IFRS 17 *Insurance Contracts*: other significant issues (extracts from Draft Endorsement Criteria Assessment)

Executive Summary

Project Type	Endorsement
Project Scope	Significant

Purpose of the paper

This paper presents extracts from the Draft Endorsement Criteria Assessment (DECA) relating to our assessment of the other significant issues against the technical accounting criteria.

Summary of the issues

Following approval of the project plan at the May 2021 Board meeting and consideration of the approach to technical issues at the 9 July Board meeting, including the tentative identification of priority issues, the Secretariat has conducted its assessment of the other significant issues. Separate detailed assessments of priority issues have been presented to the Board at this, and previous, Board meetings for discussion. This paper focuses on the approach to reporting the remaining significant issues and presents draft assessments against the technical accounting criteria.

Decisions for the Board

No decisions are required at this stage. Board members are asked for comments on:

- the reporting of the approach to the assessment against the technical accounting criteria set out in Appendix 1;
- the technical content of the tentative assessments in Appendix 2; and
- any further analysis or other steps required to enable the assessment of the remaining significant issues to be finalised for inclusion in the DECA.

Recommendations

The paper recommends including the two extracts set out in Appendix 1 and 2 in the DECA, subject to any amendments required by the Board and any drafting refinements.

Appendices

Appendix 1	Extract from DECA: Approach to the assessment against the technical accounting criteria
Appendix 2	Extract from Appendix to DECA: Assessment of remaining significant issues

Background

1. In May 2021 the Board approved the IFRS 17 project plan and agreed to the adoption of an exceptions-based approach to assessing the issues arising from IFRS 17 against the technical accounting criteria. It also agreed to an approach which distinguished between priority and other significant issues. At the 9 July Board meeting, the Board considered further the approach to the identification of the remaining significant issues and agreed to a tentative assessment of issues to be treated as priority issues.

2. We propose to set out our approach to the assessment of the standard against the technical accounting criteria in the DECA. A draft of this material is included as Appendix 1 to this paper.

3. A key difference between our approach to priority issues and our approach to other significant issues is that separate detailed assessments of priority issues are presented to the Board. We have presented papers on priority issues for discussion at this, and previous, Board meetings.[1] Assessments of priority issues will be included in the body of the DECA.

4. At the 9 July Board meeting the Board agreed to cover the other significant, but non-priority, issues collectively. Our proposal is to include the assessments of these other significant issues in an appendix to the DECA, reflecting their lower priority status. This paper presents a draft of this proposed appendix to the DECA as Appendix 2.

Questions for the Board

Questions for the Board
5. Does the Board have any comments on: • The proposed approach to reporting priority and other significant issues in the DECA? • The draft DECA section on the approach to the assessment against the technical accounting criteria, as set out in Appendix 1? • The technical content of the draft assessments of the remaining significant issues, as set out in Appendix 2? • Any further analysis or other steps required to enable the assessment of the remaining significant issues to be finalised for inclusion in the DECA?

[1] Those papers cover the following topics: discount rates; CSM allocation for annuities; with-profits inherited estates; and grouping insurance contracts: profitability buckets and annual cohorts.

Next steps

6. The assessments included in the draft Appendix 2 are tentative assessments based on work to date. We propose to ask for specific feedback on these assessments in our public consultation on the DECA.

7. Subject to any changes required by the Board, we plan to incorporate Appendix 1 and Appendix 2 into the DECA. Any changes to the approach to reporting technical accounting issues that the Board requires can be incorporated in an updated version and presented to the Board in October.

8. The Secretariat also welcomes comments on the drafting of these assessments in Appendix 2 by email.

Appendix 1: Extract from Draft Endorsement Criteria Assessment

4.2 Approach to the assessment against the technical accounting criteria

1. SI 2019/685 requires an assessment of whether IFRS 17 "*meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management*" [regulation 7 (1) (c)]. We refer to these criteria collectively as the technical accounting criteria.

Development of approach

2. In carrying out this assessment we have considered all principal aspects of IFRS 17. However, in the interests of efficiency and effectiveness we have carried out a detailed analysis against the technical accounting criteria only in relation to significant issues (an 'exceptions-based approach').

3. This approach means that detailed analyses against the technical accounting criteria have focused on issues raised by UK stakeholders or which otherwise have been subject to considerable debate. All such issues have been discussed with the Insurance Technical Advisory Group (TAG)[1].

4. For example, the measurement of estimated future cash flows for groups of contracts is a fundamental element of IFRS 17 and is addressed in the standard by specific requirements and extensive application guidance. However, based on our work and on information from stakeholders we are not aware of significant endorsement concerns in relation to these requirements in the UK. Therefore, under an exceptions-based approach we have not included a detailed report on the assessment of this issue in the draft Endorsement Criteria Assessment (DECA).

5. The analysis against the technical accounting criteria has been performed on a topic-by-topic, rather than on a criterion-by-criterion basis to minimise the risk of repetition.

