Insurance Technical Advisory Group

Meeting Summary – 23 February 2021

Meeting held virtually

Attendees

Members

Jo Clube (Aviva plc)

Richard Crooks (Legal & General Group Plc)

Stuart Reilly (Direct Line Group Plc)

Danny Clark (KPMG)

Gail Tucker (PwC)

Kevin Griffith (EY)

Mark Spencer (BDO)

Dean Buckner (UK Shareholders' Association)

Tony Silverman (AM Best)

Sian Morgan (Columbia Threadneedle Investments)

Wijdan Yousuf (Aon)

Anju Bell (Willis Towers Watson)

Thomas Pickup (Willis Towers Watson) (Guest)

Vasilka Bangeova (Guy Carpenter & Company Limited)

Andrew Spooner (Deloitte)

Observers

Andrew Murray (Bank of England)

UK Endorsement Board

Seema Jamil O'Neill (Technical Director)	UK Endorsement Board secretariat (Chair)
Peter Drummond (Senior Project Director)	UK Endorsement Board secretariat
Dean Battersby (Project Manager)	UK Endorsement Board secretariat

1. Welcome and introductions

- The Chair welcomed Thomas Pickup, who had been invited as a guest to present the paper on risk adjustment.

2. Update on UK Endorsement Board (UKEB)

- The Chair informed the TAG that interviews for Board members had been completed and that she expected between eight and twelve board members to be announced in due course.

- The Chair also noted that the Statutory Instrument delegating functions to the UKEB had been laid in parliament but was yet to be debated. The UKEB would need to formally adopt its Terms of Reference at a meeting in order for the delegation of statutory functions to be completed.

- The Chair reaffirmed the role of the Insurance Technical Advisory Group ("TAG") as being to provide technical input to the secretariat and that its role was advisory but not decision-making. TAG members were reminded that the assessment of technical issues against the endorsement criteria developed as a result of discussions at the TAG meetings will form one part of the overall evidence base to be considered by the Board when assessing adoption of IFRS 17.

3. Summary of previous meeting

- The summary of the previous meeting was discussed. A query was raised over whether "most" or "some" members had supported the recognition of the shareholder's share of the inherited estate as equity. The secretariat confirmed that a majority of TAG members had supported that view.

- One TAG member raised the concern that the summary did not adequately reflect the complexity and nuanced nature of the discussion in arriving at this conclusion. It was agreed that the wording would be amended.

- No other issues were noted, and subject to the one amendment, the summary of the meeting was approved by the TAG for publication.

4. Risk Adjustment for Non-Financial Risk ('RA')

- The paper considered the treatment under IFRS 17 of the RA and focused on the different approaches to calculating it permitted in the standard.

- The paper acknowledged that the requirement to disclose a RA was an improvement over current UK practice. However, IFRS 17 intentionally allowed for multiple approaches and the paper went on to highlight the risk of the IASB failing to achieve its objectives because of the extent of entity-specific judgements and flexibility allowed in its calculation. The paper asked whether additional guidance should be provided to address this issue.

- Another key issue raised by the paper was the potential volatility of the RA which may be difficult to relate directly to the performance of the business over time. Due to the inherent high level of subjectivity and uncertainty in the measurement of risk, changes in the RA are likely to be magnified compared to those used to estimate the fulfilment cashflows ("FCF").

- The paper therefore suggested that the lack of a specified methodology for the calculation of the RA will lead to further comparability issues thus impairing the clarity of this disclosure for users.

- The following points were noted during the ensuing discussion:

  Calculation of the RA

  - One member expressed the view that adjusting the valuation of insurance contracts for risk was fundamentally contrary to the IFRS principle of neutrality and that the impact of risk should be reflected in regulatory capital rather than in capital available for investors. However, other members noted that the concept of risk is prevalent in other areas of accounting and considered its inclusion necessary in IFRS 17 as insured event outcomes might have the same mean but a different risk profile (i.e. different levels of variability around the mean). It was noted that IFRS 17:B88 required the RA to reflect both favourable and unfavourable outcomes.

  - One TAG member suggested that additional guidance to help determine the RA was not required as IFRS 17 stipulates the use of judgement in the calculation, which in turn should reflect how an entity calculates its own cost of risk.

