Insurance Technical Advisory Group

Meeting Summary – 8 July 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)[1]
Kevin Griffith (EY)
Mark Spencer (BDO)
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)

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
Caroline Federer (Project Manager)	UK Endorsement Board secretariat
Gabriela Martinez (Project Manager)	UK Endorsement Board secretariat

[1] Present from section 4 onwards

1. Welcome and update from secretariat

- The Chair welcomed TAG members to the meeting and made members aware that the UK Endorsement Board (UKEB) would be discussing IFRS 17 at both of its Board meetings in July. These meetings are open to public observers and recordings are uploaded on the UKEB website after the meetings.

2. Minutes of previous meeting

- The Secretariat had received further comments on the minutes of the previous meeting. The updated minutes would be recirculated to the TAG for approval.

3. Prohibition on measuring reinsurance contracts held using the variable fee approach

- The paper discussed certain specific implications for financial reporting arising from the prohibition in IFRS 17 *Insurance Contracts* from measuring reinsurance contracts held using the variable fee approach (VFA).

- Key points noted in the paper were:

    - IFRS 17 prohibits reinsurance contracts held (and reinsurance contracts issued) from being measured under the VFA (IFRS 17: B109). When underlying business is measured under the VFA this can give rise to accounting mismatches in respect of the treatment of changes in financial risks.

    - Subject to certain conditions in paragraph B116 of IFRS 17, the Standard permits the use of the risk mitigation option (RMO) to reduce any accounting mismatches. Under the RMO, an entity may choose not to recognise a change in the CSM to reflect some or all of the changes in the effect of the time value of money and financial risk on the entity's share of underlying items and the fulfilment cash flows. The effect is instead recognised directly in profit or loss (IFRS 17: B115), as it is under the GMM.

    - In the UK, certain reinsurance transactions require the reinsurer to track and provide the benefits that are ultimately paid under the underlying VFA contracts. In such instances, the reinsurance contracts would meet the VFA eligibility criteria described in paragraph B101 of IFRS 17, except that paragraph B109 of IFRS 17 would prohibit it.

    - The RMO will reduce, but not entirely remove, the accounting mismatches that can arise from applying the VFA to the underlying insurance contracts and the GMM to the reinsurance contracts held.

    - In principle, the inability to apply the same measurement model to the underlying insurance contracts and the corresponding reinsurance contracts held may result in accounting mismatches that are difficult to explain to users of financial statements, reducing their understandability.

  - When reinsurance is a means of transferring the economic risk and reward of the underlying VFA portfolio to the reinsuring entity, such contracts conceptually meet the VFA eligibility criteria set out in IFRS 17. However, the specific prohibition in the standard on measuring reinsurance under the VFA will result in measurement of such contracts that does not reflect the underlying economic effect of the transaction, thus reducing the relevance of the information.

- The following points were noted during the ensuing discussion:

  - TAG members commented that this topic had been discussed at the ICAEW insurance discussion group and a discussion paper had been submitted to the IASB. TAG members cited two scenarios in which challenges arise:

    - internal reinsurance arrangements - resultant mismatches arise at the legal entity level, rather than the group level, which may have implications for distributable reserves; and

    - disposal of a book of with-profits business via a reinsurance arrangement prior to a Part VII transfer.

  - A TAG member noted that if the issue arises primarily from internal arrangements this would be seen primarily as a matter of capital transfer rather than earnings management and would be picked up in individual entity regulatory reporting.

  - A TAG member questioned whether the inability to apply the VFA to reinsurance contracts would force companies into a greater application of the RMO.

  - It was noted that simply removing the prohibition might give rise to other unintended consequences that would need addressing, such as a lack of comparability with entities for whom the prohibition was not removed.

  - TAG members considered that this issue may be pertinent for the UK but were uncertain as to the prevalence of the issue. One member noted his expectation that the expansion of the RMO would have addressed most problems. TAG members noted that other fora had not considered it a critical issue.