Identification of 'significant issues'

6. In this context 'significant issues' means aspects of the standard:

   a) where there is a question over whether IFRS 17's requirements on that aspect meet the technical accounting criteria; and

   b) which have a potentially significant impact in the UK: that is, the issue is likely to be material to at least some companies and/or the efficient and effective functioning of UK capital markets.

[1] https://www.endorsement-board.uk/endorsement-projects/ifrs-17/technical-advisory-group

7. The process adopted by the Secretariat to identifying significant issues has spanned a number of months and has been responsive to stakeholder input throughout that period. Principal components of that work included:

   a) desktop analysis of the standard, the basis for its requirements, and of commentaries and technical analyses issued by, for example, accounting firms and professional bodies;

   b) consideration of feedback from UK stakeholders on IFRS 17 as issued in 2017 and their input to the amendments finalised in 2020, including comment letters submitted to the IASB;

   c) review of submissions to EFRAG from UK stakeholders, discussions with EFRAG staff and review of EFRAG's Draft Endorsement Advice;

   d) discussions with insurers and the Association of British Insurers, and review of responses to our preparer survey;

   e) consideration of investor and analyst views expressed to the IASB during its outreach work[2], discussions with UK-based analysts and ratings agencies and review of responses to our user survey; and

   f) input from the Insurance TAG, initially in developing the group's work plan and subsequently in developing its forward agenda on an ongoing basis.

8. A further consideration during this process was to separate out issues that had the potential to be endorsement issues from those that were questions of interpretation or implementation. The Secretariat acknowledges that the distinction between endorsement and interpretation/implementation issues is not always clear cut. However, a number of issues arising from the process set out in paragraph 7 above have been judged to be more in the nature of interpretation or implementation questions so are not included in Appendix [X]. For example, such issues could include requirements of IFRS 17 which in general are considered to meet the technical accounting criteria but which are complex or require significant judgement to apply to particular fact patterns.

9. We have confirmed through our outreach that there are no further significant issues of concern to UK stakeholders that we have not otherwise addressed. For example, our surveys of insurers and users of insurers' accounts asked respondents to highlight issues for consideration during the endorsement assessment. Similarly, in recent meetings with users of accounts we have asked for them to inform us of any additional issues: no significant new matters have arisen.

Identification of 'priority issues'

10. A subset of significant issues, referred to as 'priority issues', has been identified. These are issues that are likely to have one or more of the following features:

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[2] For example, see IASB Board Paper 2A from July 2017, summarising 35 discussions with 153 investors and analysts https://www.ifrs.org/content/dam/ifrs/meetings/2017/july/iasb/ap02a-insurance-contracts.pdf

a) they relate to a pervasive aspect of the standard;

b) they have generated significant UK public interest and/or controversy;

c) they are estimated to be material to UK insurers; and/or

d) they are significant to the long term public good assessment of IFRS 17.

11. Detailed individual assessments of priority issues have been presented to the Board for discussion at Board meetings.

12. In developing the list of priority and other significant issues, the Secretariat has received advice from Board members.

Presentation in the [Draft] Endorsement Criteria Assessment

13. As explained above, our approach involves reporting our assessment against the technical accounting criteria for each significant issue.

14. Assessments of the priority issues have been included in section [XX] of the DECA. The priority issues are:

    a) Profit recognition – allocation of CSM for annuities;

    b) Discount rates;

    c) Grouping insurance contracts: profitability buckets and annual cohorts; and

    d) With-profits: inherited estates.

15. The assessments of the remaining significant issues have been included in Appendix [X]. The topics assessed are:

    a) Risk adjustment for non-financial risk;

    b) Interest accretion at the locked in rate for CSM under the GMM;

    c) Recognition of income from reinsurance to match losses from onerous underlying contracts;

    d) Contracts acquired in their settlement period;

    e) Contracts that change nature over time;

    f) Other comprehensive income option;

    g) Transition requirements; and

    h) Other VFA issues:

        i. Ineligibility of reinsurance contracts for VFA;

ii. Prohibition of retrospective application of the risk mitigation option;

iii. Eligibility for VFA when there are mutualised cash flows; and

iv. Non-profit contracts in a with-profits fund

16. In conducting our assessments against the technical accounting criteria, we have adopted an absolute, rather than a relative, approach. This means that for both priority and other significant issues the assessment is an absolute one against the criteria (does IFRS 17 provide information that is understandable, relevant, reliable and comparable?) rather than a relative one (does IFRS 17 provide information that is more understandable, relevant, reliable and comparable than current, or any other, accounting?). Our consideration of whether IFRS 17 is likely to improve the quality of financial reporting will be included in our IFRS 17 long term public good assessment.

17. The assessments in Appendix 2 include some risks to the technical accounting criteria that we have become aware of from our own analysis or from stakeholder feedback. We have also set out mitigating factors that we believe must be weighted against those risks. Such risks often arise from the balance that needs to be struck between competing objectives, for example between the objectives of relevance and comparability, or between reliability and comparability. The identification of risks in an assessment does not therefore imply that, on balance, for that particular set of IFRS 17's requirements the technical endorsement criteria are not met.

18. Our overall conclusion on whether the technical accounting criteria are met for IFRS 17 as a whole is set out at paragraph [XX – *to be updated when incorporated into the DECA as a whole*].

