Insurance Technical Advisory Group

Meeting Summary – 26 January 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)

Vasilka Bangeova (Guy Carpenter & Company Limited)

Andrew Spooner (Deloitte)

Richard Olswang (Prudential) (guest)

Gillian Starkie (M&G) (guest)

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 attendees to the meeting, in particular Richard Olswang and Gillian Starkie who had been invited to present papers to the TAG on with-profits issues.
- The minutes of the previous meeting were approved by the TAG.

2 Update on UK Endorsement Board (UKEB)

- The Chair informed the TAG that interviews for Board members had commenced. Board appointments are the responsibility of the Department for Business, Energy and Industrial Strategy and are expected during March.
- The Chair also highlighted that the legislative process for delegation of Statutory Functions to the Board is expected to commence in early February. The completion of this process will allow the Board to start working in its official capacity.
- The Chair noted that the Endorsement Board's website was up and running and was being enhanced. She welcomed feedback.

3 IFRS 4 Amendments

- The IFRS 4 amendments extending the deferral of IFRS 9 for insurers were adopted for use in the UK on 5th January 2021. The secretariat explained that separate UK adoption was necessary because legal advice had highlighted that the European Commission regulation adopting the amendments did not come into effect until 20 days after publication in the Official Journal, taking the effective date beyond the end of the Implementation Period completion date of 31 December 2020. The UK adoption work on this amendment, undertaken by the UKEB Secretariat during the Implementation Period, had helped ensure a smooth adoption process.

4 With-profits inherited estate

- The paper considered the treatment under IFRS 17 of the inherited estate ('estate') in with-profits funds (surplus assets in the fund, over and above those needed to meet contractual obligations) in two different scenarios: (i) where the fund was open to new business; and (ii) where it was closed to new business.
- The paper focused on whether, in each of the two scenarios, the shareholders' portion of the estate (typically 10%) should be considered to be part of the insurance liability or shareholder equity under IFRS 17. The paper also considered the consequential implications for profit emergence.
- Key points dealing with **open funds** were:
    - 90% of the estate can be considered to be fulfilment cash flows, in accordance with paragraph B71 of the Standard. However, the remaining 10% is not required to be paid to policyholders and therefore does not fall to be treated as fulfilment cash flows.

  - As there is no provision in IFRS 17 for there to be contractual service margin (CSM) other than for groups of contracts, it was not possible to view the 10% as CSM, whether for current or future contracts.

  - If the 10% cannot be regarded as fulfilment cash flows or CSM, the only alternative is to regard it as a component of shareholder equity.

  - The paper went on to argue that, considering this fact pattern against the endorsement criteria, it was unlikely that this treatment would be understood by users since the profit was in reality not accessible to shareholders ('locked-up'). It could be argued that shareholder value and profits were overstated as profits were recognised before the services to policyholders had been provided, thereby undermining 'relevance'. On 'reliability' and the 'true and fair' principle, it could be argued that the profit did not faithfully represent the underlying economics. Compared to existing financial reporting, there was an argument that this was not an improvement.

- Key points dealing with **closed funds** were:

  - Identifying the underlying items (typically asset share, plus the cost of guarantees, plus the allocation of the estate).

  - Determining how any estate should be attributed to insurance liabilities, considering factors including the terms of any Court attribution, the PPFM and any other commitments made to policyholders. Policyholders typically have a reasonable expectation that 90% of the estate, in excess of the amounts required to meet the cost of guarantees, will be distributed to them through enhancements to policyholder pay-outs. Shareholders would expect to receive 10% of these estate distributions, making it appropriate to treat their share of the estate as CSM (and hence as part of the insurance liability).

  - If the transition approach is a fair value approach, then it will be necessary to attribute a fair value to the estate as well as the corresponding fulfilment cash flows of the estate in order to determine its contribution to the CSM on transition.

  - This would result in a quite different position from that in an open fund.

- The following points were noted during the ensuing discussion:

  - IFRS 17 does not clearly set out the treatment of the estate as either a liability or equity. Some members commented that although it did not 'feel' like equity, nothing in the standard made it a liability. A key determining question was whether the profit had actually been earned and warranted recognition in equity or whether there continued to be a liability in an open fund.

  - Several members observed that if the shareholders' share of the estate is not a liability under the standard, then it seemed appropriate to treat it as equity. As it represented profit from past contracts it could be considered to have been earned. Additionally, the estate appeared to have loss absorbing features similar to equity and the fact that it was not immediately accessible did not preclude presentation under equity.

- One member noted that the shareholder's share could be presented as a separate class of equity which conveyed different rights. This was consistent with the accounting treatment of financial instruments with complex rights and obligations where additional disclosure was not unusual. Other members supported this but highlighted the need for additional disclosure.

- Two members expressed the view that the accounting between open and closed funds should not differ and that there is there is a continuum between when a fund is open and closed for business.

- It was acknowledged that there was uncertainty as to precisely how much of the estate would go to shareholders until there was a formal attribution of the estate. It was possible that in some cases part of the profit expected to be attributed to shareholders might in fact be attributed to policyholders and have to be recognised as a liability (in fulfilment cash flows).

- One member noted that from a regulatory perspective the 10% is viewed as own funds (i.e. as equity, even if non-distributable) and the 90% as a liability.

- The question of percentage attribution was raised. Typically, most with-profit funds referred to a 90%/10% split, with the company's Principles and Practices of Financial Management (PPFM) stating that at least 90% should go to policyholders. In the past, bonuses had been distributed on other bases, e.g. a 95%/5% basis, but mostly it was 90%/10%.

