Insurance Technical Advisory Group

Meeting Summary – 25 May 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)
Sandra Thompson (Board Member)	UK Endorsement Board (for item 3 only)
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 TAG members and UKEB member Sandra Thompson, who was there to observe the discussion on the contractual service margin amortisation.

2. Minutes of previous meeting

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

3. Contractual service margin amortisation – coverage units for release of CSM under IFRS 17

- The paper discussed the recognition of the contractual service margin (CSM) in profit or loss for annuities, including bulk purchase annuities. It set out two views for interpreting the requirements of IFRS 17 *Insurance Contracts* 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.

- Key points noted in the paper were:

    - The overarching principle in IFRS 17 is that entities that issue insurance contracts without direct participation features recognise profit when they provide insurance coverage or service relating to investment activities (investment-return service).

    - IFRS 17 requires the CSM to be recognised in profit or loss over the coverage period of a group of insurance contracts. As such, the amortisation of the CSM reflects the provision of insurance contract services, based on the identification of coverage units that reflect the benefits provided and the expected coverage period (IFRS 17: B119).

    - IFRS 17 provides minimal guidance on how to determine the quantity of benefits provided. For many contract types this does not create any difficulties but for annuities, some consider that significant judgement is required to determine coverage units that appropriately reflect the service provided.

    - Differences in interpretation of how to determine coverage units for annuities stem from the unique features of annuity contracts – the occurrence of the insured event (policyholder survival) triggers an extension of insurance cover and the provision of an income stream for life is a key benefit of the policy.

    - The IFRS 17 Transition Resource group (TRG) concluded that benefits should be determined by giving consideration to the expected policyholder benefits rather than the costs to the insurer of providing the benefits.

    - Some key judgments are: whether the policyholder receives any benefit from the contract beyond the annuity payment in the current period; whether the ability to make a valid claim is a trigger to recognise the full benefit from the insurance service provided; or if the valid claim that can be made within the period is a limit on the maximum contractual cover measured in the benefits.

- IFRS 17 requires the contractual service margin to be recognised in profit or loss over the coverage period of the group of insurance contracts, and in a pattern that reflects the provision of service. This will result in relevant information because it will enable users to evaluate the performance of an entity in line with the provision of service. This results in faithful representation of an entity's financial performance over the coverage period, and its performance obligations. However, excluding a component of the service as under view A, may reduce that relevance.

- IFRS 17 does not prescribe how an entity should determine the quantity of benefits provided under a contract, and thus how to determine the coverage units and their corresponding weighting. Given the possibility that different methods can be used for this calculation, there is a risk that the resulting financial statements will be less comparable and less understandable.

- CSM amortisation is intended to reflect the provision of insurance contract services in the period, based on benefits provided to policyholders. Excluding the benefit the policyholder gains from having a guaranteed income for life (as per View A) may not faithfully represent the services provided, thereby reducing the reliability of the financial information.

- The following points were noted during the ensuing discussion:

  - TAG members were divided in their views. Those supportive of view A made the following points:

    - No additional service, as defined in IFRS 17, was provided over and above the cash payments made to policyholders. The transfer of risk is already reflected in the risk adjustment.

    - It was unclear how view B would be applied in practice or how the View B methodology related logically to the perceived service, or the requirements of IFRS 17 B119.

    - Whether it was correct (under View B) to place reliance on alignment with pricing, since pricing determines the total CSM initially recognised but the question is how that CSM should be allocated.

    - It would not be possible to apply View B to deferred annuities without creating inconsistencies with the accounting treatment of other products, such as reinsurance binders and endowments.

    - The amendment to IFRS 17 permitting recognition of CSM in profit or loss during the investment phase was introduced to reflect that, although there was no insurance coverage during this phase, entities were still providing a service (an investment return service). It is unclear how view B aligns with this because, to the extent it is a valid insurance service, the stand ready obligation would be present throughout the annuity contract, in both the deferred and payment phase, so the amendment would not have been required.

- View A closely reflected the discussions at the TRG.
- Whether View B was in line with the revenue recognition principles in IFRS 15 *Revenue Recognition*, which requires that revenue is recognised on provision of service and does not incorporate an element of stand ready obligation.

