows companies to defer implementation to a later date;
- Larger insurers will be affected by IFRS 17 more than smaller ones and a few IASB members considered that larger insurers are able to finalise implementation project within 3.5 years.

One Board member noted that some insurers may consider earlier adoption of IFRS 17 and that based on the complications the IASB faced amending IFRS 15 after issue he would prefer not to amend IFRS 17 once issued as this complicates implementation for early adopters and complicates the endorsement process.

Level of aggregation

10 out of 11 Board members voted in favour of retaining the definition of a portfolio in IFRS 17 for the level of aggregation. The portfolio is then required to be disaggregated into groups of insurance contracts that at inception are (1) onerous, (2) profitable with no significant risk of becoming onerous and (3) other profitable contracts. When an entity assesses the risk of contracts becoming onerous, it should consider how its internal reporting provides information about changes in estimates and the sensitivity of the fulfilment cash flows to changes in estimates.

Further disaggregation of the specified groups is permitted. Only contracts issued within the same year are permitted to be grouped. CSM allocation on the basis of passage of time should be based on coverage units, i.e., reflecting the expected duration and size of contracts in the group. All Board members present voted in favour of permitting the use of a weighted-average locked-in discount rate for the period when contracts are aggregated for accretion of interest on the CSM within a group.

A few Board members noted that they would prefer to have more principle-based requirements for the level of aggregation. However, as a result of field testing they observed that earlier suggested requirements based on key assumptions and similar profitability resulted in significantly higher granularity of measurement than they expected. Hence, the requirements proposed by the Staff are a pragmatic and operational solution that achieves the IASB's objectives.

A few Board members supported three profitability groups as a minimum requirement for disaggregation as a means to avoid cross subsidization of profitable and onerous contracts. One Board member noted that in practice many portfolios may have less than three profitability groups, for example, if insurers do not write contracts which are onerous at inception.

A few Board members supported the minimum requirement for the annual cohort for disaggregation as a means to avoid the CSM that does not correspond to the number of contracts in force ('endless pot of the CSM'). One Board member observed that 'endless pot of the CSM' undermines the notion of profit and loss and allows management of the financial results. One Board member considered the annual cohort requirement excessive, arguing that there will be no CSM at the end of the coverage period due to the requirements for the release of the CSM based on the coverage units. However, other Board members did not agree with his comments.

In response to the enquiries of Board members about contracts with mutualisation the Staff clarified that:

- They will provide additional clarification about mutualisation in the next draft of IFRS 17;
- The annual cohorts requirement applies to all contracts, including those with mutualisation;
- Mutualisation should be considered when insurers calculate cash flows, but it does not override the requirements for the level of aggregation; and
- Mutualisation should only be considered if it forms part of the contractual terms.

The Staff also noted that it is not necessary to analyse the profitability of insurance contracts individually at inception if there is existing information about expected profitability of portfolios or parts thereof used for management reporting.

One Board member observed that the feedback from the field testing indicated that participants erroneously thought that fulfilment cash flows were required to be disaggregated at the same level as the CSM, while that was not the intention of the IASB. When the CSM is disaggregated at a more granular level than the fulfilment cash flows, changes in the fulfilment cash flows should be allocated to the CSM groups on a reasonable and supportable basis.

Transition

All Board members present voted in favour of the proposed Staff recommendations set out below.

The retrospective approach should be applied on transition to groups of insurance contracts (defined in the same way as for the measurement of the CSM) unless it is impracticable or if groups at inception of contracts in force on transition cannot be identified. An entity is then permitted to choose between the modified retrospective approach and the fair value approach, unless a modified retrospective approach is impracticable, in which case an entity must use the fair value approach.

One Board member questioned the proposal for a free choice between the modified retrospective and fair value approaches, suggesting that the modified retrospective approach is superior to the fair value approach. The Staff clarified that the modified retrospective approach itself includes a number of choices and that additional optionality resulting from the free choice of the fair value option for a group of contracts does not appear to be excessive. In addition, users will be provided with information about the use of different options in the disclosures.

The objective of a modified retrospective approach should be to achieve the closest outcome to retrospective application that is possible using reasonable and supportable information. An entity is permitted to use the minimum specified modifications necessary to meet the objective of using information that is available without undue cost or effort.