Appendix 2: Appendix to Draft Endorsement Criteria Assessment

Assessment of remaining significant issues

1. In carrying out the assessment required by SI 2019/685 we have considered all principal aspects of IFRS 17. As set out in section 4.2 of the DECA we have carried out a detailed analysis against the technical accounting criteria and reported our assessment only in relation to significant issues (an 'exceptions-based approach').

2. In this context 'significant issues' means aspects of the standard:

   a) where there is a question over whether IFRS 17's requirements on that aspect meet the technical accounting criteria; and

   b) which have a potentially significant impact in the UK: that is, the issue is likely to be material to at least some companies and/or the efficient and effective functioning of UK capital markets.

3. A subset of significant issues, referred to as 'priority issues', have been identified. These are issues that are likely to have one or more of the following features:

   a) they relate to a pervasive aspect of the standard;

   b) they have generated significant UK public interest and/or controversy;

   c) they are estimated to be material to UK insurers; and/or

   d) they are significant to the long term public good assessment of IFRS 17.

4. Assessments of priority issues have been included in section [XX] of the DECA.

5. The remaining significant issues assessed in this Appendix cover:

   a) Risk adjustment for non-financial risk;

   b) Interest accretion at the locked-in rate for CSM under the GMM;

   c) Recognition of income from reinsurance to match losses from onerous underlying contracts;

   d) Contracts acquired in their settlement period;

   e) Contracts that change nature over time;

   f) Other comprehensive income option;

   g) Transition requirements; and

   h) Other VFA issues:

i. Ineligibility of reinsurance contracts for VFA;

ii. Prohibition of retrospective application of the risk mitigation option;

iii. Eligibility for VFA when there are mutualised cash flows; and

iv. Non-profit contracts written by a with-profits fund.

Risk adjustment for non-financial risk
IFRS 17 requirements
IFRS 17 defines the risk adjustment for non-financial risk (RA) as "the compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts". [IFRS 17 Appendix A] An entity shall apply the RA to the estimate of the present value of future cash flows when measuring a group of insurance contracts. [IFRS 17: 37] The RA also reflects the degree of diversification benefit the entity includes when determining the compensation it requires for bearing non-financial risk, and both favourable and unfavourable outcomes in a way that reflects the entity's degree of risk aversion. [IFRS 17: B88] The RA shall be included in the measurement of insurance contracts in an explicit way, as it is conceptually separate from the estimates of future cash flows and the discount rates that adjust those cash flows. [IFRS 17: B90] IFRS 17 is principle-based and does not specify the estimation technique(s) to be used to determine the RA, but states the characteristics that the RA shall have. [IFRS 17: B91] An entity shall apply judgement when determining an appropriate estimation technique for the RA. When applying that judgement, an entity shall also consider whether the technique provides concise and informative disclosure so that users of financial statements can benchmark the entity's performance against the performance of other entities. [IFRS 17: B92] In the case of **reinsurance contracts held**, an entity shall determine the RA so that it represents the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts. [IFRS 17: 64 and Illustrative Example 11] ***Disclosures*** Disclosures are required about significant judgements and changes in judgements made by an entity in applying IFRS 17. Specifically, an entity shall disclose the inputs, assumptions and estimation techniques used, such as the approach used to determine the RA, including whether changes in the RA are disaggregated into an insurance service component and an insurance finance component or are presented in full in the insurance service result. [IFRS 17: 117(c)(ii)] An entity shall also disclose the confidence level used to determine the RA. If an entity uses a technique other than the confidence level technique for determining the RA, it shall disclose the technique used and the confidence level corresponding to the results of that technique. [IFRS 17: 119]
Accounting impact
Initial recognition On initial recognition of a group of insurance contracts, the RA affects the measurement of the fulfilment cash flows. [IFRS 17: 32] For profitable contracts the impact of applying a higher or lower RA is reflected in (and offset by) the contractual service margin (CSM) so there is no immediate effect on profit or equity. For a group of contracts that is only marginally profitable the RA applied can affect the likelihood that the group is initially assessed as onerous. For a group of contracts that is onerous on initial recognition, the RA applied affects the amount of the loss that is initially recognised. Subsequent measurement