  - Other members echoed similar thoughts on the calculation of the RA, stating that there are other areas in accounting requiring estimates to be made where even less guidance is provided. An example was the valuation of derivatives for bilateral counterparty valuation adjustments. Therefore, the lack of detailed guidance is not a new issue.

  - The alternative to recognising the RA was potentially to include it in the contractual service margin ("CSM"): the difficulty in differentiating these two elements of the overall liability was noted. However, members did not consider this appropriate as the RA provides significant useful information to users of the financial statements on the compensation for risk required by insurers.

  - The RA is used to set out the entity's assessment of risk and the compensation it requires to bear it which is useful information for users of accounts. TAG members agreed that prescribing overly prescriptive methodologies could obscure this critical information.

  Interaction with regulatory requirements

  - Some TAG members drew similarities between the RA and risk margin ("RM") as described in Solvency II.

  - The RM is a capital adjustment for regulatory purposes rather than the compensation for bearing insurance risk, as the RA is defined in IFRS 17. However, users' familiarity with the concept will enhance the understandability of financial statements using IFRS 17. TAG members noted that Solvency II requires significant disclosure regarding the RM. They were of the view that there is likely to be a similar level of disclosure on the RA.

Disclosure of the RA

- Several members acknowledged that IFRS 17 disclosure requirements provide users with far greater insight into the financial and operating factors affecting insurers compared with current IFRS 4 accounting. This is evidenced by the disclosures of the RA which will help users of financial statements assess management's appetite for risk.

- Similarities were drawn between the RA and expected credit loss estimates used in banking. For the latter, the standard does not mandate that the same methodology be applied by all entities but instead requires explanations which enhanced users' understanding of the level of risk assumed.

- One TAG member raised the point that it may be too early to prescribe a methodology for the calculation of the RA given that preparers had not yet had the chance to produce disclosures which could then be assessed by users.

Profit or loss issue

- One TAG member raised the issue of profit or loss comparability. For example, two insurers which offer the same type of business might have different RAs (one large and one small) but both will price similarly according to market conditions. The split between RA and CSM would therefore be different between the two entities. However, the CSM and RA will run off at different rates and ultimately affect revenue recognition. Users will therefore have more information on the statement of financial position but less clarity on the profit or loss impact.

- Another TAG member, however, noted that different release patterns of the RA and CSM will provide useful information to users, separating the profits arising from bearing risk and from those derived from the provision of services.

Conclusion

- Most TAG members agreed that the RA represented an improvement in transparency, and that the RA was a useful tool with information value.

- Most TAG members also agreed that no further disclosure requirements regarding confidence levels should be mandated and that prescribing a single methodology for calculating the RA was unnecessary.

5. Cross cutting question

- The secretariat noted that several issues had been discussed in previous TAG meetings in relation to the amount of judgement required, or the amount of flexibility afforded, by

IFRS 17. The secretariat therefore anticipates that the UKEB may take the opportunity to make recommendations to the IASB about specific areas arising from the work of the TAG. However, there was a question of whether there were other, more effective routes for addressing any areas of concern.

- The following points were raised in the ensuing discussion:
  - One TAG member felt the IASB's IFRS 17 Transition Resource Group ("TRG") should not be involved, as it could possibly lead to no clear decision being made until after the standard's implementation date.
  - Issues identified with IFRS 17 should be dealt with similarly to any other accounting standard: significant issues should be referred to the International Financial Reporting Interpretations Committee ("IFRIC"), and some recommendations regarding the potential focus for the Post-Implementation Review efforts could be made by the UKEB.
  - The question was raised as to whether UK specific guidance could be provided. However, TAG members identified several concerns with this: that accounting guidance on international standards was within the IASB's remit; and UK entities with cross-border listings in other jurisdictions would be unable to use such guidance as it may not be acceptable to other listing authorities outside the UK. However, some could foresee the possibility of guidance covering disclosures and in exceptional circumstances only. If needed, this would be something best left to industry to lead, perhaps with PRA and FRC oversight.
  - The Chair confirmed that the UKEB secretariat did not currently anticipate having to recommend that the UKEB provide accounting guidance.

