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IASB proposes to further amend IFRS 17

IASB agrees to propose certain further amendments to IFRS 17 to better reflect the economics of insurance contracts

At a glance

On 23 January 2019 the IASB continued its discussions on IFRS 17/ It tentatively agreed to propose amendments to IFRS 17 to:

- Require allocation of insurance acquisition cash flows to anticipated future renewals;
- Require recognition of a gain in profit or loss when an insurer recognises losses on onerous underlying insurance contracts at initial recognition, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis;
- Expand the scope for the risk mitigation exemption for insurance contracts with direct participation features to reinsurance contracts held that are used to mitigate financial risk. However, the Board will not expand the scope of the variable fee approach to reinsurance contracts issued or held; and
- Require consideration of the existence of an investment return service in allocating the CSM using coverage units.

The Staff plans to bring papers on the remaining implementation concerns and challenges to the Board during the first quarter of 2019. At a future meeting the Board plans to consider the package of all the proposed amendments to ensure that they comply with the criteria the Board agreed in October 2018 and will consider the need for additional disclosures as a consequence of the proposed amendments. The Board expects to publish an Exposure Draft of the amendments to IFRS 17 around the end of the first half of 2019, to be in a position to finalise amendments such that 1 January 2022 remains as the proposed effective date of IFRS 17.

The views in this In transition are based on our observations from the 23 January 2019 meeting, and they might differ in some respects from the official minutes of the meeting to be published by the IASB at a later date

Background

1. In connection with the issuance of IFRS 17, the IASB established a transition resource working group ('TRG') to provide a public forum for stakeholders to follow the discussion of questions raised on implementation of the new standard. The purpose of the TRG is to facilitate a public discussion to provide support for stakeholders, and information to the Board, on implementation questions arising from the application of IFRS 17.

2. Since the issuance of the standard, IASB staff have also been engaged in a variety of activities with stakeholders to follow the implementation of IFRS 17. At the IASB meeting on 24 October, the Board agreed to explore potential amendments to IFRS 17 based on a list of implementation issues and concerns compiled by the staff. The Board noted that the criteria sets a high hurdle for change, and any amendments suggested would need to be narrow in scope and deliberated quickly to avoid significant delays in the effective date.

3. In November 2018, the IASB Board agreed to start the process to amend IFRS 17 to defer the mandatory effective date of IFRS 17 by one year. Subject to IASB due process, entities will be required to apply IFRS 17 for annual periods beginning on or after 1 January 2022. The Board noted that limiting the deferral to one year would minimise disruption to entities that are furthest advanced in implementation, address users' concerns that adoption of IFRS 17 and IFRS 9 should not be significantly delayed, and provide a clear signal to the industry that it should not stop implementation projects.

4. In December 2018 the IASB continued discussions of the concerns and implementation challenges raised by stakeholders of IFRS 17. The IASB agreed to propose one narrow-scope amendment to require presentation of insurance contracts on the balance sheet at the portfolio level rather than at the grouping level used for contract measurement purposes. The other eleven implementation challenges discussed in this meeting did not result in any proposed amendments.

Overview of items discussed during the January IASB Board meeting

5. Continuing with the discussions of concerns and implementation challenges raised by IFRS 17 stakeholders, at the January 2019 meeting the Board evaluated 5 of the 25 concerns and implementation challenges reported in October 2018, noting that the remaining six issues plus the question postponed in December would be discussed further in the first quarter for 2019 aiming for issuance of an exposure draft containing the proposed changes around the end of first half this year.

