Insurance Technical Advisory Group

Meeting Summary – 27 April 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)
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
Justin Ryan (Project Director)	UK Endorsement Board secretariat
Dean Battersby (Project Manager)	UK Endorsement Board secretariat
Caroline Federer (Project Manager)	UK Endorsement Board secretariat

1. Welcome and update from Secretariat

- The Chair welcomed attendees to the meeting.

- The Chair updated the Technical Advisory Group (TAG) on progress with the set-up of the UK Endorsement Board (Board). Since the last TAG meeting, the UK Endorsement Board members had been appointed and had held two public Board meetings.

- The Chair also highlighted that the legislative process for delegation of statutory functions to the Board was underway. The legislation had already passed through the House of Commons and the debate in the House of Lords was scheduled shortly. Once the legislation has been made, expected during May, the UKEB will start working in its official capacity.

2. Minutes of previous meeting

- The minutes of the previous meeting were approved by the TAG.

3. Reinsurance – recovery of losses on onerous underlying insurance contracts

- The paper considered whether the IFRS 17 accounting for the recovery of losses on onerous underlying insurance contracts raises endorsement concerns, principally in respect of the understandability and reliability of information in financial statements.

- Key points noted in the paper were:

    - 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 time they recognise losses on groups of onerous underlying insurance contracts. This requirement is not dependent on whether the group of reinsurance contracts held is in a net gain or a net cost position. Recognising income in this manner 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).

    - The standard requires an entity to establish a loss-recovery component of the asset for remaining coverage of a group of reinsurance contracts held (IFRS 17:66B). The loss-recovery component is adjusted subsequently to reflect changes in the loss component of the onerous group of underlying insurance contracts.

    - The recognition of income upfront when the group of reinsurance contracts held is in a net cost position affects the understandability of results for users of financial statements. It is not apparent from the profit or loss statement whether the group of reinsurance contracts held is in a net cost or net gain position, nor the extent to which there will be future losses on reinsurance.

- Recognising income on reinsurance contracts held in a net cost position may not faithfully represent the economics of the contracts because it results in a deferral of the net cost. The deferral of the net cost of reinsurance to subsequent accounting periods reduces the reliability of financial information as the deferral of losses contradicts a fundamental objective of IFRS 17 to provide more timely information about loss making contracts.

- Users would need a thorough understanding of the standard and the resulting disclosures to interpret results and identify that the loss-recovery component carried forward will be recognised as an additional cost in future periods.

- The accounting implies that the reinsurance contract covers elements of the loss that may not be recovered, so may not give a faithful representation of the transaction. 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 the fact that other expenses or the risk adjustment are likely to contribute to the loss on the group of underlying insurance contracts. Such expenses may not be recoverable from reinsurers.

- The following points were noted during the ensuing discussion:

  - One TAG member noted that mathematically, as the loss-recovery component increases, the adjusted reinsurance contractual service margin tends towards the reinsurance premium payable under the contract. It is considered appropriate to recognise the reinsurance premium payable over the coverage period and therefore it would be appropriate to reflect that treatment in the loss-recovery component. Provided that users understand the principles behind the loss-recovery component, this treatment will result in accounts that are reliable and understandable. Another member agreed that the accounting outcome was not counterintuitive if one accepted the principle that the cost of buying reinsurance should be spread over the coverage period.

  - Changes in reinsurance coverage have the potential to drive significant movements in profit or loss, which will be challenging to explain to users. UK protection products tend to be onerous but are underwritten so that they are profitable after reinsurance. Applying the accounting requirements of IFRS 17 to these products will result in volatility and results that are hard to explain. For example, if a group of protection products is onerous and subject to 90% reinsurance coverage, a net loss of 10% of the underlying loss will be recognised on initial recognition of the underlying contracts. However, if the same contracts were subject to 100% reinsurance coverage, and even if the reinsurance were in a net cost position, no loss would be recognised on inception.

  - One TAG member noted that in practice it will not be possible to determine whether claims or expenses resulted in the group of contracts becoming onerous. Therefore, the simplifying assumption made by the IASB, that the loss on the underlying contracts derived from claims, was necessary. Another member commented that they did not expect expenses to be material.

- It was unclear whether, on subsequent measurement, IFRS 17 paragraph B119F requires an entity to strip out expenses to adhere to the restriction that the carrying amount of the loss-recovery component shall not exceed the portion of the carrying amount of the loss component the entity expects to recover.

