pwc

No. INT 2018-01
9 February 2018

Transition Resource Group debates IFRS 17 implementation issues

Insurance TRG holds its first meeting since issuance of IFRS 17

At a glance

At its first meeting held on 6 February 2018, the IFRS Transition Resource Group for *Insurance Contracts* (TRG) discussed several implementation issues related to the new accounting standard for insurance contracts, IFRS 17. The issues discussed related to separation of insurance contracts, contract boundary of insurance contracts and reinsurance contracts held, quantity of benefits for identifying coverage units, and the accounting for and presentation of insurance acquisition cash flows.

Background on TRG

1. In connection with the issuance of IFRS 17, 'Insurance Contracts', the IASB established a working group, the TRG, to provide a public forum for stakeholders to follow the discussion of questions raised on implementation of the new standard. The TRG comprises financial statement preparers and auditors, and an additional three members with observer status representing international security regulators, insurance supervisors and actuarial organisations.

2. Overall, 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. During the meetings, the TRG members share their views on the issues. The TRG will not issue guidance. The IASB will determine what action, if any, will be taken on each issue. Possible actions include providing supporting implementation guidance, such as webinars and case studies, and/or referral to the Board for potential editorial corrections or referral to the Interpretations Committee.

3. Additional background on the issues discussed at the TRG meeting can be found on the IASB website.

Highlights of TRG discussions

Summary of issues discussed

4. There were seven agenda items discussed at the meeting. Some of these issues have resulted in clarification of the guidance, and some require further consideration. A summary of the issues discussed is provided in the table below:

Date	TRG Agenda Ref #	Topic discussed	Anticipated next steps
6 February 2018	1	Separation of insurance components in a single contract	No further action expected from the TRG
	2	Boundary of contracts with annual repricing mechanisms	No further action expected from the TRG
	3	Boundary of reinsurance contracts held	No further action expected from the TRG
	4	Insurance acquisition cash flows paid on an initially written contract	No further action expected from the TRG
	5	Determining quantity of benefits for identifying coverage units	The TRG agreed to discuss this topic further in May 2018, including coverage units for contracts with investment components
	6	Insurance acquisition cash flows when using fair value transition	No further action expected from the TRG
	7	Reporting on other questions submitted	Some topics are expected to be brought back for further TRG discussion

Areas discussed at the TRG meeting

Separation of insurance components in a single insurance contract

5. The staff paper addresses two related issues: whether IFRS 17 permits or requires the separation of an insurance contract into smaller insurance subcomponents; and whether a reinsurance contract held can or should be separated into components reflecting the underlying contracts.

6. TRG members generally agreed with the staff paper view that the lowest unit of account in IFRS 17 is the contract, and that there is a presumption that a contract with the legal form of a single contract would generally be considered a single contract in substance.

7. However, TRG members also noted that substance over form is a relevant principle in applying IFRS 17, just as it is in the application of other IFRS standards. There might be certain facts and circumstances where legal form does not reflect the substance, and separation is required. However, overriding the legal contract to reflect substance is not a policy choice; it is a significant judgement requiring careful consideration of all relevant facts and circumstances.

8. An example of where the presumption that a single legal contract is the lowest unit of account under IFRS 17 might be overridden is a situation where transactions that are typically written as separate contracts have been bundled together as one legal contract for customer convenience, but where there are no interdependencies between the different components. Factors to consider, in assessing whether there are separate

contracts in substance, could include shared deductibles and limits, situations where the components are not sold separately, or where the lapse or termination of one component results in the termination of the entire contract.

PwC observation
We expect that principles discussed at the meeting, for separation of insurance or reinsurance contracts into smaller insurance components, would result in a high hurdle to overcome the presumption that the legal contract is the lowest unit of account for accounting purposes. However, there might be limited situations, consistent with the example provided during the meeting, where there are no interdependencies and the substance indicates that separation is appropriate.

