IFRS 17 *Insurance Contracts* –Technical Issues

Appendix 1: Tentative IFRS 17 technical issues for assessment against endorsement criteria in SI 2019/685

Summary of principal technical topics considered by the Secretariat and which are expected to be addressed in the [Draft] Endorsement Criteria Assessment. These topics have also been considered by the Insurance Technical Advisory Group (TAG).

Priority issues

IFRS 17 requirements	Key challenges raised	Reasons for ranking as priority
1. Profit recognition – Allocation of CSM (coverage units) - Tentative classification pending further analysis and outreach		
An entity that issues insurance contracts without direct participation features recognises profit when the entity provides insurance coverage or any service relating to investment activities (investment-return service). The amount of the Contractual Service Margin (CSM) recognised in profit or loss in each period reflects the insurance contract services provided (both insurance coverage and investment-return services) in that period. The amount is determined by identifying the coverage units in each group of contracts. The number of coverage units in a group is the quantity of insurance contract services provided, determined by considering the quantity of benefits provided under a contract and its expected coverage period. (IFRS 17: B119)	Concerns have been raised that the standard's requirements regarding the determination of coverage units are not clear. Further, is the limited guidance in IFRS 17 for how to weight investment and insurance services appropriate and adequate? In particular, insurers are concerned that the interpretation of those requirements will lead to outcomes for UK annuities that are not an appropriate reflection of the underlying economics.	• CSM allocation is a pervasive issue. The most controversial aspect relates mainly to annuities and bulk purchase annuities, but questions regarding weighting insurance and investment services may also affect other products • This is a particular issue for the UK given the prevalence of annuity/bulk purchase annuity business • A priority topic for both preparers and auditors, it has been debated at key UK sector technical fora • CSM allocation may involve significant entity-level judgement • It is estimated to be material by the main UK annuity providers to the extent that it may have the potential to impact dividend capacity
2. Measurement – Discount rates		
IFRS 17 requires the discount rates applied to estimates of future cash flows to reflect the time value of money,	Some stakeholders have raised concerns that the requirements in IFRS 17 regarding the determination of	• This is a pervasive aspect of IFRS 17, often with a material impact on the accounts

IFRS 17 requirements	Key challenges raised	Reasons for ranking as priority
the characteristics of the cash flows and the liquidity characteristics of the insurance contracts. (IFRS 17: 36) IFRS 17 does not require a particular estimation technique but permits a 'bottom-up' approach or a 'top-down' approach. Applying the bottom-up approach, an entity adjusts a liquid risk-free yield curve to reflect the differences between the liquidity characteristics of the financial instruments that underly the rates observed in the market and the liquidity characteristics of the insurance contracts (IFRS 17: B80). Applying the top-down approach, discount rates are determined based on the expected returns of a reference portfolio, adjusted to eliminate factors not relevant to the liability, for example market and credit risk (IFRS 17: B81).	discount rates will lead to excessive subjectivity (whether in respect of illiquidity premiums or the elimination of market and credit risk). Further, does IFRS 17 require the use of discount rates that are too high because they are in excess of risk-free rates?	• An area of significant entity-level judgement • Requirements have attracted controversy and are a primary focus for certain stakeholders • Use of rates in excess of risk-free has (indirectly) been referred to in parliamentary debate • Users of accounts consider this an area of potential concern due to the subjectivity and the scope for variety in rates applied
3. Level of aggregation – Annual cohorts		