Since the RA is part of the fulfilment cash flows [IFRS 17: 32(a)(iii)], changes in the RA that relate to prior/current service are recognised in profit or loss in the period in which they occur. The portion of the RA relating to the liability for remaining coverage is recognised in insurance revenue as the risk is released, while the portion of the RA relating to the liability for incurred claims is recognised in insurance service expenses [IFRS 17: 41a, 42a-b]. Changes in the risk adjustment that relate to future service adjust the contractual service margin as specified in paragraphs B96-B100 [IFRS 17: 44c]. An entity is permitted (but not required) to disaggregate the change in the RA between the insurance service result and insurance finance income or expenses. If an entity does not make such a disaggregation, it shall include the entire change in the risk adjustment for non-financial risk as part of the insurance result. [IFRS 17: 81] Current UK accounting standards do not require an explicit risk adjustment over and above best estimate liabilities, but this risk is typically included in the measurement as an implicit margin. It is expected that all UK insurance entities will be affected by the application of the RA requirements in IFRS 17, and many entities are likely to encounter some complexities in its calculation. The relative size of the RA compared with the present value of estimated future cash flows will vary depending on the expected variability in insurance outcomes, diversification benefits and the entity's risk appetite.
Tentative assessment against the technical accounting criteria
The fact that there is a market for risk is the core principle of the insurance industry, and therefore it is **relevant** to include an explicit RA in an insurer's financial statements. This: • Provides a clearer insight into the insurance contracts, distinguishing risk- generating liabilities from risk-free liabilities; • Results in a profit recognition pattern that reflects both the profit recognised for bearing risk and the profit recognised for providing services. • Reveals circumstances in which the entity has charged insufficient premiums for bearing the risk that the claims might ultimately exceed expected premiums. • Reports changes in estimates of risk promptly and in an understandable way. The complexity of the methods needed to calculate the RA might introduce a risk to the **reliability** of these estimates. The RA, and in particular the RA for certain products such as non-proportional reinsurance, is difficult to estimate reliably without the use of complex actuarial methodologies, which might represent a challenge for smaller entities. However, this risk is mitigated by the fact that even relatively small insurers are likely to need to calculate the risks covered by the RA for the purpose of current regulatory reporting. The degree of flexibility allowed in the calculation of the RA, as well as the level of expert judgement needed, in particular for some lines of business and within consolidated insurance and reinsurance group structures, may present a challenge to **reliability** and **comparability,** both between different entities and between successive reporting periods. However, this flexibility is consistent with the principle-based approach elsewhere in IFRS 17 and with the approach for a similar risk adjustment for non-financial risk in IFRS 13. The RA is a new concept in financial reporting under IFRS for insurers and reinsurers. The calculation of the RA is a technically challenging area and the details of the calculation may present a challenge to the **understandability** of financial statements for some users of accounts. Further, the RA will potentially be volatile between reporting periods in ways that are complex and therefore difficult to relate directly to the performance of the business, and this may therefore lead to **reduced understandability** of historical accounts.

However, the overall concept of allowing for the uncertainty in estimates of insurance liabilities is not complex, can be explained by insurers and is generally already understood by users of insurers' accounts. In addition, disclosures such as those on significant judgements, estimation techniques used and the confidence level will mitigate concerns over **reliability, comparability and understandability** of the RA and will help users of financial statements gain an understanding of its nature and impact.

The option to either disaggregate the RA between the insurance service result and insurance finance income or expenses or to present the full RA in the insurance service result may reduce **comparability** between entities. However, this risk is balanced by the fact that optionality allows entities to assess the relative costs and benefits of disaggregation in their particular circumstances.

Overall, the inclusion of a separate RA improves transparency in an insurer's financial statements and hence **enhances the relevance** of the information. Coupled with IFRS 17's disclosure requirements, the requirement for an explicit RA also **enhances comparability** between entities within the insurance industry and also between successive reporting periods.

Interest accretion at the locked-in rate for CSM under the GMM
IFRS 17 requirements
Entities applying the General Measurement Model (GMM) are required to measure the fulfilment cash flows and the CSM at two different types of discount rates: • Fulfilment cash flows are measured based on *current* discount rates. [IFRS 17: 40 and B72(a)] • The CSM is measured based on the discount rate determined at initial recognition (the *locked-in* discount rate). This means the locked-in rates are used for: ○ Accreting interest on the CSM. An entity shall apply discount rates determined at the date of initial recognition and applicable to nominal cash flows that do not vary based on the returns of any underlying items. [IFRS 17: 44 and B72(b)] ○ Measuring changes to the CSM arising from changes in fulfilment cash flows that relate to future service, such as: ▪ Experience adjustments arising from premiums received in the period that relate to future service and related cash flows. ▪ Changes in estimates of the present value of the future cash flows in the liability for remaining coverage (except for those related to the effects of the time value of money and financial risk). An entity shall apply the discount rates which reflect the characteristics of the cash flows determined on initial recognition of the group of insurance contracts. [IFRS 17: 44 and B72(c)]
Accounting impact
The application of *current* discount rates for fulfilment cash flows and *locked-in* discount rates for CSM leads to a difference that represents the cumulative effect of changes in financial variables on the underlying change in estimates between the date the insurance contracts were initially recognised and the date of the change in estimates. Such a difference gives rise to a gain or loss that is included in profit or loss or other comprehensive income, depending on the accounting policy choice an entity makes for the presentation of insurance finance income or expenses. [IFRS 17: BC275] (For more information on this accounting policy choice refer to the OCI Option assessment [***here***]). We expect most UK insurers will account for their financial assets at fair value through profit or loss under IFRS 9 and will therefore not use the OCI option available in IFRS 17 to disaggregate the presentation of insurance income or expenses. This means that, for most UK insurers, the impact of changes in interest rates arising from both their financial assets and the fulfilment cash flows of their insurance contracts accounted for under the GMM will be recognised in profit or loss. The gain or loss resulting from the use of a locked-in rate for the CSM may therefore result in volatility in profit or loss. This issue is likely to be more significant for long-duration insurance contracts accounted for under the GMM. The financial impact of applying a locked-in rate rather than a current rate cannot yet be quantified, but stakeholders have estimated that it could be significant.
Tentative assessment against the technical accounting criteria
The CSM does not represent future cash flows but represents the unearned profit in the contract, measured at the point of initial recognition and adjusted only for specified