Boundary of contracts with annual repricing mechanisms

9. The key issue addressed is whether the 'reassessment of risks' referred to in determining the contract boundary under paragraph 34(b) of IFRS 17 refers only to insurance risk or whether it includes other broader risks such as lapse and financial risk. To illustrate, the staff paper analysed how the contract boundary for insurance contracts with an annual repricing mechanism at the portfolio level might be determined.

10. The key message conveyed by the IASB at the TRG meeting was that paragraph 34(b) is meant to be an extension of paragraph 34(a), which focuses on policyholder risk. The analysis in paragraph 34(b) involves considering whether the entity has the practical ability to reassess the risk, and whether premiums for coverage up to the date when risks are reassessed take into account risks related to periods after the reassessment date. An IASB Board member and the staff noted that 'risk' should be interpreted as policyholder risks, and not all risks for the insurer. Therefore, insurance risk (for example, mortality) is relevant, because it is a risk transferred from the policyholder to the entity. Other risks, such as lapse and expense risk, are not relevant in the assessment, since these are risks of the insurer but are not risks transferred from the policyholder.

11. The staff emphasised that the two examples in the paper were provided to facilitate discussion rather than to draw conclusions on any particular fact pattern. One example was yearly renewable term life insurance where the premium was determined using a step rated premium table, except for specific adjustments for some health conditions of the individual policyholder determined during underwriting at contract inception. The entity repriced the premiums annually at the portfolio level. A second example was similar to the first, but with an investment component that was unit linked.

12. The staff view was that the two examples in the paper were one-year contracts, due to the annual repricing. TRG members had mixed views on this example. Some thought that the existing policyholder who was not re-underwritten on renewal had a substantive benefit above a new policyholder of the same age. However, some changed their view when the staff clarified that, in the example, in the annual repricing exercise, the entity was looking at actual experience of the portfolio, and not just at a general mortality table.

PwC observation
Overall, TRG members found the staff's clarification that 'risk' refers to policyholder risk to be helpful, although there were some questions on how to apply that concept in practice and to the particular examples provided. It was agreed that the staff would draft its summary of the meeting, and the group would determine whether further discussion or clarifications might be needed.

Boundary of reinsurance contracts held

13. This paper asked the TRG to address two submissions relating to reinsurance contracts held. The first issue is how the contract boundary guidance in paragraph 34 of IFRS 17 should be applied to such contracts. The second issue is whether the estimation of future cash flows for the reinsurance ceded should include cash flows relating to future expected direct contracts not yet written.

14. On the first issue, there was general agreement by TRG members that the analysis in the staff paper was appropriate, and that the contract boundary in the reinsurance contracts held should be applied from the contract issuer's perspective (that is, it is the reinsurer's ability to reprice the risk that should be considered). In the case of a termination clause, it was observed that this would impact the contract boundary.

15. The second issue relates to the interpretation of the recognition guidance in paragraph 62 of IFRS 17 for reinsurance contracts providing proportional coverage. Paragraph 62(a) notes that a group of proportional reinsurance contracts should be recognised at the beginning of the coverage period of the group, or at the initial recognition of any underlying contract, whichever is later.

16. The staff interprets paragraph 62 to mean that cash flows included in a proportional reinsurance contract held would include those from future expected underlying contracts. Recognition of these fulfilment cash flows would occur on the date when the first underlying contract that is reinsured is written, or the coverage period begins, if later. The staff noted that this provision was meant to be similar to the concession provided for recognition of issued insurance contracts, whereby a contract is recognised when coverage begins rather than when the agreement is signed, which could have resulted in earlier recognition.

17. Some TRG members disagreed with this treatment, because it would result in an accounting mismatch between the measurement of insurance contracts issued and the measurement of the reinsurance contract held that covers the same contracts. They believe that recognition of the reinsurance ceded should occur as each underlying contract is written.

