Insurance Technical Advisory Group

Meeting Summary – 15 September 2020

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)

Sian Morgan (Columbia Threadneedle Investments)

Wijdan Yousuf (Aon)

Anju Bell (Willis Towers Watson)

Vasilka Bangeova (Guy Carpenter & Company Limited)

Andrew Spooner (Deloitte)

UK Endorsement Board

Seema Jamil O'Neill (Technical Director)	UK Endorsement Board secretariat (Chair)
Caroline Federer (Project Manager)	UK Endorsement Board secretariat

Observer

Andrew Murray (Bank of England)

Apologies

Tony Silverman (AM Best)	
Peter Drummond (Senior Project Director)	UK Endorsement Board secretariat

1. Welcome and Introductions

- The Chair welcomed attendees to the meeting and noted that apologies had been received from Peter Drummond and Tony Silverman.
- The Chair welcomed Andrew Murray from the Prudential Regulation Authority (PRA) at the Bank of England. Andrew will be attending Technical Advisory Group (TAG) meetings as an observer. With reference to the minutes of the July meeting Andrew noted that as an observer, his role was not specifically to represent policyholder interests.
- The TAG approved the minutes from the July meeting for publication on the website.
- The Chair highlighted the recent appointment of Pauline Wallace, the inaugural Chair of the UK Endorsement Board (UK EB). The process to appoint Board members of the UK EB is expected to commence in due course.

2. Structure of TAG Papers

- A template for TAG papers was presented to members for their comments and suggestions. No significant changes were proposed.
- In response to a question about the impact assessment work, the Chair informed the TAG that an assessment of the costs and benefits of IFRS 17 is a statutory requirement. The UK EB secretariat expect to carry out an impact assessment in accordance with government guidelines as part of the endorsement activities.

3. Contracts acquired in their settlement period

- The UK EB secretariat presented the paper. Key points noted were:
    - Certain IFRS 17 requirements create a difference in accounting between contracts issued by the entity and contracts acquired[1] in portfolio transfers or business combinations.
    - Claims liabilities for contracts issued by an entity are accounted for under IFRS 17 as a liability for incurred claims. However, if the same contracts are acquired, and assuming the ultimate cost of the claims is uncertain, the insurance contract liabilities are expected to be accounted for as a liability for remaining coverage. This in turn means that insurance revenue is recognised and that such contracts may need to be accounted for under the general measurement model (GMM). This may create an operational burden for insurers who might otherwise only apply the premium allocation approach (PAA) to contracts they issued.
    - The paper discussed the requirements against three endorsement criteria, understandability, comparability and costs and benefits.
    - The paper asked whether the resulting accounting provides information that is useful to users of the accounts and whether any operational burden of the

[1] "Contracts acquired" refers to contracts acquired in a transfer of insurance contracts that do not form a business or in a business combination within the scope of IFRS 3.

required treatment is justified.

- During the ensuing discussion, it was noted that:
  - The transition relief provided in the *Amendments to IFRS 17,* permitting entities to account for claims liabilities acquired in their settlement phase as a liability for incurred claims, was only available for entities applying the modified retrospective and fair value approaches to transition.
  - The requirements in IFRS 17 regarding contracts acquired in their settlement period were perhaps more appropriate for entities that made acquisitions as part of their business model, e.g. run-off insurers, because for such entities it is intuitive to recognise revenue for the provision of service. However, the requirements appear less appropriate, and the resulting information less understandable and more burdensome, for other entities that make acquisitions infrequently.
  - Concerns may arise with reference to the Lloyd’s Reinsurance-to-close model. At the end of each year of account, the remaining insurance liabilities are reinsured into the following year of account. In certain circumstances this process may lead to those insurance liabilities being accounted for as acquired in their settlement period. Corporate members that increase their level of participation in the following year, in certain circumstances, may need to account for their increased share as contracts acquired. Members expressed a view that this could create an operational burden and questioned whether the accounting treatment was understandable.
  - The treatment required by IFRS 17 is expected to lead to a different profit recognition profile compared with current practice because a key principle of IFRS 17 is that no profit is recognised on inception.
  - The accounting treatment for contracts acquired will likely create concerns mostly for some non-life insurers and only affect those making acquisitions.
  - The principles underlying the IFRS 17 requirements are consistent with acquisition accounting under IFRS 3 *Business Combinations* and will therefore enhance comparability with other IFRS reporters.
  - Disclosures about contracts acquired are required, by paragraph 108(a) in IFRS 17, to provide useful information to users of financial statements.

4. Determining the illiquidity premium when setting discount rates

- The TAG discussed a paper, submitted by a TAG member and expressing strong views on the requirements of the standard, on the use of an illiquidity premium when setting discount rates. The key points in the paper were:
  - The valuation of long-term insurance liabilities is highly sensitive to the discount rate applied, with the potential to materially impact balance sheet values.
  - IFRS 17 requires the use of current discount rates, that reflect the characteristics of the cash flows of the contracts and do not include an insurer’s own credit risk.