  - On balance, TAG members concluded that this was not a significant issue for the UK.

4. Assessing eligibility for the variable fee approach when there are mutualised cash flows

- The paper discussed the assessment of the criteria in IFRS 17 paragraphs B101(b) and B101(c) for insurance contracts in a group that affect the cash flows to policyholders of contracts in other groups, as explained in paragraphs B67-B71 of IFRS 17.

- Key points noted in the paper were:

  - Paragraph B69 of IFRS 17 sets out the following simplified example of contracts with cash flows that affect or are affected by cash flows to policyholders of other

contracts:

- An entity has 2 groups of insurance contracts (Group A and Group B) where the policyholders share returns on the same specified pool of underlying items and some policyholders are required to bear a reduction in their share of the return because of guaranteed payments to other policyholders. In this case the future payments to policyholders in Group A are expected to be reduced from a share in the returns on underlying items of CU350 to CU250 because of payments of a guaranteed amount to policyholders in Group B.

- In the case of mutualised insurance contracts, IFRS 17 is open to interpretation when estimating the cash flows to be paid to policyholders when calculating the VFA eligibility assessment. There are two opposing views to determine the cash flows the entity expects to pay the policyholder when performing the variable fee approach (VFA) eligibility assessment (IFRS 17: B101b,c):

  - *Approach 1*: The amounts include only those the entity expects to pay to the current policyholders of the contracts in the group (i.e. the post-mutualisation cash flows of CU 250 in the example above).

  - *Approach 2*: The amounts include all the cash flows the entity expects to pay to all policyholders – those in the group and those in other groups that the cash flows are shared with – in the current and future periods (i.e. the pre-mutualisation cash flows of CU350 in the example above).

- Approach 2 may result in more contracts being eligible for the VFA than Approach 1. Divergence in practice may reduce comparability, because the same insurance contracts may be accounted for under different measurement models.

- On transition to IFRS 17, the date of assessment for VFA eligibility of a contract depends on the transition approach applied. The choice of assessment date may also affect whether or not a contract meets the VFA eligibility requirements. For example, a savings contract with investment guarantees in-the-money at the transition date might satisfy the variability criterion under B101(c) if assessed at inception, but not if assessed at the transition date. This has the potential to result in inconsistent application in practice. Furthermore, for contracts which change their nature over time, the timing of the VFA eligibility assessment, at either inception or transition, may result in a different accounting treatment. Such contracts may meet the eligibility criteria for the VFA during the with-profits accumulation phase but be ineligible during the non-profit annuity pay-out phase.

- The relevance and understandability of financial information is increased if insurance contracts are accounted for under an appropriate accounting model. TAG members were encouraged to consider whether the expected accounting outcome of Approach 2 (more contracts eligible for the VFA) better suits the characteristics of the relevant insurance products.

- The following points were noted during the ensuing discussion:
  - In TAG members' view, when facts and circumstance align, there is industry consensus on the applicable approach leading to limited concerns about comparability.
  - Some TAG members considered that, in principle, approach 2 was likely to lead to appropriate accounting outcomes for many products.
  - The choice of which date to apply the VFA eligibility assessment on transition to IFRS 17 permits entities to apply judgement and measure the contracts under the measurement model that more closely aligns with the characteristics of the contracts.
  - TAG members agreed this was a widespread issue in the UK. However, due to the emerging consensus, it was unlikely to lead to significant comparability issues.