6. Contracts That Change Nature Over Time

- The paper dealt with contracts that change their nature over time, specifically those with-profits savings contracts that contain a Guaranteed Annuity Option ("GAO") which provides an option to take an annuity at a guaranteed rate at a later date.
- The paper noted that any potential issues with accounting for such contracts could be avoided if a contract boundary could be established at the annuity vesting date, based on the fact that there is a cash flow between the entity's funds and that the annuity is purchased at open market prices. However, since the entity's obligations and the policyholder's costs and benefits do not change at the point the annuity vests, IFRS 17 requires the contract to be accounted for as a single contract.
- The paper noted operational difficulties arising from this: these types of contracts had to be accounted for separately from other with-profit contracts and annuity contracts, and this led to complexity due to the need to develop multiple models to account for similar contracts.
- Two key issues were identified in the paper, being:
  1. Where the variable fee approach ("VFA") has to be applied in the annuity payout

phase when the general measurement model ("GMM") would ordinarily be used; and

2. Where the GMM has to be applied in the with-profits savings phase when the VFA would ordinarily be used.

- The following points were noted during the ensuing discussion:

Contract boundary

- Some TAG members noted their early hopes that the IASB would amend the standard to allow a contract boundary to be established at the point where the annuity was purchased i.e. when a cash flow occurred.

- However, other TAG members agreed with the IASB's approach that no contract boundary could be established due to the fact that the cash flow occurred between different components of the same entity i.e. the entity was transacting with itself.

- Therefore, this could not be seen as a contract boundary: the purchase of the annuity by the fund was a means of fulfilling one of the existing contractual obligations but did not create a new obligation between the insurer and policyholder.

- This issue is prevalent across various large insurers and is linked not only to GAOs but also to guaranteed minimum pensions ("GMP"). The issue is not unique to the UK.

- One of the issues is that current accounting systems do not have historic data required to deal with such contracts as required under IFRS 17. This will be a particular issue on transition when the lack of historic data would result in insurers having to use the fair value approach.

Operational difficulties

- The operational difficulties were highlighted by several TAG members with particular focus on the accounting for with-profits funds. The use of the GMM for a with-profit fund will cause operational complexities as well as hinder the availability of valid information for internal and external purposes.

- Additional judgement would be required in weighting the CSM across the two phases of these contracts and members agreed that, due to this, the CSM tool would need to be enhanced in order to accommodate participating business where the GMM was used.

- TAG members noted that on transition the fair value approach did offer some relief, however it was likely to lead to a smaller CSM. Members agreed that the overall quality of the accounting may be negatively impacted due to the inability to apply a retrospective approach.

Application of the 'incorrect' measurement model

- Consideration was given to the following two issues:

(i) Where the VFA was applied in the annuity pay-out phase where the GMM would ordinarily be used; and

(ii) Where the GMM was applied in the with-profits savings phase where the VFA would ordinarily be used.

- TAG members agreed that the second was the most likely scenario. The question was how significant the accounting impact was and whether the outcome would be merely sub-optimal or actually incorrect.

- TAG members agreed that there could be material implications for the accounting, particularly relating to the profit profile from applying the GMM in the savings phase. However, the exact (quantitative) implications were not yet apparent as insurers would need to do further detailed modelling in order to determine the impact. TAG members did, however, note that this would result in differences in insurance revenue, CSM and profit profile as well as affecting the quality of earnings.

- Members also agreed that, under the VFA model, changes in the effect of the time value of money and financial risks would adjust the CSM rather than being taken through profit or loss. This would be a key difference when compared to applying the GMM in the savings phase.

Conclusion

- Most TAG members agreed that very little could be done to solve this issue with contracts which change nature over time before the implementation of the standard. However, this issue should continue to be monitored and should be a focus of the PIR.

Forward Agenda

- The secretariat reminded the TAG that a session with the IASB was confirmed for March, focusing on annual cohorts. The intention was also to complete the discussion regarding the accounting for non-profit business in a with profits fund in March.

- The secretariat highlighted that volunteers were still welcome to contribute to future TAG meetings, in particular on the topic of transition planned for May 2021.

- One TAG member questioned when the endorsement decision was likely to be made by the UKEB. The secretariat explained that this would for the UKEB to decide. The expected project timeline currently indicated a decision could be made by the end of 2021. But a number of factors could affect the final adoption date, including the need to ensure sufficient time was allowed for public consultation. The Chair confirmed that IFRS 17 is expected to be brought to the UKEB board as soon as possible.

7. AOB

- No items of AOB were noted.

End of meeting