- Some stakeholders are concerned about:
  - the difficulty of reflecting the inherent illiquidity of insurance contracts in discount rates; and
  - the lack of detailed guidance in the standard in instances where it is not possible to observe market rates for an instrument with the same characteristics as the cash flows of the insurance contract.
- The paper challenged whether the adjustments for liquidity characteristics proposed by the standard were supported by observable data, expressing the view that market observables contradict the existence of an illiquidity premium.
- The paper also expressed the concern that any method of estimating the illiquidity premium would be open to bias and manipulation and potentially impact direct comparability between insurers.

- During the ensuing discussion:
  - It was noted that the principle in IFRS 17 is that the discount rate must reflect the characteristics of the insurance liabilities.
  - Several members noted that this is an area of significant measurement uncertainty and judgement will need to be applied in determining the illiquidity premium.
  - Several members explained that the inclusion of an illiquidity premium does not result in profits being recognised upfront, but that the magnitude of the premium would impact the measurement of components of the insurance liability recognised on balance sheet, that is the fulfilment cash flows and the contractual service margin.
  - The remeasurement of the illiquidity premium may result in experience adjustments across the duration of the insurance liabilities. These would be recognised in profit or loss as insurance finance income or expense in the period in which they occurred.
  - It was also noted that the disclosure requirements in IFRS 17 are detailed and more extensive than current practice. This increased information in disclosures should improve understandability of the information for users of financial statements and facilitate comparability.
  - IFRS 17 provides a simplification in the top-down approach to setting discount rates, whereby entities are not required to adjust the yield curve, derived from a reference portfolio of assets, for differences in liquidity characteristics between the assets and the insurance contracts.
  - The author of the paper doubted whether the illiquidity premium reflected economic substance and would present reliable information, and challenged whether users of accounts would be able to perform their own recalculations with the information presented in financial statements. Some members took the view that the illiquidity premium may be difficult to observe in practice and may be small in magnitude in some cases. However, the disclosure requirements of IFRS 17 are more extensive than current practice and should

support understanding.

  - Other TAG members noted that the insurance liability cash flows are often predictable, allowing insurers to invest for the long-term. They believe this provides the justification for the use of an illiquidity premium when using a bottom-up approach to discount those liabilities and ensures discount rates reflect the characteristics of the insurance liabilities.
  - It was noted that illiquidity premiums are calculated and subject to audit under current accounting requirements.
- The TAG will continue the discussion of discount rates at a subsequent meeting.

5. Hybrid Contracts that allow switching

- The key points noted in the paper were:
  - In "hybrid" contracts, the policyholder has the ability to invest in either a pure unit linked fund or a participating fund or both. Furthermore, the policyholder can "switch" between funds over the lifetime of the contract.
  - These contracts share characteristics of financial instruments, leading to questions as to: whether they are within the scope of IFRS 9 *Financial Instruments* or IFRS 17; and the appropriate accounting treatment if the policyholder switches between funds.
  - The analysis in the paper was based on the assumption that the hybrid contracts provide no insurance benefits and under IFRS 17 would be accounted for as investment contracts with discretionary participation features.
  - The paper discussed whether any investment components can be identified as distinct and accounted for under IFRS 9. It also considered the accounting treatment if the policyholder switches its investment between funds over the lifetime of the contract.
- During the ensuing discussion, it was noted that:
  - Under current practice, hybrid contracts are not accounted for consistently. Some insurers unbundle the unit linked fund and account for it under IFRS 9, and account for the discretionary participating feature under IFRS 4 *Insurance Contracts*. Other insurers account for the whole contract under IFRS 4.
  - IFRS 17 has been designed to address the accounting of contracts with participation features if the issuer also issues insurance contracts. Accounting for such contracts under IFRS 9 therefore does not seem appropriate.
  - Significant judgement will be required when assessing whether distinct investment components exist and can be unbundled. If entities interpret the standard in different ways the current lack of consistency will remain.
  - It became clear that this was primarily an interpretation issue. The industry is expected to continue its discussions of the accounting treatment. TAG members will revert to the group if endorsement concerns are noted.

6. Basis for selecting topics for consideration

- This paper outlined the rationale for selecting topics for consideration at TAG meetings.
- For a topic to be considered by the TAG, it would be expected to lead to:
  - a question over whether IFRS 17's requirements on that topic meet the endorsement criteria. The principal relevant technical criteria are understandability, relevance, reliability and comparability. In addition, the question of cost versus benefit are to be considered; or
  - a potentially significant impact in the UK. This could be seen if the issue is likely to be material to some companies and/or the efficient and effective functioning of UK capital markets.
- Members expressed a view that caution must be taken not to include topics for discussion which are primarily interpretation issues. The TAG was not set up to provide interpretation advice and should not be used to consider such issues.

7. Forward Agenda

- The forward agenda was distributed for comment and the Chair asked TAG members to submit comments and questions on it to the UK EB secretariat.

8. AOB

- The Chair noted that she had received a query from a member concerning sharing of TAG papers to enable members to gather advice and views. Members expressed agreement that ability to share papers with a select group, on a confidential basis, would be helpful in developing their own views for the TAG meetings.
- The Chair agreed to give the matter further consideration and revert to the group ahead of the next meeting.

End of meeting