Contracts issued more than one year apart cannot be included in the same group (IFRS 17: 22).
The insurance business model is one of risk pooling and risk sharing. Measuring profitability on an individual contract level may not reflect this, therefore some level of aggregation is appropriate.
The annual cohort requirement aims to balance the loss of information caused by aggregating contracts with the operational burden of collecting information, consistently with the risk pooling that underpins a typical insurance business model. The requirement aims to ensure that useful information about profitability is not lost.
	Some stakeholders have expressed concerns that the annual cohort requirement will not result in useful financial information, particularly for contracts with inter-generational risk sharing.
	Does the annual cohort requirement result in useful information for all types of insurance contract, including those that share risks across policyholder generations?
	Does the annual cohort requirement appropriately balance the loss of information caused by aggregating contracts with the burden of collecting information? Is the cost/benefit test met for all types of insurance contract?
		• This is a pervasive aspect of IFRS 17
		• The annual cohort requirement is a major issue for EU endorsement – we understand there may be an optional EU carve out
		• Although stakeholder feedback suggests the concerns of UK insurers are not as great as those of EU insurers, implications for UK groups remain in respect of:
		  ○ competitiveness ('level-playing field' concerns if there is an EU carve-out)
		  ○ comparability with EU groups
		• The requirement is expected to be a feature of the long term public good assessment (e.g. in relation to competition, comparability, standing of UK as a financial centre)

Other significant issues

IFRS 17 requirements	Key challenges raised	Reasons for ranking
4. Measurement - Risk adjustment		
The risk adjustment is an explicit allowance for uncertainty in the amount and timing of future cashflows. It reflects the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk. (IFRS 17: 37) IFRS 17 does not specify the estimation techniques used to determine the risk adjustment (IFRS 17: B91). However, if an entity uses a technique other than the confidence level technique, they are required to disclose the technique used and the confidence level corresponding to the results of that technique (IFRS 17: B92).	The concern is that IFRS 17's requirements in relation to the risk adjustment permit excessive flexibility, to the detriment of comparability and understandability. Further, is the standard sufficiently clear on how the risk adjustment should be set when risks are reinsured? Are disclosure requirements adequate?	• Issues concerning the risk adjustment are pervasive • However, concerns raised were generally not considered significant by most TAG members (conclusions were that the risk adjustment represented an improvement in transparency, and that it 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 risk adjustment was unnecessary. • Best practice may develop • Recommend including the issue as a focus of the Post Implementation Review (PIR)
5. Measurement - General Measurement Model: interest accretion at locked-in rate		
Under the general measurement model IFRS 17 requires an entity to measure fulfilment cash flows and the CSM at two different sets of discount rates (IFRS 17: B72): • Fulfilment cash flows must be measured based on current discount rates. • The CSM must be measured based on "locked-in" discount rates (rates at inception). The locked-in discount rates will be used to: ○ Accrete interest on the CSM; and ○ Measure changes to the CSM, for example due to changes in operating assumptions.	Stakeholders have expressed concerns that the requirement to accrete interest on the CSM at the locked-in rate (the rate determined at the date of initial recognition – para. 44 (b) in conjunction with B72 (b)) leads to unjustifiable operational complexity. Further, does the requirement lead to amounts in the performance statement that are useful to users?	• Some major UK life companies have expressed strong views about this issue. • However, it is not all pervasive as it does not apply to the Premium Allocation Approach or the Variable Fee Approach and the materiality of the issue is not yet wholly clear.