- A TAG member noted that on day-one a recovery would be permitted, even if expenses contribute to the loss and are not reinsured. However, if the expenses assumption is revised subsequently, no recovery would be permitted in later periods. This may result in information that is difficult to understand for users.

- The Secretariat observed that the objective of reinsurance arrangements is to mitigate risk and not necessarily to reduce a loss on underlying insurance contracts. The existence of reinsurance does not prevent the underlying insurance contracts from being onerous and IFRS 17 reflects this by requiring insurance contracts and reinsurance contracts held to be accounted for separately.

- TAG members acknowledged that the requirement for the group of reinsurance contracts held to be entered into before or at the same time as the loss on the underlying insurance contracts was intended to limit abuse. However, the possibility of abuse was not significant, as writing onerous contracts for a prolonged period of time was not a sustainable business model.

- The timing constraint in IFRS 17 paragraph B119C may result in income statement volatility in certain circumstances. The income offset would not be available for underlying insurance contracts issued during the period of a reinsurance contract renegotiation even though such contracts are shielded by reinsurance during this period. Furthermore, the timing constraints result in complexities for insurance contracts covered by losses occurring during reinsurance contracts, as some contracts eligible to be reinsured under the contract would not meet the requirements of the income offset according to IFRS 17 paragraph B119C.

- Entities are expected to be able to leverage existing systems and methods for tracking the loss component when monitoring the loss-recovery component, limiting costs associated with these requirements. However, additional costs could arise from the need to explain results.

- The loss-recovery component is a function of the discount rate associated with the gross unit of account, because it is calculated based on the loss component on the underlying insurance contracts. However, as it adjusts the CSM of the reinsurance contracts held it will result in an accounting mismatch. This would result in distortions impacting the insurance finance result, although they are expected to be immaterial.

- On balance, TAG members agreed that the requirements provided useful information. They were designed to mirror the requirement to immediately recognise a loss on underlying insurance contracts and better reflect the economics of the transaction. Members agreed that the requirements may result in outcomes that are difficult to explain. Disclosures regarding key judgements and the development of the loss-recovery component will be important in ensuring the understandability of financial statements. In this context, it was noted that paragraph 98 of IFRS 17 required the reconciliations under paragraph 100 of IFRS 17 to be adapted to reflect the features of reinsurance contracts held.

- TAG members agreed that this topic should be recommended to the IASB for consideration in the post-implementation review of IFRS 17.

4. With-Profits issues and discussions to date

- The Secretariat noted that papers on with-profits issues had been brought to the TAG in January and March 2021 but that discussions had not been completed. This was therefore a continuation of the previous discussions.
- The paper considered the accounting treatment of:
    - An inherited estate in closed and open funds; and
    - Non-profit business in a with-profits fund that is open to new business.

Treatment of an inherited estate in closed and open funds

- Key points noted in the paper were:
    - No significant potential endorsement issues had been identified in relation to the treatment of an inherited estate in a closed fund.
    - The principal challenge relating to the accounting for an open fund was that the accounting would not fairly reflect the underlying economics because profit would be recognised before it was accessible to shareholders and before it had been fully earned.
    - The main difference between the analyses in the January papers for open and closed funds was that, while inherited estate assets were considered to be underlying items for with-profits contracts in the closed fund, that was not the case for the open fund. In an open fund the shareholders' share of profits from the inherited estate would be recognised directly as shareholder profit, whereas in a closed fund, the shareholders' share would be recognised as CSM.

Non-profit business written in an open with-profits fund

- Key points noted in the paper were:
    - The January paper had concluded that in cases when surpluses from non-profit contracts accrued to an inherited estate, the non-profit contracts were not considered to be underlying items for the with-profits contracts.
    - It was noted that the scenario in which non-profit contracts "back" the estate was a rare occurrence.

- In cases when surpluses from non-profit contracts accrued to with-profits policyholders, two views had been expressed regarding the treatment of the policyholders' share of non-profit contract surpluses.

  i. One view was that, no liability under IFRS 17 paragraph B71 could be established for these obligations because the non-profit policyholders did not share in the same specified pool of underlying items (IFRS 17: B67(a)). Therefore, 100% of the non-profit contract surpluses would be recognised as shareholder profit, even though shareholders were only entitled to 10%.

  ii. An alternative view was that, the obligations to pay surpluses from the non-profit contracts to the with-profit policyholders derived not from the non-profit contracts but from the Principles and Practices of Financial Management (PPFM) documentation and/or with-profits contracts. The with-profits policyholders' share of non-profit contract surpluses could be included in the measurement of the with-profits contract liability.