amounts. [IFRS 17: BC274] Changes in financial conditions do not give rise to changes in the value of future margins, as the amount paid by a policyholder when they receive services does not change in line with interest rates. Using a locked-in rate for calculating interest on the CSM means performance reflects contract pricing at the time the insurance contract was written and therefore enhances **relevance**.

When changes in fulfilment cash flows (such as changes in estimates and experience adjustments) relate to future service, the expected profit relating to that future service changes and therefore adjust the CSM. [IFRS 17: BC276C] Using a locked-in rate to determine adjustments to the CSM for changes in estimates of cash flows that relate to future service provides **relevant** information as it ensures consistency with the measurement of the CSM on initial recognition and avoids reflecting adjustments for changes in assumptions relating to financial risk.

A core benefit introduced by IFRS 17 is the presentation of insurance income and expenses separately from the insurance service result. The use of locked-in rates allows the insurance service result to be unaffected by changes in interest rates, to be more clearly separable from the insurance finance result and therefore to assist users of financial statements **understanding** an entity's performance.

The requirement to calculate interest on the CSM is consistent with IFRS 15 *Revenue from Contracts with Customers*, which requires an entity to adjust the promised consideration to reflect the time value of money if the contract has a significant financing component. This consistency with IFRS 15 therefore **enhances comparability** with other entities.

Applying locked-in interest rates to the CSM could potentially **impair the relevance** of the insurance finance result as it could be distorted by cumulative finance adjustments (such as to reflect the cumulative effect of changes in financial variables on underlying changes in estimates). This could result in volatility in the insurance finance result, the direction and size of which are not a function of the underlying features of the contract but rather the changes in interest rates since initial recognition of the insurance contracts. Due to its complex nature this adjustment may also **impair understanding** of an entity's performance.

However, some insurers could potentially **mitigate this volatility** in profit or loss by electing to disaggregate its insurance finance income or expense in profit or loss and other comprehensive income, effectively transferring such volatility to the other comprehensive income.

IFRS 17's disclosure requirements should also help to **mitigate concerns over understandability**: IFRS 17: 110 requires an entity to explain the total amount of insurance finance income or expenses and its relationship with the investment return on assets. Such disclosures should assist users in understanding the information presented in an entity's financial statements.

Recognition of income from reinsurance to match losses from onerous underlying contracts

IFRS 17 requirements

IFRS 17 requires a company to account for reinsurance contracts held separately from underlying insurance contracts issued [IFRS 17: BC 298].

On initial recognition of, or on addition of onerous contracts to, groups of insurance contracts that are expected to be loss making, a company must recognise the loss immediately in profit or loss. When such insurance contracts are covered by reinsurance contracts held, IFRS 17 requires an entity to recognise corresponding income from reinsurance in profit or loss [IFRS 17: 66A] at the same time 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 income recognised from a group of reinsurance contracts held is calculated by multiplying:

1. the loss recognised on the underlying insurance contracts; and
2. the percentage of claims on the underlying insurance contracts that the entity expects to recover from the group of reinsurance contracts held [IFRS 17: B119D].

If the group of onerous underlying insurance contracts includes contracts that are not covered by reinsurance, the Standard permits an entity to apply a systematic and rational method of allocation to determine the proportion of losses recognised that relate to insurance contracts covered by the group of reinsurance contracts held [IFRS 17: B119E].

The standard requires an entity to establish a loss-recovery component of the asset for remaining coverage of a group of reinsurance contracts held that determines amounts that entities will recognise in profit or loss in subsequent periods as reversals of recoveries of losses [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 carrying amount of the loss-recovery component cannot exceed the portion of the carrying amount of the loss component of the onerous underlying insurance contracts the entity expects to recover from reinsurance [IFRS 17: B119F].

Disclosures

IFRS 17 requires the separate presentation of amounts relating to reinsurance contracts held and underlying insurance contracts in profit or loss [IFRS 17:82] and on the balance sheet [IFRS 17: 99b]. An entity is also required to adapt the disclosure requirements of paragraphs 100-109 to reflect the features of reinsurance contracts held that are different from insurance contracts issued [IFRS 17: 98].

Accounting impact

Subject to certain requirements being met, an entity is permitted to recognise income from reinsurance to offset the upfront loss recognised at initial recognition of onerous underlying contracts. This reduces the negative effect on profit or loss on day one. The recognition of income in profit or loss is not dependent on whether the group of reinsurance contracts held is in a net gain or a net cost position.

Although the overall ultimate net cost of reinsurance over its coverage period remains unaffected, entities with net cost reinsurance will effectively increase the amount of losses deferred – income is recognised immediately, in the form of the loss recovery, but the net cost deferred over time is increased, as illustrated by the following example.