- Noting that IFRS 15 requires profit to be recognised from contractual arrangements when performance obligations are satisfied, one view was that in this case the point at which services were transferred to the customer, and performance obligations satisfied, was when new contracts were written. Based on the principles in IFRS 15, therefore, it was argued that the inherited estate should not be recognised in equity.

- Another member, however, expressed a view that IFRS 15 should not be used in this context as IFRS 17 specifically addresses profit recognition for these contracts. The entity's ability to control the declaration of bonuses was also relevant as well as the entity's contractual entitlement to the 10% prior to an attribution.

- If the shareholders' share of the estate is recognised as CSM, the basis for future release would be in line with asset shares and how policyholders earned their asset share. The services provided were investment and accumulation, which ultimately protected policyholders from downside risk, providing them with cash and accumulation of the estate.

- In conclusion, most TAG members supported recognition of the 10% (the shareholders' share) as equity but no definitive conclusion was reached. The classification as equity, however, was not clear cut but rather seen to be the most appropriate classification having explored other classification options. Additional consideration of this topic was likely to be required and would be brought to a future TAG meeting.

5 Non-profit business in a with-profit fund

- The paper considered non-profit business written in a with-profit fund that was open to new business. It considered scenarios where surpluses of the non-profit business accrued to with-profit policyholders as well as where surpluses accrued to the inherited estate. Each of these scenarios led to different concerns but in each case the difficulties stemmed from the fact that the non-profit contracts functioned as underlying items for the with-profit fund.

- The paper focused on non-profit annuities written in the with-profit fund. Key points raised in the paper were:

    - There was uncertainty over the accounting for the non-profit annuity contract included in the with-profit funds, including whether the risk adjustment and CSM should reflect the risk and profit from the whole contract or only the shareholder's share.

    - In cases where profits from the non-profit business accrued to the inherited estate, IFRS 17's requirements would appear to result in the shareholder's interest (and potentially also the policyholder's interest) being recognised as profit before shareholders had any right to it.

    - In cases where profits from the non-profit business accrued to with-profit policyholders, a mismatch would arise between the measurement of the non-profit contracts using IFRS 17 principles and their valuation as underlying items for the with-profit contracts (at fair value).

- The following points were noted during the ensuing discussion:

Accounting for the non-profit annuity contract

- Most TAG members agreed that IFRS 17 required that the standard was applied at a contract level. This would ensure the risk adjustment and CSM of the annuity contracts reflect the risk and profits arising from the whole contracts and not just the shareholder's share. This view was supported by the IASB educational material relating to mutuals.

- Other TAG members noted that there was uncertainty over the measurement of the risk adjustment, given that it needed to be measured from the perspective of the entity rather than from that of the group of contracts. In addition, it was necessary to consider the extent to which the entity's Principles and Practices of Financial Management (PPFM) created rights and obligations such that the CSM was measured after taking into account the rights of with-profit policyholders to surpluses from the annuities.

Accounting for profits accruing to the inherited estate from the non-profit annuities

- In principle, 90% of the profits from these contracts should be classified as a liability under IFRS 17:B68 or B71 reflecting the fact that these amounts would be included in future distributions to current and future policyholders. However, B71 appeared to be subject to B67 which requires the policyholders to share in returns from a specified pool of underlying items which is not the case for the non-profit

annuities. As such, 100% of the profits from the non-profit annuity will be recognised in equity as shareholder profit even though 90% is expected to be transferred to policyholders.

- There was a question as to whether B71 was in fact restricted by B67 (requirement for the sharing in the specified pool of assets). Furthermore, it may be necessary to consider whether the obligations to policyholders derived from the PPFM rather than the annuity contracts.

- One TAG member noted that it would be helpful to assess the difference between open and closed funds. In a closed fund, both the 90% and the 10% formed part of the overall insurance contract liability. The issue that arose was that a distinction was being made between assets in the inherited estate that were used to support the non-profit business and assets that were underlying items. If that distinction was not made then the amount should be recognised as a liability.

- No overall conclusions were reached by the TAG on this point.

The mismatch arising when profits from the annuity assets accrue to with-profit policyholders

- The annuity book acts as an investment for the with-profit fund. If the investment were a bond, the bond could be fair valued and with-profit policyholders would benefit from the changes in fair value and no mismatch would arise. However, annuities were more complicated as the with-profits policyholders benefit from the surpluses from the annuities and not from the change in fair value of the annuity book. Those surpluses are determined on a Solvency II basis rather than a fair value basis.

- It was agreed that accounting mismatches occur in other areas of accounting so this particular mismatch in IFRS 17 was not unique.

- The secretariat noted that the IASB had considered this mismatch issue but had not proposed amending the standard as there was nothing particularly exceptional about this accounting outcome. Similar mismatches could also arise if other, non-annuity underlying items were not accounted for at fair value.

- It was agreed that this paper be revisited at a later meeting in order to provide more time to discuss the issues raised.

6 Forward Agenda

- The secretariat highlighted to the TAG members that volunteers were still sought to assist with the topics relating to transition and annual cohorts. TAG members were reminded that papers could be prepared in conjunction with another TAG member.

- With respect to annual cohorts, it would be important to consider the differences in UK and EU stakeholder concerns relating to this requirement. The secretariat noted that the IASB staff were willing to present directly to the TAG on this topic.

- With regard to the potential tax implications of IFRS 17, particularly on transition, TAG members noted that industry had started to discuss this with HMRC.

- TAG members were invited to direct any other comments on the forward agenda to the secretariat by email.

7 AOB

- TAG members were reminded to send in their short biographies for publication on the UKEB website.

End of meeting