6. Below is the summary of the decisions reached by the IASB in this meeting on potential amendment of the standard applying the evaluation criteria agreed in October 2018

Staff paper	*Concerns and implementation challenges*	*IASB Decision*
Insurance acquisition cash flows for renewals outside the contract Boundary (Staff Paper 2A)	Insurance acquisition cash flows directly attributable to newly issued contracts that economically anticipates future renewals outside the contract boundary	Amend
Reinsurance contracts held—onerous underlying insurance contracts (Staff Paper 2B and 2C)	Losses from onerous underlying insurance contracts that are covered by proportionate reinsurance contracts held	Amend
Reinsurance contracts held—underlying insurance contracts with direct participation features (Staff Paper 2D)	Reinsurance contracts ineligible for the variable fee approach	Not amend
	Limitation of risk mitigation exemption for insurance contracts with direct participation features	Amend
Recognition of the contractual service margin in profit or loss in the general model (Staff Paper 2E)	Amortisation of the contractual service margin for contracts under the general model that include an investment return service	Amend

Insurance acquisition cash flows for renewals outside the contract boundary

7. At the 23 January meeting the Board agreed to amend IFRS 17 to require the allocation of part of the insurance acquisition cash flows directly attributable to newly issued contracts to any anticipated contract renewals. Such amounts would be recorded as a separate asset subject to an impairment test until the renewed contracts are recognised. The impairment test would be based on the expected fulfilment cash flows of the related group of contracts.

8. This decision is a significant change from IFRS 17 as currently issued. At the 6 February 2018 TRG meeting, the TRG observed that no part of non-refundable insurance acquisition cash flows directly attributable to newly issued contracts could be allocated to any anticipated contract renewals. Stakeholders raised concerns that in certain situations the economic substance of the arrangement includes an expectation that contracts will be renewed, and thus the entity is willing to pay a large up front commission. Attributing such acquisition cost to only the initially issued group of insurance contracts might cause the group of insurance contracts to be onerous on initial recognition, even though the economic substance of the contracts is that they are profitable.

9. Stakeholders have also reported that treating such acquisition cash flows as only attributable to the initially issued contract is, in their view, inconsistent with the requirements in IFRS 15, which allows anticipated renewals to be considered.

10. The IASB observed that although a wider range of costs are included in acquisition cash flows under IFRS 17 than under other standards such as IFRS 15 (which are incremental at the contract level), the definition of acquisition cash flows should not be amended. The Board decided not to prescribe how the allocation of insurance acquisition cash flows should be done, noting that IFRS 17 as currently written has several components of fulfilment cash flows that already are subject to allocation.

11. During the discussion one Board member emphasised that when the recognised asset is tested for impairment, the assessment should be done using the fulfilment cash flows of the contracts expected to be renewed and not against other newly anticipated contracts or the overall profitability of the entity or the portfolio.

12. On a separate matter, in responding to a question from a member on renewal commissions, the staff noted that some renewal commissions meet the definition of acquisition cash flows, while others do not and are treated as maintenance costs.

Reinsurance contracts held - onerous underlying insurance contracts

13. The IASB agreed to expand the scope of the current exception relating to the recognition of a gain in profit or loss on reinsurance held when an entity recognises losses on onerous underlying insurance contracts. Under IFRS 17 as currently written, the recognition of a gain applies only to the extent changes in fulfilment cash flows adjust the contractual service margin ('CSM') subsequent to contract issuance, and applies to all types of reinsurance contracts held. Under the proposed amendment, the requirement to recognise a gain on the reinsurance contract when the entity recognises a loss on onerous underlying contracts would be expanded to apply at contract inception, but only to the extent the reinsurance contracts 'cover losses of each contract on a proportionate basis'. The Board asked the staff to clarify and emphasise in the drafting that the offset would only apply where the reinsurance contract incepts on or before the date that the underlying contracts incept. The proposed exemption would also be applicable for contracts accounted for under the premium allocation approach ('PAA').

14. The Board noted that such an amendment would not be aligned with the main principles in the standard, as IFRS 17 considers the rights and obligations arising from

reinsurance contracts independently from the underlying insurance contracts. However, the Board acknowledged that IFRS 17 already has exemptions from this principle and therefore the change would only be an expansion of the current exemptions.

15. The staff paper noted that in the deliberation of the original exemption it was concluded that a gain should never be recognised on a purchased reinsurance contract on initial recognition, as no service had yet been received. The Board reasoned that the typical scenario would be that the reinsurance contract in its entirety would result in a net outflow (net cost), and that a situation where the entire contract would result in a net gain, i.e. net inflow, would be rare. One Board member noted that the reason for considering the change is that they have received new information from stakeholders that the situation of an onerous underlying contract is not rare. As noted in the staff paper the Board had not considered a scenario where a single reinsurance contract might be in a net cost position but cover both onerous and profitable underlying contracts. The IASB staff clarified that this amendment would not require separation of the reinsurance contract, - it will be accounted for as one contract with one CSM.