Insurance contracts issued		Reinsurance contracts held		Total	
Premiums	100	Reinsurance premiums	(65)	Net premiums	35
Claims	(150)	Claim recoveries	60	Net claims	(90)
Loss	**(50)**	**Net cost**	**(5)**	**Net position**	**(55)**

The percentage of claims expected to be recovered from reinsurance is 40% and the loss-recovery is 20.

	Recognised at inception	Recognised over time
Insurance revenue	0	100
Insurance service expenses	(50)	(100)
Insurance contracts issued	**(50)**	**0**
Reinsurance premiums	0	(65)
Amounts recovered from reinsurance	20	40
Reinsurance contracts held	**20**	**(25)**
Profit/(loss)	**(30)**	**(25)**

The adjustment to determine the amount of income to recognise in profit or loss is calculated by multiplying a claims recovery percentage by the loss on the onerous underlying contracts, disregarding any contribution to the loss on those contracts made by other expenses or the risk adjustment. Such expenses are frequently not recoverable from reinsurers.

Tentative assessment against the technical accounting criteria

Recognising information about the expected loss recoveries on reinsurance contracts provides **relevant** information because it complements the information about expected losses on underlying insurance contracts. IFRS 17's requirement ensures that income from reinsurance is recognised at the same time that losses are recognised on the underlying contracts, thereby avoiding a mismatch.

Recognising corresponding income on reinsurance contracts held that are in a net gain position provides **relevant** information because it reflects the right that the entity has to recover the losses from reinsurance and therefore better reflects the economics of the transaction. Stakeholders have informed us that this situation is prevalent for UK protection products because it is not uncommon for the underlying contracts to be onerous when considered in isolation, but profitable after reinsurance.

Conversely, recognising income on reinsurance contracts held in a net cost position, and thereby deferring recognition of the net cost of the reinsurance contracts, may not faithfully represent the economics of the contracts and may seem imprudent, **impairing reliability**. However, an entity has the right to recover claims from the reinsurer regardless of whether claim recoveries are expected to be higher or lower than the reinsurance premiums paid. Further, it is consistent with the principles of IFRS 17 that the cost of the reinsurance coverage (the premiums paid by the entity to the reinsurer) is recognised over the duration of the contract as the reinsurer provides service. This treatment also reflects the fact that the entity has the right to recover not only expected claims but also unexpected claims.

The recognition of income upfront when the group of reinsurance contracts held is in a net cost position might impair the **understandability** of financial performance for users of the accounts. It will not necessarily be readily apparent from the accounts whether the relevant group of reinsurance contracts held is in a net cost or net gain position, nor will the extent to which future losses on reinsurance are expected be immediately apparent. This may also **impair comparability**. However, losses and loss recoveries will be presented in separate line items in profit or loss and separately in the notes, providing useful information and **mitigating the risk to understandability and comparability**. Users with a more sophisticated level of understanding should be able to interpret the financial information and identify that the loss-recovery component carried forward will be recognised as an additional cost in future periods.

The timing constraint in IFRS 17 paragraph B119C may result in income statement volatility, **reducing relevance**. The income offset is not available for underlying insurance contracts issued during the period of a reinsurance contract renegotiation even though such contracts may be shielded by reinsurance during this period. Furthermore, the timing constraint results 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 for income offset.

However, stakeholders had also expressed concerns that the recognition of upfront income from reinsurance would be open to abuse, enabling entities to achieve a desired accounting outcome by entering into reinsurance contracts with the intention of deferring losses on underlying contracts. The requirement to have entered into the group of reinsurance contracts held before, or at the same time, as the loss is recognised on the group of onerous underlying insurance contracts, **mitigates this risk to reliability**. The timing constraint therefore strikes a balance between the objectives of relevance and reliability.

The calculation of the loss-recovery component is determined by the overall loss on the underlying insurance contracts, including expenses that may not be recoverable under the reinsurance contract held. The accounting implies that the reinsurance contract covers elements of the loss that will in fact not be recovered, so may not give a faithful representation of the transaction, **impairing reliability**. However, stakeholders have indicated that they do not anticipate the expenses to be a material item in the fulfilment cash flows. Furthermore, the simplifying assumption that the loss on insurance contracts is caused solely by claims reduces complexity and cost to preparers and reflects the connection between insurance claims and reinsurance recoveries.