18. The IASB staff and the three Board members emphasised that the objective of the standard was not a matching principle, because the main principle in the standard is to measure the expected future cash flows within the boundary of the reinsurance contract. For a proportional reinsurance contract, the reinsurer is obligated to accept business that would be written within the boundary of the reinsurance contract, even if contractual terms of the underlying contracts have not yet been agreed, and the insurer has a present right to this coverage. In summary, the staff noted that TRG members agreed that the standard required cash flows to be recognised for underlying insurance contracts not yet written, but that they did not like that treatment.

PwC observation
The IASB staff noted that recognition of fulfilment cash flows for reinsurance ceded at the beginning of the coverage period of the first underlying contract, rather than of each underlying contract, would not be expected to produce a large 'mismatch' on the balance sheet, given that any asset or liability is presented net with the contractual service margin (CSM). Nevertheless, this provision will require the calculation of fulfilment cash flows and CSM for business not yet written, and TRG members noted that it would require significant effort to comply with the requirements.

Insurance acquisition cash flows paid on an initially written contract

19. The issue addressed is whether a large non-refundable commission paid to an agent for an annual insurance contract should be allocated entirely to the initial contract for accounting purposes if the entity expects renewals outside the contract boundary to occur, it and has priced its contract and its commission rate with that expectation. In the fact pattern provided, attributing the large commission entirely to the initial one-year contract would result in an onerous contract.

20. Most TRG members agreed with the staff view that a literal interpretation of the guidance would require the large non-refundable commission to be included in the measurement of the contract grouping to which the initially written contract belongs. However, many TRG members noted that this does not reflect the economics of the transaction, because the commission is paid and the product is priced with the expectation of contract renewals. Some TRG members also noted that the treatment is inconsistent with IFRS 15.

21. During the discussion, a separate question arose about capitalisation of other directly attributable acquisition expenses that are not contract specific but are incurred at a higher level, and why the guidance referred to permitting capitalisation only for 'issued contracts'. The staff clarified that the reference to recognising an asset or liability for insurance acquisition cash flows relating to a group of 'issued' insurance contracts in paragraph 27 of IFRS 17 was meant to distinguish the contracts from those that are 'held' (that is, reinsurance). It was not meant to indicate that acquisition costs incurred relating to as yet unissued contracts could not be capitalised.

22. It was observed by several TRG members that, if other non-contract-specific costs are capitalisable and allocable to current as well as future contracts, it seemed inconsistent not to allow capitalisation and allocation of commissions to both current and future contracts. The staff argued that this is an appropriate difference in the attribution period between more generally attributable acquisition costs (current and future contract periods) and commission cash flows (initial contract period only), because commission cash flows are unconditionally paid and identifiable at the individual contract level and thus cannot be attributed to future contracts.

PwC observation
It was noted in the meeting that currently many commission arrangements do not contain any 'clawback' clauses that require an agent to refund a portion of the commission if the contract is not renewed. Consequently, even if the acquisition cash flows from an economic perspective consider future renewals, such commission arrangements will be treated differently from those that have such a clawback provision.

Determining quantity of benefits for identifying coverage units

23. The agenda paper addresses the definition of 'quantity of benefits' in paragraph B119(a) of IFRS 17, which serves as the basis for recognising the contractual service margin. The staff paper identified two factors that might be included in the determination of quantity of benefits arising from insurance coverage. These were: (1) the likelihood of insured events occurring, to the extent that they affect the expected duration of contracts; and (2) variability across periods in the level of cover. The staff analysis noted that the amounts expected to be claimed would not affect the coverage units.
The staff paper included four examples (credit life insurance, a general insurance adverse development cover, a five-year warranty contract, and a pay-out annuity) and applied these factors to the contracts. At a future meeting, the staff will provide additional examples that include investment components.