5. Prohibition of retrospective application of the risk mitigation option

- The paper discussed the prohibition of retrospective application of the risk mitigation option (RMO).
- Key points noted in the paper were:
  - The RMO is available to entities that mitigate the effect of financial risk on either the amount of the entity's share of the underlying items or the fulfilment cash flows set out in paragraph B113(b) of IFRS 17, provided that the entity uses derivatives, reinsurance contracts held or non-derivative financial instruments measured at fair value through profit or loss for risk mitigation (IFRS 17: B115). An entity may choose not to recognise a change in the contractual service margin (CSM) to reflect some, or all, of the changes in the effect of the time value of money and financial risk. The effect is instead recognised directly in profit or loss (IFRS 17: B115).
  - To reduce the risk of bias, IFRS 17 does not permit entities to apply the RMO to periods before the transition date. Entities can apply the RMO prospectively on or after the date of transition as long as the risk mitigation relationships are designated before application (IFRS 17:C3b).
  - To respond to concerns that prohibiting retrospective application of the RMO will reduce comparability between risk mitigation activities taking place before and after the date of initial application (IFRS 17: BC393B), the IASB permitted an entity that could otherwise apply IFRS 17 retrospectively, to instead apply the fair value transition approach to groups of insurance contracts, if they meet certain conditions (IFRS 17: BC393A).
  - Applying the fair value approach (FVA) to transition, the distortion related to risk mitigation activities from previous periods does not exist because the group of insurance contracts will be measured using current estimates of financial

assumptions and the derivatives (or the non-derivative financial instrument) will be measured at fair value. Therefore, equity on the transition date reflects both previous changes in the fulfilment cash flows due to changes in financial assumptions, and previous changes in the fair value of the financial instruments.

  - The application of the RMO, and in particular the prohibition of retrospective application, has not been raised as a topic of major concern for the UK. In particular, a number of UK life insurers have indicated that they do not intend to apply the RMO.

- The following points were noted during the ensuing discussion:
  - This topic has not been a feature of many industry discussions and TAG members considered that this may be either because entities have not yet thoroughly considered the application of the RMO, or that they intend to apply the FVA to transition.
  - One TAG member referred to the limitations about reconsidering hedge relationships under IFRS 9 *Financial Instruments*, arguing that there was precedence for the requirements in IFRS 17.
  - TAG members commented that the amendment permitting the application of the FVA to transition was an imperfect solution and suited some types of insurance contracts better than others.
  - IFRS 17's requirements might be seen as a trade-off between reliability and comparability. It was noted that allowing retrospective application would be optional so might give rise to other concerns relating to comparability in any event.
  - TAG members did not think that it would be an issue for entities applying the fair value through profit or loss approach to measure their financial instruments, because hedge accounting is less applicable.
- Overall, TAG members did not think the prohibition of retrospective application of the RMO was likely to be a significant issue for UK insurers.

6. Initial application of IFRS 17 and IFRS 9 – comparative information

- The paper discussed the IASB's proposed narrow-scope amendment to IFRS 17 and asked for TAG members' preliminary feedback.
- Key points noted in the paper were:
  - At its June 2021 meeting, the International Accounting Standards Board (IASB) agreed to propose a narrow-scope amendment to IFRS 17. The proposed amendment would permit an entity within the scope of IFRS 17 to apply a classification overlay for the comparative period(s) presented on initial application of IFRS 17 and IFRS 9. No amendments were proposed to IFRS 9 Financial Instruments. An Exposure Draft was expected to be published by the end

of July with a 60-day comment period

- Many insurers will first apply IFRS 17 and IFRS 9 at the same time on or after 1 January 2023. The transition requirements in the two Standards apply at different dates:

  - the IFRS 9 transition requirements apply on the date of initial application (ie 1 January 2023 for many insurers); whilst

  - the IFRS 17 transition requirements apply on the transition date, the beginning of the comparative annual reporting period (ie 1 January 2022 for many insurers), or earlier if the entity voluntarily restates more than one year of comparative information.

- For some insurers, the difference in the transition requirements will result in the following one-time classification differences in the comparative information presented on initial application of IFRS 17 and IFRS 9:

  - significant accounting mismatches between insurance contract liabilities measured at current value and some related[2] financial assets measured at amortised cost.

  - if the entity chooses to restate comparative information for IFRS 9, classification differences may occur between financial assets derecognised in 2022 (to which IFRS 9 will not apply) and other financial assets (to which IFRS 9 will apply).