Contracts acquired in their settlement period
IFRS 17 requirements
In accordance with the principles of IFRS 3, IFRS 17 requires entities to account for insurance contracts acquired (whether in a transfer of insurance contracts that do not form a business, or in a business combination within the scope of IFRS 3) as if they had entered into the contracts on the date of the transaction [IFRS 17: B93]. Therefore, an entity must assess whether a contract meets the definition of an insurance contract based on the facts and circumstances available on the date of the transaction. In the case of insurance contracts acquired in their settlement period, paragraph B5 of IFRS 17 states that when insurance contracts cover events that have already occurred, but the financial effect of which is still uncertain, the insured event is the determination of the ultimate cost of those claims.[1] As the insured event has not yet occurred, the insurance contract liability is classified as a liability for remaining coverage. When the insurance contracts are acquired, unless the premium allocation approach (PAA) is applied, the acquirer recognises a contractual service margin (CSM) equal to any positive difference between the consideration received or paid and the fulfilment cash flows at the acquisition date. If the insurance contracts acquired are onerous, the excess of the fulfilment cash flows over the consideration paid or received is either recognised as part of goodwill or a gain on a bargain purchase for contracts acquired in a business combination, or as a loss in profit or loss for contracts acquired in a transfer. A loss component is established and subsequently measured in accordance with IFRS 17: 49-52 [IFRS 17: B95A]. As the contract is in its settlement period and the ultimate cost of the claims remains uncertain, the acquirer recognises a liability for remaining coverage. On subsequent measurement, the acquirer recognises insurance revenue for the reduction in the liability for remaining coverage for services provided in the period. The CSM is recognised in profit or loss as insurance revenue over the expected claims settlement period, based on coverage units. Insurance service expenses will be recognised in profit or loss based on the actual claims settlement amounts in each reporting period. ***Disclosures*** Entities are required to separately present amounts resulting from contracts acquired from other entities in transfers of insurance contracts or business combinations [IFRS 17: 108(a)].
Accounting impact
Certain IFRS 17 requirements create a difference in accounting between contracts issued by the entity and contracts acquired in portfolio transfers or business combinations. The classification of the insurance contract liability as a liability for remaining coverage or incurred claims does not affect the calculation of the fulfilment cash flows but does affect other aspects of recognition and measurement. Claims liabilities for contracts issued by an entity are accounted for 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 be recognised under the general measurement model (GMM). This

[1] This assessment is written on the assumption that contracts acquired in their settlement period meet the definition of insurance contract.

may create an operational burden for insurers who might otherwise only apply the premium allocation approach (PAA) to contracts they issued.

Tentative assessment against the technical accounting criteria

Treating the insured event as the determination of the ultimate cost of the claims and recognising insurance revenue in profit or loss over the period that insurance service is provided is consistent with IFRS 17's general measurement model and the requirements of IFRS 15 *Revenue from Contracts with Customers*. The required treatment of acquired contracts therefore provides **relevant** and more **comparable** information.

IFRS 17's requirements for acquired contracts are broadly consistent with acquisition accounting under IFRS 3 *Business Combinations* and will therefore **enhance understandability** and **comparability** with other IFRS reporters. This will further enhance the transparency of the insurers' financial information made available to the listed markets.

Initially, IFRS 17's requirements for contracts acquired in their settlement period may potentially reduce **understandability** because the recognition of insurance revenue may not be aligned with users' current expectations. It may be unclear what insurance service is provided to the policyholder, and therefore why insurance revenue is recognised by the acquirer. Some stakeholders have also questioned whether analysts will need to adjust reported revenue and may request additional disclosures to enable analysis of performance.

However, concerns about understandability are likely to decline over time and will be mitigated by IFRS 17's disclosure requirements. In particular, the standard requires separate disclosure of the effect on the balance sheet of contracts acquired from other entities in the period, **enhancing understandability**. [IFRS 17: 108]

The treatment of contracts acquired in their settlement period required by IFRS 17 might **reduce comparability** between insurance contracts acquired pre- and post-transition to IFRS 17. A transition relief available in the modified retrospective approach[2] permits an entity to account for a liability for claims settlement of a contract acquired before the date of transition as a liability for incurred claims, rather than as a liability for remaining coverage. Insurance contracts acquired in their settlement period after the date of transition must be accounted for as a liability for remaining coverage.

However, the risk to comparability from this relief is outweighed by the considerations around practicability, which significantly **enhances reliability**, because reliable information cannot be provided in the absence of the required information.

IFRS 17's requirements might also **reduce comparability** between acquired and issued contracts. Contracts in their settlement period that were issued by the entity would be accounted for as a liability for incurred claims. Changes in the liability for incurred claims would be recognised in profit or loss as insurance service expenses, not insurance revenue. Conversely, if acquired, the entity would account for the same obligations as a liability for remaining coverage, because the insured event becomes the determination of the ultimate cost of the claims.

However, where acquisitions of insurance contracts are a significant part of its business, or significant in the context of a reporting period, an entity is likely to need to explain the impact of acquisitions to users of the accounts in any event. The disclosure requirements noted above, and the general IFRS 17 requirement to provide additional disclosures where necessary to enable users of the accounts to assess the effect of contracts on the

2 The relief is available only to the extent that an entity does not have reasonable and supportable information to apply a fully retrospective approach [IFRS 17: C8]

entity's financial position, financial performance and cash flows [IFRS 17: 94], **mitigate these risks to comparability**.

Stakeholders have expressed concerns with reference to the Lloyd's Reinsurance-to-close model. At the end of each year of account, 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. This could create an operational burden and stakeholders have questioned whether the accounting treatment was **understandable**. However, this is likely to affect only a small number of specialist insurers and disclosures should mitigate risks to understandability.