- On the assumption that 100% of the profit from the non-profit contracts is recognised in equity, any subsequent distribution out of the inherited estate would require the establishment of an additional fulfilment cash flow liability (for the 90% policyholders' share) and CSM (for the 10%). Although in aggregate and over time the shareholder profit would be correct, the treatment causes volatility.

- 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:

Treatment of an inherited estate in closed and open funds

  - Several members noted that they disagreed with the analysis in the January papers that there was a distinction between open and closed funds in respect of what constituted underlying items. In an open fund, the underlying items might be viewed as equivalent to the asset share or might include all assets in the fund. A fundamental point was that the fulfilment cash flows are best estimate cash flows and should consider all potential scenarios. The distinction between open and closed funds is that in a closed fund there is more certainty about amounts to be distributed to policyholders and shareholders. On that basis, there should be fewer differences between open and closed funds, and there should not be a cliff edge effect when a fund is closed.

  - One member observed that one of the potential reasons for confusion around this topic is that IFRS 17 does not refer to an inherited estate. In IFRS 17, the assets in a fund will be paid to shareholders and policyholders, either existing or future. As such, IFRS 17 does not contain the inherited estate concept – assets that do not belong to either of these parties.

  - A member noted that other standards also give rise to profits which may not be accessible to shareholders because they are non-distributable. An example was unrealised gains or credit items arising in equity under equity-settled share-based payment schemes in IFRS 2 *Share-based Payment.*

- Profit recognition under IFRS 17 is different from current practice where shareholder profits are recognised when a transfer to policyholders takes place.

- A member noted that clear disclosure would be critical as it was unlikely that the accounting itself could tell the whole story. Users should be able to distinguish between profits recognised from an inherited estate and those from outside the with-profits fund regardless of whether the fund is open or closed. Similarly, to the extent recognised in CSM, amounts arising from an inherited estate should be separately identified.

- Ultimately, however, members considered that a single answer does not exist for this issue as each with-profit fund is unique. The definition of an underlying item and the facts and circumstances relating to each fund must be carefully considered before determining the underlying items in each scenario.

Non-profit business written in an open with-profit fund

- A member observed that whether a liability could be recognised for the policyholder's share of non-profit contract surpluses would depend on what were determined to be the underlying items for the with-profits contract. Once the facts and circumstances had been assessed, should the non-profit contracts be considered to be underlying items, the with-profits policyholders' share of non-profit contract surpluses should be included in the measurement of the with-profits contract liability.

- Members noted that the issues arising in this situation are rare. A key determining factor will be the specific facts and circumstances relating to the individual fund i.e. the PPFM documentation, scheme arrangements and any legal agreements.

- IFRS 17 does not explicitly recognise that a with-profits fund is similar to a mutual fund within a limited insurance company. One of the main reasons for the issues arising is that, financial statements are prepared for shareholders, but IFRS 17 requires a policyholder perspective to be taken, notably regarding the treatment of with-profits contracts.

Conclusion

- Members recommended that the TAG should focus on the endorsement, rather than implementation or interpretation, issue related to this topic. Use of IFRS 17 to report on UK with-profits contracts is likely to give rise to various challenges, including those discussed such as inherited estates and underlying items in open and closed funds. These were UK-specific issues and some additional disclosure may be required.

5. Forward agenda

- The Secretariat asked TAG members for comments on the forward agenda.
- One TAG member raised the point that the "bow wave" effect should be taken into consideration in May, as part of the discussion on CSM allocation. This issue had been raised in Continental Europe and required consideration in the UK context.
- Members raised the possibility that the annual cohorts issue may need reconsideration. Should the European position diverge from IFRS, as issued by the IASB, the UK position on the issue would need careful consideration. The technical and practical implications of a difference between UK and EU-adopted IFRS 17 may need to be brought back to a future TAG meeting.
- The Secretariat informed the TAG that the annual cohorts issue will be included in the draft endorsement criteria assessment ("DECA") and that TAG members' views on this matter will be sought prior to public consultation.

6. AOB

- TAG members' feedback would be sought on the effectiveness and operation of the group.

End of meeting