- Members supportive of View B made the following points:
  - Annuities provide an additional service in excess of the annual payments, provision of a guaranteed income for life. Policyholders purchase an annuity, rather than an "annuity certain" (a financial instrument with no insurance), to transfer the longevity risk to the insurer.
  - View A did not reflect the economics and pricing of bulk purchase annuities. Applying View A would result in an overstatement of the CSM after initial recognition and consequential understatement of profit and equity. This would impact key metrics and result in information that was not understandable for users of financial statements.
  - Annuity contracts are priced for the full duration of the contract, not separately for the investment return and insurance coverage phases. Determining a weighting of coverage units between the deferred and payment phases would be arbitrary and require significant judgement. View B would work well across both phases.
  - There is an active market for bulk purchase annuities in the UK, with sophisticated buyers and sellers. Therefore, it is possible to reliably measure the fair value of such contracts. The alignment of CSM release with pricing was designed to show that View B was not too aggressive.
  - Their analysis was that View B was consistent both with the approach expected to be taken for other protection products and with IFRS 15.
- One member acknowledged that these contracts recognise the risk of longevity changes and provide a service to address this risk.
- A member discussed possible methods of measuring service, noting that in their view cash payments were not a reliable measure of service and suggesting a correlation to capital held. However, other members noted that capital held by an insurer covers both service and risk (i.e. reflects both the CSM and risk adjustment) so would not be a reliable measure of service.
- A member noted that in their view the impact of the debate between View A and View B was heightened by IFRS 17's constraints over when relevant services under annuity contracts could be recognised (i.e. in which phase of the contracts).

- TAG members noted that bulk purchase annuities represent a significant and growing product line in the UK insurance market. Therefore, the difference between applying View A or View B to determine coverage units may have a material impact on profit recognition over the coming years. One member noted that annuity products were long duration and pervasive in the UK, increasing the materiality of the issue. The Secretariat was advised to consider conducting a materiality assessment.

- TAG members noted that this may be primarily an interpretation, rather than an endorsement, issue. It was also noted that the issue had been discussed at other fora, including the TRG and the ICAEW insurance discussion group.

- A suggestion was made that the overall impact of IFRS 17's requirements on the accounting treatment of annuities should be considered, including the impact of the risk adjustment.

Conclusion

- The Chair asked TAG members to consider whether this was an interpretation or implementation issue and whether it might be appropriate to refer the topic to the International Financial Reporting Interpretations Committee (IFRIC).

- The Secretariat will further consider this topic and will report back to members at the July TAG meeting.

4. Transition to IFRS 17

- The paper considered the transition requirements in IFRS 17.

- Key points noted in the paper were:

    - IFRS 17 requires an entity to restate comparative information about insurance contracts for the annual period immediately before the date of initial application (IFRS 17:C1). The IASB concluded that restatement of comparatives was important because, given the diverse treatments being applied under IFRS 4, IFRS 17 introduces fundamental changes to the accounting for insurance contracts and the impacts of the Standard are pervasive on insurers' financial statements.

    - Unless it is impracticable to do so, IFRS 17 requires an entity to apply the Standard retrospectively (IFRS 17:C3). This is consistent with the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

    - If, and only if, it is impracticable to apply IFRS 17 fully retrospectively an entity will adopt either:

        - 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 modified retrospective approach (MRA) permits specific modifications to the retrospective application. These modifications are intended to achieve the closest outcome to the full retrospective approach using reasonable and supportable information available without undue cost or effort. They allow an entity to determine specified matters at the transition date, rather than at initial recognition of a group of insurance contracts, and use specified proxies for some requirements.

- Under the fair value approach (FVA), IFRS 17 requires an entity to determine the CSM or loss component of the liability of remaining coverage at the transition date. This is calculated as the difference between the measurement of the fair value of a group of insurance contracts and the fulfilment cash flows of the group as at that date (IFRS 17:C20).

- IFRS 17 requires disclosures on transition to provide useful information to users. An entity is required to explain how it determined the measurement of insurance contracts at the transition date, to enable users to understand the nature and significance of the methods used and judgements made (IFRS 17:115). CSM and insurance revenue are disclosed separately for groups of contracts under each of the three transition methodologies for as long as the contracts are in force.