16. The Staff noted that subsequent to publication of the staff papers several stakeholders have reached out expressing concerns that the expanded scope only applies to proportionate reinsurance contracts. The Board agreed with the staff's explanation of the limited scope of the proposed amendment, noting that for proportionate contracts there is a direct linkage between the reinsurance and underlying contracts on inception. That is, claims are reimbursed as a specified percentage of the claims incurred. One member noted that the Board is being pragmatic in this proposed amendment as the loss on the underlying contract could be due to cash flows other than claims, Several Board member agreed with the rationale for restricting the amendment to proportionate reinsurance contracts but that the term by 'proportionate' should be included either in the defined terms in the standard or more explanation given in the basis for conclusions.

Reinsurance contracts held—underlying insurance contracts with direct participation features

Risk mitigation exception to the variable fee approach

17. The Board agreed to amend IFRS 17 to expand the scope of the risk mitigation exception for insurance contracts with direct participation features so that it applies not only when derivatives are used, but also when entities use reinsurance contracts to mitigate the financial risks in these contracts. In order to be eligible for this exception, the conditions outlined in the current standard must be met for reinsurance contracts.

18. Under IFRS 17 as currently written, when entities use derivatives to mitigate the financial risks arising from insurance contracts and certain criteria are met, an entity is permitted to recognise changes in financial risk in profit or loss instead of adjusting the CSM as is normally required under the variable fee approach ('VFA') for participating contracts. This exception was included to allow entities to avoid the accounting mismatch that would otherwise result and better reflect the net economics of an entity's decision to hedge the financial risk inherent in the participating contracts, for example minimum return guarantees. The staff papers note that some reinsurance held may act in the same mitigating way as derivatives, and therefore the same accounting election should apply when an entity purchases reinsurance for this financial risk mitigation purpose.

19. In its December 2018 Board meeting the IASB agreed to discuss the retrospective application of the risk mitigation exemption on transition at a future meeting. The IASB did not have that discussion at this meeting, but is is expected to discuss it in the upcoming months.

Expansion of the scope of the variable fee approach

20. The VFA applies to contracts that meet the definition of insurance contracts with direct participation features, where the entity promises an investment return based on underlying items less a variable fee. IFRS 17 notes that neither reinsurance contracts held nor reinsurance contracts issued are eligible for the VFA. Some stakeholders raised concerns that accounting mismatches will occur when underlying contracts are accounted for under the VFA and the reinsurance held contract is accounted for under the general measurement model. The staff paper noted these concerns and recommended to not expand the scope of the VFA to reinsurance contracts issued or held and instead amend the risk mitigation exception.

Recognition of the contractual service margin in profit or loss in the general model

21. The Board agreed to propose an amendment so that in the general model, the CSM is allocated on the basis of coverage units that are determined by considering both insurance coverage and 'investment return service.' An 'investment return service' can only exist where an investment component is present. However, the staff noted that the existence of an investment component will not automatically mean that an investment return service is present. The staff noted that the 'investment return service' is different from asset management services performed in conjunction with a participating contract subject to the VFA because for non-VFA contracts the entity is not managing assets on behalf of the policyholders (i.e. not providing asset management services). Instead it is providing the policyholder with access to an investment return that would not otherwise be available to the policyholder because of the amounts invested, liquidity, complexity or expertise.

22. Under the proposal, an entity would be required to use judgement, consistently applied, in deciding whether an investment return service exists; no objectives or criteria for that determination will be included in the standard. The investment return service would end when the entity has made all investment related payments to the policyholder under the contract. The assessment of the relative weighting of the benefits provided by the insurance coverage and the investment return services and their pattern of delivery would not be prescribed but instead would be determined on a systematic and rational basis by management. In addition, cash flows relating to fulfilling the investment return service (but excluding gains/losses on any investments) would be included in the measurement of the insurance contract. For the determination of PAA eligibility, an entity should consider both the insurance coverage and any investment return service

23. The Board is proposing the above changes based on stakeholder feedback at the May 2018 TRG and through various other outreach that some contracts that do not meet the VFA criteria nevertheless provide investment-related services or other services. They agreed that investment services should be reflected in the coverage units that are used to allocate CSM over the period of the services provided.