- An entity would be permitted (but not required) to apply a classification overlay (the 'classification overlay') in the comparative period(s) presented on initial application of IFRS 17 and IFRS 9. The proposed classification overlay would apply only to financial assets that are related to insurance contract liabilities.

- An entity would recognise in the opening retained earnings (or other component of equity, where applicable) the difference between:

  - the carrying amount of the financial asset at the transition date to IFRS 17 applying the classification overlay; and

  - the previous carrying amount at that date.

- The classification overlay will increase the understandability of comparative information as it will enable entities to avoid classification mismatches (arising purely from differences in transition requirements) which do not represent economic mismatches. This will enhance the relevance and comparability of financial information between periods. However, it is likely to reduce the comparability between insurers.

[2] 'Related' is the word used in the IASB staff paper. It is expected to be amended in the Exposure Draft to make it consistent with paragraph C29(a) of IFRS 17.

- The following points were noted during the ensuing discussion:
  - One TAG member noted the uncertainty around the definition of "insurance related assets" and the concern that it may be interpreted differently.
  - A challenge for entities would be to avoid the use of hindsight.
  - The overlay approach would apply to both, entities restating comparatives under IFRS 9 and those that do not restate comparative information. Entities may reconsider whether to restate comparatives because it may be that applying this option will generate the same result at lower cost.
  - Depending on how the available options were implemented, insurers might end up with several different categories of financial assets on transition, which could be confusing for users of the accounts.
  - Under the proposed amendment entities could classify financial assets in accordance with IFRS 9, but without applying the IFRS 9 (business model or SPPI) assessments nor the expected credit losses model. It will be necessary to read the Exposure Draft to understand how entities would apply this in practice.
  - TAG members agreed that this was not a significant concern for a large proportion of UK insurers because they measure financial assets under a fair value through profit or loss model. Challenges were identified for assets measured as at fair value through other comprehensive income.
  - A transition impact on reserves is anticipated for financial assets that are subsequently derecognised, although TAG members were unsure of the quantum.

Next steps

  - On release of the exposure draft by the IASB, the Secretariat will prepare a draft comment letter and invite public comments.

7. CSM Allocation – Update

- A paper on this topic was discussed at the May 2021 TAG meeting. This paper was a continuation of the previous discussions, with a focus on next steps.
- Key points noted in the paper were:
  - At its May 2021 meeting the TAG discussed a paper on the recognition of the CSM in profit or loss for annuities, including bulk purchase annuities. It set out two views for interpreting the requirements of IFRS 17 and determining coverage units that appropriately reflect the service provided:
    - *View A* reflects solely the payments made to the policyholder for each period; and
    - *View B* incorporates both the payment and the stand ready obligation, that ensures the policyholder continues to receive that payment for the rest of

their life.

- TAG members were divided in their views on whether view A or view B, or both views, were permissible under the standard. It was noted that the issue had been discussed at other fora, including the Transition Resource Group for IFRS 17 (TRG) and the ICAEW insurance discussion group.

- Since the May TAG meeting the Secretariat had conducted a number of follow up discussions to gather more detailed information on the matter and the two views. The Secretariat had also met with the IASB technical staff to better understand the requirements of the Standard in this area and to discuss potential next steps and timelines.

- The Secretariat presented the following potential next steps to the TAG for comment, as a means of advancing discussions on this issue:

  - referral to the IASB's TRG for IFRS 17;

  - referral to the Interpretations Committee; or

  - continue to discuss at other fora and allow the matter to be resolved by industry.

- The Secretariat also asked TAG members whether they considered this an endorsement or interpretation issue.

- The following points were noted during the ensuing discussion:

  - A primary objective of IFRS 17 is to provide a consistent basis for recognising profit. Some TAG members were concerned that there was an endorsement issue because View A would, in their view, lead to an approach that did not reflect the economics of the insurance product and would provide misleading information to users of financial statements.