<table>
<tr><td colspan="3">6. Measurement – Inability to reassess measurement model (contracts that change nature over time)</td></tr>
<tr>
<td>UK with-profits savings contracts commonly contain a guaranteed annuity option (“GAO”) giving the policyholder the option to take out an annuity at retirement at a guaranteed rate. These contracts typically have participating features during the savings phase but there is no participation post-retirement once the annuity option vests and the contract moves to the annuity payout phase.
Under IFRS 17, the accounting model applied is determined at inception, or in some circumstances may be assessed at transition under the modified retrospective and fair value approaches. The result is that:
• The variable fee approach (VFA) may be applied to the vested annuity despite there being no significant savings element or underlying items post-vesting.
• The entire contract including the participating phase may fail VFA eligibility testing and require measurement under the general measurement model (GMM).</td>
<td>IFRS 17 does not permit the measurement model for groups of contracts to be reassessed: the challenge is that this does not always lead to useful information, in particular for savings contracts that become annuity liabilities (e.g. via a guaranteed annuity option).
If insurers were able to assess the accounting model separately for each of the savings and annuity phases, then in general the VFA would apply to the savings phase and the GMM to the annuity phase.</td>
<td>• This issue was recognised by the IASB as a key UK issue (considered but not addressed by the 2020 amendments)
• IFRS 17 seems to have the potential to lead to sub-optimal accounting
• The issue is relevant mainly to with-profits business, and mostly closed to new business – it therefore seems to be primarily a legacy issue
• The most likely problem scenario appears to be the application of the GMM in the with-profits savings phase (when some UK insurers consider application of the VFA would be more appropriate). Therefore, contracts may fall under the ‘wrong’ model for a limited period only (i.e. until the annuity vests)
• The impact is estimated to be material for some insurers but is not yet wholly clear (hard to assess)</td>
</tr>
<tr><td colspan="3">7. Measurement – Variable Fee Approach: eligibility criteria (including inability to apply VFA to reinsurance contracts held)</td></tr>
<tr>
<td>Insurance contracts with direct participation features that meet certain criteria are accounted for under the variable fee approach (VFA). Such contracts are substantially investment-related service contracts. The eligibility criteria are:
• The contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;
• The entity expects to pay to the policyholder a substantial share of the fair value returns on the underlying items; and</td>
<td>The primary challenge is that the eligibility criteria for the VFA in IFRS 17 lead to excessive operational complexity (in particular the application of B107/B108).
In addition, is the standard clear on how to determine VFA eligibility for contracts with mutualised cash flows?
Some stakeholders have expressed concerns that reinsurance contracts may need to be measured using a different model from that used to measure the underlying insurance contracts. In particular, IFRS 17 does not permit reinsurance contracts to be accounted for under the VFA: will that lead to less relevant information and operational complexity?</td>
<td>Preliminary assessment
• Industry expressed significant concerns about the requirements; there is uncertainty over the application to certain types of contract
• However, concerns over eligibility criteria seem mainly operational (cost-related)
• The IASB considers that the standard does not prevent pragmatic approaches
• Issues around contracts with mutualised cash flows appear mainly interpretation issues</td>
</tr>
</table>

• The entity expects a substantial portion of any change in amounts to be paid to the policyholder to vary with the change in fair value of the underlying items. (IFRS 17: B101 The test to determine whether a contract is eligible for the VFA is required to be performed at the individual contract level (IFRS 17: B107). Reinsurance contracts issued and reinsurance contracts held are ineligible for the VFA as they cannot be insurance contracts with direct participation features (IFRS 17: B109).		• Assessment in respect of prohibition of VFA for reinsurance contracts held – outstanding
8. Measurement - With-Profits: inherited estates / non-profit business in a with-profit fund		
Inherited estates The standard does not directly address the treatment of with-profits inherited estates. The inherited estate represents excess assets in the fund above those required to meet contractual obligations. The sources of the estate are typically unknown, but may be due to seed capital, historic underpayment to shareholders and/or policyholders, historic profits and the investment return on these amounts. However, the standard recognises that some insurance contracts have cash flows that affect the cash flows to policyholders of other contracts. IFRS 17 requires the fulfilment cash flows of each group to reflect the extent to which contracts in the group cause the entity to be affected by expected cash flows, whether to policyholders in that group or to policyholders in another group, regardless of whether those payments are expected to be made to current or future policyholders (IFRS 17: B68). *Non-profit business in a with-profit fund* When non-profit contracts are written in a with-profit fund, the non-profit contract falls within the scope of IFRS 17 and is required to be measured under its	In the UK the use (appropriation) of the with-profits estate is generally subject to the entity's Articles and the fund's Principles and Practices of Financial Management. Surplus attributable to shareholders is generally not accessible by shareholders unless and until policyholder bonuses are declared. Some insurers have challenged whether the treatment of the inherited estate under IFRS 17 reflects the economics of the business. For example, is the shareholder's interest in the estate recognised as profit or as CSM? Does IFRS 17 lead to the recognition of profit before shareholders are entitled to it (before it is 'earned')? As the estate is not allocated to individual contracts, can it be recognised as a separate liability on the balance sheet? Concern has been raised that the accounting under IFRS 17 for non-profit business in a with-profit fund gives rise to accounting mismatches. Does the accounting give rise to relevant information?	• These are UK-specific issues • The issues are limited to a few with-profits providers; with-profits business is mostly closed to new business • Strong concerns have been expressed by some insurers; however, the concerns are not wholly shared by other stakeholders (including TAG members). • The issues are very fact-dependent; one view is that the concerns are essentially implementation challenges • Non-profit business written in a with-profits fund is considered to be rare • More generally, disclosures could provide a solution