24. After some discussion, it was decided that members and the IASB would reflect on the comments made at the meeting and that the staff would bring a paper to the next TRG meeting in May. This was due to the fact that there was diversity in views regarding the draft principles provided by the staff, and how to determine the quantity of benefits in the examples provided. In addition, some TRG members noted that they found it challenging to apply the paper's principles to more complex contracts, such as those with multiple types of coverage (for example, those not separated under Agenda paper #1), those with insurance cover in effect for only a portion of the contract (such as annuities), and contracts with investment components (for example, a whole life contract where net amount at risk changes as surrender value changes). TRG members were asked to submit comments on the paper to the staff, including their reactions to the principles and their potential application in practice.

25. TRG members made various observations, noting that 'quantity of benefits' was not synonymous with 'level of coverage', that using the stated contract limit as the quantity of benefits was not appropriate in some situations, and that it was unclear how groups of contracts rather than individual contracts would be assessed and how probability weighting should be applied to contract duration estimates. Some TRG members noted that, in the case of an adverse development cover where the majority of the claims are paid earlier in the coverage period, an even amortisation of the CSM over expected duration, due to lack of any specified limit, would not reflect the timing of the benefits provided.

PwC observation
It was evident from the meeting that this issue is a critical and pervasive issue requiring future TRG discussion, and the factors proposed by the staff need further consideration.

Insurance acquisition cash flows when using fair value transition

26. In applying the fair value transition approach, this paper addressed the issue of whether insurance acquisition cash flows that occurred prior to the transition date should be recognised as revenue and expense in the statement of profit or loss for reporting periods subsequent to the transition date.

27. The TRG agreed with the staff view that, applying the fair value approach on transition, the amount of insurance acquisition cash flows included in the measurement of the contractual service margin will only be the amount occurring after initial recognition that is also included in the fulfilment cash flows. The entity is not required, and is not permitted, to include in the measurement of the contractual service margin any insurance acquisition cash flows occurring prior to the date of transition. Since insurance acquisition cash flows that occurred prior to the date of transition are not included in the measurement of the CSM at the transition date, they are not included in the presentation of insurance revenue and expenses.

Reporting on other questions submitted

28. In total, 27 items were submitted for the February meeting, six of which were discussed in detail, as noted above. Agenda paper #7 summarises the status of other submissions received that, in the staff's view: (a) can be answered applying only the words in IFRS 17 (6 issues); (b) do not meet the submission criteria (4 issues); or (c) are being considered through a process other than a TRG discussion (2 issues). In addition, the remaining items represent issues that were not sufficiently described or were not submitted in time for the meeting, some of which might be discussed at a later stage.

29. After questions were raised by several TRG members relating to a few of the items in paper #7, the chair of the TRG noted that certain submissions that did not meet the submission criteria, or were answered by the staff applying the words in the standard, are expected to be brought back for a further TRG discussion, including premiums received and how to present groups of insurance contracts in the statement of financial position.

PwC observation
The chair of the TRG acknowledged that implementation of IFRS 17 will be challenging for companies and will require considerable investment in systems and processes. He noted that the Board considered these practical challenges during the development of the standard, and that the principal role of the TRG is to provide helpful implementation support and not to reconsider issues already debated and decided on by the Board.

Topics to be discussed at future TRG meetings

30. There are some other issues that have been received that might require consideration by the TRG. It is expected that these, along with other issues received by 21 March 2018, will be considered for the next meeting in May 2018.

What's next

31. The IASB will prepare a report of the meeting, expected to be made publicly available within two working weeks from the meeting date.

32. An IASB Board member noted that, based on previous experience from the IFRS 9 TRG, it would be helpful if, for the next meeting, TRG members could explain (with examples) how they are interpreting the words in the standard. Adding examples to the interpretation would assist industry observers in their implementation projects.

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

- 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.

For more information on this publication please contact:

Gail Tucker
Partner
+44 (0) 207 212 3867
gail.l.tucker@pwc.com

Mary Saslow
Director
+ 1 860 241 7013
mary.saslow@pwc.com

Lars Jorgensen
Senior Manager
+44 (0) 207 804 2882
jorgensen.lars@pwc.com