  - IFRS 17 is a principle-based standard and does not prescribe any particular approach to allocating the CSM. The May 2018 TRG paper stated that different methods can be used to determine the quantity of benefits as long as they achieve the objective of reflecting the insurance service provided in each period. Judgement needs to be applied to determine the method that best reflects the insurance service provided.

  - One interpretation of the additional service provided, over and above the cash payments, is that the insurer uses their knowledge and expertise to manage longevity risk, investment risk, and predictions of changes in these risks over time. Annuity providers are differentiated by their ability to manage these risks more accurately.

  - Initial modelling performed by a TAG member on the "peace of mind" service suggested that the level of this service was fairly constant over the coverage period, and not recognised upfront, as it is in current practice.

- Supporters of View B emphasised that an annuity is a protection product and the policyholder's primary motivation in buying an annuity is to obtain the "peace of mind" service.
- Proponents of View A cited the following challenges to View B:
  - The risk adjustment reflects the service for bearing risk, not the CSM;
  - It is unclear why the investment-return service was introduced if, under View B, an insurance service was already being providing during the deferral period in the form of a "peace of mind" service;
  - Applying View B for annuities would create inconsistencies with other products; and
  - If the policyholder dies, the benefits, including the "peace of mind" service cease.
- One TAG member noted that the discussion could be seen in the wider context of the recent debates about amending the Solvency II capital requirements for annuities. Another TAG member suggested that, if View A were required to be applied, the biting capital constraint could switch from Solvency II to the IFRS accounts.
- A TAG member suggested that, in reviewing the TRG discussions, more weight appeared to be given by some to the TRG's comments on the example than on their statement that different methods of CSM allocation could be applied to reflect facts and circumstances and that judgement needed to be applied.
- Users of financial statements may, in some cases, consider the CSM and risk adjustment together for their analysis, because the risk adjustment is also recognised as revenue in profit or loss.
- TAG members failed to reach a consensus on:
  - how to define the nature of the service provided by annuities;
  - whether the release from longevity risk should be recognised as part of the allocation of the CSM or only through the risk adjustment; and
  - the appropriate mechanism for recognising the CSM in profit or loss during the pay-out phase.
- Additional challenges were noted in relation to IFRS 17's requirements for the recognition of an investment-return service.
- TAG members agreed IFRS 17 is a global standard and therefore needs to be applied consistently if stakeholders are to benefit to a full extent from international comparability. The UK Endorsement Board's role is to adopt international accounting standards and it is not an interpretative body.

Summary of endorsement concerns

- TAG members cited the following potential endorsement concerns:
  - Annuities represent the most significant and growing insurance product in the UK. The different profit recognition patterns between the two approaches may therefore be material to insurers' financial statements and, in the opinion of some TAG members, to the UKEB's long term public good assessment.
  - A potential consequence of applying View A is that it might encourage structuring transactions, leading to a potential a secondary market for bulk purchase annuities where groups of contracts are traded to release profit that has built up in the CSM. This would result in uneven profit recognition in respect of such insurance contracts, undermining a primary objective of IFRS 17.
  - Differences in interpretation may lead to a lack of comparability. Supporters of View B also consider that if insurers had to apply View A, the treatment would result in financial information that was less relevant and reliable.

Next steps

- The following potential steps were proposed to progress this issue:
  - preparation by industry of a comprehensive technical paper for discussion with IASB technical staff;
  - referral to the IASB's TRG for IFRS 17;
  - referral to the Interpretations Committee; or
  - development of a UK specific solution.
- This topic will be discussed at the 20 July UKEB meeting. Due consideration needed to be paid to the timing of any next steps, given the approaching implementation date of IFRS 17.

8. AOB

- The Secretariat advertised the upcoming UKEB webinar on the IASB's Third Agenda Consultation.
- The Chair thanked TAG members for their participation and contributions over the last ten meetings and welcomed feedback from TAG members on the operations of the advisory group.

End of meeting