<table>
<tr><td>requirements. However, IFRS 17 requires underlying items of the with-profits contracts to be measured at fair value in accordance with IFRS 13. Therefore, for the measurement of the with-profits contract, the non-profit contract must be measured at fair value.</td><td></td><td></td></tr>
<tr><td colspan="3">9. Measurement – Reinsurance: recognition of gains from reinsurance to match onerous contracts</td></tr>
<tr><td>On initial recognition of, or on addition of onerous contracts to, onerous groups of insurance contracts, IFRS 17 requires the immediate recognition of losses. To reflect that the entity has a right to recover a proportion of incurred claims through reinsurance, IFRS 17 requires an entity to recognise corresponding income from reinsurance in profit or loss (IFRS 17:66A) at the same time.

Recognising income is required if, and only if, the entity enters into the group of reinsurance contracts held before or at the same time as the onerous underlying insurance contracts are recognised (IFRS 17:B119C).

To correspond with the income recognised in profit or loss, the standard requires an entity to establish and monitor a 'loss-recovery component' (as part of the asset for remaining coverage of a group of reinsurance contracts held). The loss-recovery component determines amounts that entities will recognise in profit or loss in subsequent periods as reversals of recoveries of losses (IFRS 17:66B).</td><td>The recognition of a loss-recovery component in the liability for remaining coverage and corresponding income in profit or loss is not dependent on whether the group of reinsurance contracts held is in a net gain or net cost position. The concern is that it may be misleading to report immediate income from a group of reinsurance contracts that will result in a net cost to the entity overall.

The amount of income to recognise in profit or loss is determined by multiplying a claim recovery percentage by the loss on the onerous underlying contracts, disregarding that expenses may contribute to the loss. The contribution of expenses to the loss results in a greater proportion of the reinsurance claim recovery being recognised upfront.

Expenses are not generally recoverable from reinsurance, so is it appropriate for expenses to impact the amount of income to be recognised upfront?</td><td>• These concerns have been predominantly expressed by standard setters (including the FRC and the Australian standard setter) rather than by users or auditors.
• TAG discussion revealed relatively limited concern
• The potential for abuse is considered limited due to the restriction on the use of hindsight
• Disclosures are key and may mitigate the concerns to some extent
• Recommend including the issue as a focus of the Post Implementation Review (PIR)</td></tr>
</table>