- A misalignment arises between the transition requirements of IFRS 17 and IFRS 9 *Financial Instruments* because IFRS 9 does not require restatement of comparatives on transition (IFRS 9:7.2.15). If preparers do not restate comparatives relating to financial instruments, it may be more difficult for users to assess the interaction between insurance liabilities and the financial assets backing them.

- At its May 2021 Board meeting, the IASB will discuss a proposed narrow scope amendment that, for the purpose of presenting comparative information, would permit an entity to elect to measure financial assets derecognised between the transition date and the date of initial application of IFRS 17 at fair value through profit or loss. This proposal relates to the fact that IFRS 9's transition requirements do not permit the restatement of assets derecognised before the date of initial application. The option would only be available in certain circumstances but would address concerns of an accounting mismatch that might otherwise have arisen and resulted in financial information that would be challenging to explain.

- The paper notes that the choices permitted under the transition approaches may provide benefits in terms of practicality, though the resulting diversity in practice may give rise to a possible negative impact on comparability. The reduced comparability could be mitigated by the separate disclosures required for each transition approach that an entity applies.

- Restating comparatives for all in-force contracts at transition is expected to give rise to consistent reporting before and after transition, leading to increased relevance and comparability of results.

- Disclosures are required to enable users to understand the nature and significance of the methods used and judgements applied. These will increase the understandability and comparability of the financial statements because they require the separate presentation of different groups of contracts, facilitating analysis and comparison.

- The following points were noted during the ensuing discussion:
  - TAG members agreed that the availability of different transition approaches will impact the comparability of financial information. One TAG member highlighted that the FVA was not a proxy for the FRA or MRA and therefore will not result in an application that is directly comparable. However, members acknowledged that the disclosures in IFRS 17 would enable users to understand the approaches applied by an entity, which will facilitate comparison.
  - The full retrospective approach must be applied unless it is impracticable to do so. There will be challenges to audit the impracticability assessment and whether data can be obtained without the use of hindsight. A TAG member raised concerns that there was no materiality constraint for the use of hindsight, noting that a large amount of costs was being incurred to assess whether data could be obtained without the use of hindsight. They did not consider that these costs outweighed the benefits provided by the information.
  - Several TAG members expressed concerns that the transition requirements were challenging to apply in practice and these difficulties were driven by a number of factors including: the duration of insurance contracts; whether the entity has grown organically or via acquisition; IT infrastructure; availability of data; and the transition approach selected.
  - One TAG member commented that although the MRA permitted several simplifications to the FRA, they could have been more extensive, to reduce implementation costs.
  - One TAG member was of the view that entities will choose a transition method that will produce results that they consider to appropriately reflect the business and are understandable for users of financial statements.
  - It would be difficult to quantify the effect of applying different transition approaches because entities have not stated what approaches they are applying and the effects thereof. Furthermore, an entity will apply only one approach to each group of insurance contracts, rendering differences in terms of numbers unable to be determined.
  - The FVA will better suit some product types, because market data will be more readily available. FVA would seem to make sense if one expected the CSM to reflect the underlying economics.
  - TAG members considered that different transition approaches may result in different future profit profiles and preparers may use alternative performance measures to explain results to users.

- TAG members did not anticipate that the proposed narrow scope amendment would have a material impact for UK insurers. This was because UK insurers primarily hold financial instruments at fair value through profit or loss under IAS 39 *Financial Instruments: Recognition and Measurement*. TAG members commented that the proposed amendment would be subject to public consultation.

- In general, members did not appear to have significant concerns around the transition requirements in IFRS 17.

- The prohibition on applying the risk mitigation option retrospectively on transition would be considered at the July TAG meeting .

5. IFRS 17 user survey: Key themes and insights

- The UKEB secretariat presented some preliminary results from the IFRS 17 user outreach conducted during May 2021. These will be further analysed and presented to the UKEB in due course.

6. Forward agenda

- The Secretariat asked TAG members for comments on the agenda for the July 2021 meeting. No changes were proposed.

7. AOB

- The Secretariat discussed how TAG members could best provide input to the drafting of the Draft Endorsement Criteria Assessment.

- The Secretariat informed TAG members that the UKEB was currently conducting outreach to inform its response to the IASB's Agenda Consultation and invited member participation.

End of meeting