24. However, some Board members expressed some concern with how the definition for such services would be interpreted, including the words 'providing the policyholder with access to an investment return' and thought that perhaps the staff should consider adding some wording in drafting, even if only in the basis for conclusions, to clarify the meaning. Board members also discussed whether some guidance should be provided on how to evaluate and account for situations where an investment return service might be inconsequential or de minimis, or only manifests itself in remote scenarios.

25. Board members also expressed some concern with how the 'relative weighting of benefits' and 'pattern of delivery' on 'a systematic and rational basis' would be interpreted, noting that there was much room for judgement. However, they also acknowledged that other areas of the standard also require similar judgements and so the staff should exercise care and not be too prescriptive in this amendment.

26. In summary, the Board acknowledged that the introduction of investment return services will have a significant impact on the pattern of profit recognition where such components exist. Significant judgement is required in determining the existence of an investment return service, the weighting of components and the pattern of delivery, with all needing to be applied consistently. Board members suggested that this amendment may require additional disclosures, which the staff will consider at a future date.

Future expected discussions

27. The Board noted that discussions on the remaining implementation challenges and concerns will continue in future Board meetings, with deliberations expected to be completed in the first quarter of 2019. The Staff propose to bring back a summary of all suggested amendments and assess the total package of amendments against the criteria previously agreed to and consider the need for any amendments in the disclosures as a consequence of the proposed amendments.

28. In its papers for the October 2018 Board meeting the IASB staff presented 25 identified implementation challenges. Of the remaining concerns to be discussed at a future meeting, the staff's preliminary views in the papers for the October Board meeting indicate that it might be possible to potentially amend IFRS 17 for the following issues in a way that meets the criteria for amendment:

- Modified retrospective approach
- Loans and other forms of credit that transfer insurance risk

29. The staff's preliminary views in the papers for the October Board meeting are that the following remaining issues may not meet the criteria for amendment:

- Level of aggregation
- OCI on FV transition approach
- Date of initial application of comparatives
- Optionality on transition
- Retrospective application of risk mitigation exception on transition (Deferred from December 2019 Board meeting)

Next steps

30. The Board will follow due process by issuing an exposure draft that is expected to be issued around end of the first half of 2018, allowing an appropriate public comment period, and redeliberating responses for any proposed amendments. The expected timeframe for issuance of final amendments proposed to date, considering the due process required, is normally 12 to 18 months.

31. The Board has already published a short note of the meeting that is available here.

PwC has developed the following publications and resources related to IFRS 17, 'Insurance Contracts':

- In transition INT2018-07: IASB agrees to propose limited changes to balance sheet presentation of insurance contract assets and liabilities
- In transition INT2018-06: *IASB proposes to amend the effective date of IFRS 17 and extend the temporary exemption of IFRS 9 for insurers*
- In transition INT2018-05: *IASB agrees on criteria for evaluating any potential future amendments to IFRS 17*
- In transition INT2018-04: *TRG debates more IFRS 17 implementation issues*
- In transition INT2018-03: *Amendments to IFRS 17 on the IASB Board agenda*
- In transition INT 2018-02: *Insurance TRG addresses unit of account, contract boundary, and coverage unit issues*
- In transition INT2018-01: *Insurance TRG holds its first meeting on IFRS 17*
- In brief INT2017-05: *IFRS 17 marks a new epoch for insurance contracts*
- In depth INT2017-04: *IFRS 17 marks a new epoch for insurance contract accounting*
- *Using Solvency II to implement IFRS 17*
- *IFRS 17 – Redefining insurance accounting*

PwC clients who would like to obtain any of these publications, or have questions about this In transition, should contact their engagement partner.

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