An entity should determine the contractual service margin using the permitted modifications for the VFA determined at the beginning of the earliest period presented.

In the fair value approach an entity is permitted to assess eligibility for the VFA and level of aggregation and define discretion either at inception of a contract or at the beginning of the earliest period presented.

One Board member expressed concerns about free choice for the timing of assessment for the eligibility for the VFA between beginning of the earliest period presented and inception of the contract. The Staff explained that assessment at the beginning of the earliest period presented was intended to be allowed only if assessment at the inception date is not possible, the words will be clarified.

In the modified retrospective and the fair value approaches, an entity is not required to disaggregate contracts based on the annual cohorts and is permitted to lock-in interest rates at the beginning of the earliest period presented, instead of locking-in interest rates at the inception of a contract. If an entity uses the discount rate at the beginning of the earliest period presented, it should separately disclose insurance finance income and expense for contracts in force on transition and other contracts and disclose a reconciliation from the opening to the closing balance of the cumulative other comprehensive income for related financial assets measured at fair value through other comprehensive income.

One Board member was concerned about the relief available at transition from the requirement for the annual cohort limitation for aggregation of contracts and requested a disclosure where insurers would explain why they think that the objectives of disaggregation are still met. In response to this concern the Staff clarified that there is no relief for profitability-based disaggregation requirements on transition and entities still have to release the CSM based on coverage units. This was considered to be a pragmatic solution that allows entities to achieve the disaggregation objectives.

The Staff also explained that assets relate to liabilities for disclosure purposes either if they represent underlying assets for contracts with participating features or if assets are allocated to liabilities for management purposes.

The CSM, revenue and insurance finance income or expense should be disclosed separately for contracts in force on transition and other contracts. In addition, disclosure would be required for those situations in which the discount rate is locked at the beginning of the earliest period presented as a transition expedient.

A few Board members noted that many participants of the field testing asked for clarification in applying IFRS 13 *Fair Value* to insurance contracts for which the fair value practical expedient is elected. The IASB asked Staff to issue educational materials about the fair value of insurance contracts such as a paper or a webcast discussing basic examples.

Experience adjustments

Previously the IASB decided to recognise the combined effect of the experience adjustment and directly related change in the estimate of the present value of the future cash flows in the CSM.

At the November meeting all Board members present voted in favour of the Staff recommendation that in the BBA, when an experience adjustment causes a change in the future rights and obligations for the group of contracts (i.e. the number of coverage units), the combined effect of the experience adjustment and the change in the estimate of the present value of the future cash flows should be recognised in profit or loss. In the VFA, experience adjustments arising from non-financial risks that do not affect the underlying items and cause a change in future rights and obligations should be recognised in profit or loss, net of the related effect of changes in the estimates.

One Board member noted that presentation of the net result from experience adjustments and directly related changes in the future estimates in profit or loss is a more faithful representation of the business compared to the recognition of the result in the CSM. For the example presented in the appendix of the related Staff paper he noted that he expects higher release of the CSM in the periods when unexpected lapses occur than that presented in the example. He suggested clarifying that in the next draft of IFRS 17.

Mitigating financial risks reflected in insurance contracts

In September 2015 the IASB decided to permit an entity that applies the VFA and uses derivatives to mitigate specified financial risks arising from the insurance contract to exclude the effect of changes in those financial risks from the CSM when specified criteria are met.

At the November 2016 meeting all Board members present voted in favour of extending this provision from specified financial risks related to embedded options and guarantees to all financial risks, including changes in the entity's share in the underlying items.

The Board confirmed the availability of the provision only on a prospective basis on transition and did not address the concern around the differences between the measurement of insurance contracts at fulfilment value and related derivatives at fair value.