10. Recognition - Contracts acquired in their settlement period		
Liabilities for claims that have been incurred and arise from contracts issued by an entity are accounted for under IFRS 17 as a liability for incurred claims. However, if the same contracts are acquired from another entity, and assuming the ultimate cost of the claims is uncertain, the insurance contract liabilities are accounted for as a liability for remaining coverage. That is, they are treated as providing coverage against the risk of the claims being higher than expected and consequently give rise to insurance revenue (IFRS 17:B5).	Concern has been expressed that the application of the General Measurement Model (GMM) to contracts acquired in their settlement period will not result in relevant or understandable information. Contracts acquired in their settlement period may need to be accounted for under the GMM, even if the entity otherwise applies only the less complex Premium Allocation Approach (PAA). Are resultant costs justified?	• The issue arises mainly for general (non-life) insurance: such entities may need to apply the GMM to acquired business, even if they otherwise apply only the PAA • No significant concerns raised by preparers • TAG noted that IFRS 17's requirements may be appropriate for businesses with an acquisitions business model (consolidators) • The issue affects mainly future acquisitions due to some limited transition relief • The fundamental issue seems to be whether such contracts meet the definition of insurance contract – but sensible alternatives seem hard to achieve • Not specifically a UK issue (Australia and Canada also raised concerns) • Recommend including the issue as a focus of the Post Implementation Review (PIR)
11. Presentation – OCI option		
IFRS 17 permits entities to make an accounting policy choice to present insurance finance income or expenses (IFIE) either in profit or loss or disaggregated between profit or loss and OCI. The option is available on a portfolio by portfolio basis (IFRS 17: 88).	The challenge is whether the ability to present the impact of changes in discount rates and other financial assumptions separately in OCI appropriately balances the demands of relevance and comparability. Does the option provide more relevant information because it permits entities to reduce or eliminate accounting mismatches between insurance liabilities and their supporting investment assets? If so, does increased relevance outweigh any detriment to reliability and comparability because disaggregation of IFIE is subjective and may be applied inconsistently between entities?	• OCI option is unlikely to be widely used in the UK • In the TAG's view the impact on comparability is likely to be limited • Disclosures may allow users to adjust reported results to enhance comparability across entities • Investors are used to seeing amounts in OCI under IAS 39 and IFRS 9 • The option in IFRS 17 is probably needed given insurers' different investment strategies and measurement policies for investment assets • Recommend considering alongside the IASB's proposals for an operating profit subtotal (*General Presentation and Disclosure* ED). Some insurers have expressed reservations about those proposals given the potential inconsistency under IFRS 17

12. Transition – Application of methods / optionality on transition		
Unless it is impracticable to do so, IFRS 17 requires an entity to apply the Standard retrospectively. (IFRS 17:C3) If, and only if, it is impracticable to apply IFRS 17 fully retrospectively an entity can choose between: • the modified retrospective approach, or • the fair value approach (IFRS 17:C5) The choice of transition method is made at the level of a group of contracts.	The key concern is whether the availability of transition options appropriately balances cost considerations with impaired comparability (between entities and between pre- and post-IFRS 17 periods).	• Transition is an area of concern for users, given the break in trend data and lack of future comparability between entities and between groups of contracts within single entities • IFRS 17 transition requirements are also complex for preparers • However, some variety is inevitable: the permitted methods are required due to the nature of long-term insurance business • The TAG expressed no major concerns • Disclosure should mitigate user concerns to some extent
13. Transition – Risk mitigation option: no retrospective application		
Under the Variable Fee Approach (VFA), changes in the effect of the time value of money and financial risk on the fulfilment cash flows and on the entity's share of underlying items adjust the Contractual Service Margin (CSM) (rather than profit or loss). The risk mitigation option in IFRS 17 is available to entities applying the VFA that use derivatives or reinsurance contracts held to mitigate the effect of financial risk on the amount of the entity's share of the underlying items, or the fulfilment cash flows (IFRS 17: B113b). The option permits an entity to recognise some, or all, of the changes in the effect of time value of money and financial risk in profit or loss (instead of in CSM) to reduce or eliminate accounting mismatches (IFRS 17: B115). The risk mitigation option is not available for periods before the transition date and may only be applied on or after the transition date if the entity has designated risk mitigation relationships at or before the date it applies the option (IFRS 17: C3a).	IFRS 17 prohibits application of the risk mitigation option for periods prior to transition. The primary concern is that this will lead to distortion of brought-forward amounts (in particular between retained earnings and CSM).	**Preliminary assessment** • Impact in the UK is not yet known, but the issue may affect only a narrow range of entities (those applying the VFA and using financial instruments to mitigate risk)