Other sweep issues

The Board agreed with approaches recommended by the Staff to resolve the remaining sweep issues. No other topics were suggested for consideration at future meetings. Set out below are some of the issues and solutions recommended by the Staff:

1. In order to address concerns raised by field test participants around the inappropriate combination of insurance contracts the Staff suggested deleting the insurance contracts combination requirements. It is expected that entities will use the general IFRS requirements for combination of contracts. The Staff also expects that there will be relevant words in the Exposure Draft of the Conceptual Framework that will address the combination requirements for insurance contracts.
2. The Staff suggested replacing the derivatives unbundling requirements in IFRS 17 with a cross reference to IFRS 9 requirements, noting that the words in the current draft were meant to be consistent with IFRS 9 requirements and thus not needed to be separately stated in IFRS 17. Voluntary unbundling of components that do not meet the requirements for unbundling will continue to be prohibited.
3. The Staff confirmed the previous decision to prohibit voluntary unbundling of components of an insurance contract.
4. Since the only pre-coverage cash flows identified are acquisition costs, the Staff suggested replacing the reference to 'pre-coverage cash flows' with 'acquisition costs' throughout IFRS 17.
5. The Staff confirmed that no order for subsequent measurement of the CSM is prescribed, except for the requirement to release the CSM after the other re-measurements. One Board member explained that he preferred release of the CSM to be made at the end as changes in future estimates affecting unlocking of the CSM may occur throughout the reporting period and revenue for the current reporting period from the release of the CSM should thus include unlocking of the CSM for the current period.
6. The Staff confirmed that only the unwinding of the discount should be presented as part of the "financial result," and that changes in inflation should not be presented as such. They rejected a request to modify the PAA to deal with more complex products.
7. The Staff suggested clarifying that the VFA should not be used for reinsurance contracts.

8. The Staff proposed an additional derecognition requirement when a contract is modified. Modification will lead to derecognition of original contract and recognition of a new contract if after the modification the conclusion about unbundling of components of an insurance contract would have changed.
9. The Staff clarified that the change in the risk adjustment is permitted to be disaggregated between underwriting and finance income/ expense consistent with the way finance income/ expense is presented for that group of contracts.
10. The Staff recommended clarifying that the discount rate used in accreting interest on and measuring changes to the CSM for contracts without participation features should be the rate applicable to nominal cash flows that do not depend on the returns on any underlying items.
11. The Staff suggested clarifying that all enforceable terms should be treated as contractual terms under IFRS 17. The treatment should be aligned with the requirements of IFRS 15.
12. The Staff suggested clarifying the term 'substantial' used in the definition of direct participating contracts. They noted that it should be interpreted in the context of the IASB's intent that the VFA should be used in those arrangements in which the entity's primary obligation is to pay the policyholder an amount equal to the fair value of the underlying items, less the variable fee for service.
13. The Staff confirmed that for measurement of liabilities under the VFA, all underlying items should be measured at fair value, irrespective of their nature.
14. The Staff suggested providing guidance explaining that 'coverage units' are a way to ensure that the release of the CSM in each period reflects the duration and size of contracts in the group.
15. The Staff suggested clarifying that under the PAA the pattern of the release of the liability for the remaining coverage to revenue could change throughout the life of the contract depending on changes in facts and circumstances.
16. In response to the concerns of the entities reporting to the SEC about provision of three year comparative information, the Staff suggested explicitly providing a relief for the disclosure of information for the comparative periods exceeding one preceding year.
17. The Staff suggested providing no relief for preparers of consolidated financial statements from the requirement to calculate different CSMs for the same contracts at different levels of reporting when business combinations have occurred before adoption of IFRS 17. The CSM for the subsidiary issuing the contracts will be calculated based on the fulfilment cash flows from the contracts at the contract inception while for the consolidated financial statements the CSM will be calculated based on the fair value and fulfilment cash flows from the acquisition date
18. The Staff suggested clarifying that IFRS 17 does not require entities to bifurcate expected cash flows and apply different discount rates to each of those cash flows.
19. The Staff suggested clarifying that different cash flows from an insurance contract are not required to be separately measured.
20. The Staff suggested clarifying that an inflation index is a financial variable whereas inflation specific to a contract is a non-financial variable. This clarification may be relevant for the application of the option in the VFA to recognise changes in financial variables in profit or loss rather than the CSM if they are hedged with a derivative. This may also impact whether changes in the future estimates are recognised in the CSM or in the statement of comprehensive income under the BBA.

Contact us:

If you would like to discuss any of the issues raised in this summary, please call or contact Gail Tucker or Mary Saslow or speak with your usual contact at PwC.

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