IFRS 17's requirements will mean a change to current accounting practice in the UK so may pose initial risks to understandability. However, these risks need to be balanced with the objective of consistency with other IFRS Standards and hence enhanced comparability and relevance.

Contracts that change nature over time

IFRS 17 requirements

UK with-profits savings contracts commonly contain a guaranteed annuity option ("GAO") giving the policyholder the option to take out an annuity at retirement at a guaranteed rate. These contracts typically have participating features during the savings phase but there is no participation once the annuity option vests.

Under IFRS 17, the accounting model applied is determined at inception or, in some circumstances, may be assessed at transition under the modified retrospective and fair value approaches [IFRS 17: B102, C9(b), C21(b)].

The entity's obligations and the policyholder's costs and benefits do not change at the point the annuity vests. Therefore, it is unlikely that the contract boundary requirements in paragraph 34 of IFRS 17 are met at the annuity vesting date. The contract boundary therefore includes both a with-profits savings phase and an annuity pay-out phase that would be accounted for under separate measurement models were they stand-alone contracts. It is likely that some, but not all, of these contracts will meet the VFA eligibility criteria. This is partly dependent on the assessment date and whether the guarantee is 'in the money' at that date.

The primary measurement difference between the GMM and the VFA is that changes in the fulfilment cash flows arising from time value of money and financial risks are:

- regarded as part of the variability of the fee for future service and recognised in the CSM under the VFA [IFRS 17: 45]; and
- recognised immediately in profit or loss as insurance finance income or expense (IFIE) under the GMM [IFRS 17: 87].

Accounting impact

If IFRS 17's contract boundary requirements are not met, then the insurer will not account for a new contract at the vesting date, but rather for a single contract that includes both the savings phase and the annuity pay-out phase. The result of IFRS 17's requirements is that:

- the VFA may be applied to the vested annuity despite there being no significant savings element or underlying items post-vesting (see A below); or
- the entire contract including the participating phase may fail VFA eligibility testing and require measurement under the GMM, despite there being a significant savings element and underlying items prior to vesting (see B below).

The primary measurement difference between the accounting models impacts both the timing and presentation in profit or loss of changes in the fulfilment cash flows arising from time value of money and financial risks:

- Under the VFA, changes will be recognised in line with the provision of service, as the CSM is recognised, through insurance revenue; and
- Under the GMM, changes will be recognised immediately as IFIE.

Scenario B is expected to be more prevalent in the UK since this type of contract was predominantly issued a number of years ago and, since the accounting model will therefore often be determined at transition, it is less likely that the VFA eligibility criteria will be met.

A- Accounting for annuities under the VFA

Adjusting the CSM for changes in the fulfilment cash flows arising from the time value of money and financial risks can reduce the reported CSM. This is because, as the discount rate on the fulfilment cash flows is unwound, the corresponding expense is adjusted against the CSM. Ignoring any changes in discount rates, the unwind of the discounting will increase the likelihood that the CSM reduces to zero and the contracts become onerous, thereby resulting in greater volatility in profit or loss.

Accounting for annuities under the VFA will therefore result in a decrease in insurance revenue, as the reduction in CSM reduces the corresponding amounts recognised in profit or loss.

The risk mitigation option (RMO), under which changes in the effect of the time value of money and financial risks are recognised in profit or loss rather than in CSM, would be effective in reducing these issues, however eligibility is dependent on each insurer's risk management practices.

B- Accounting for with-profits contracts under the GMM

Under the GMM, the unwind of the discounting and changes in financial risks that under the VFA would be within the 'variable fee' earned on with-profits contracts, will be recognised directly in IFIE in profit or loss. This has the opposite effect to that for annuities under the VFA, increasing both insurance revenue (because the CSM is not reduced) and insurance finance expense over the life of the contract.

The fulfilment cash flows during the savings phase will include the future cashflows relating to the annuity pay-out phase, bringing the profit margin that the annuity company or fund expects to make into the CSM. This is likely to introduce mismatches with the returns on backing assets that are managed on a Solvency II basis (which typically includes the cost of the GAO to the with-profits fund at market prices), and which will also be recognised directly in profit or loss.

The additional complexities of including cash flows beyond vesting in with-profits fulfilment cash flows, and applying different accounting models to annuities depending on whether they are stand-alone or arose from a savings contract with a GAO, will increase implementation costs for impacted insurers. However, while these costs may be significant they are not expected to be prohibitive.

Tentative assessment against the technical accounting criteria

Including all phases of the contract in the fulfilment cashflows will faithfully represent all the insurers' rights and obligations that arise from policyholders' options in these contracts, and thereby provide **relevant** information. The inability to reassess the measurement model ensures that IFRS 17 maintains clear and consistent contract boundary requirements across all types of insurance contracts, ensuring **comparability** of financial information.

Treating annuities sold on a stand-alone basis separately from annuities resulting from a savings contract with a GAO reflects the facts that a combined contract might be priced differently from a stand-alone contract, and that pricing is likely to have been at different times and under different market conditions. Further, the annuity may not always vest at pure market rates. IFRS 17's requirements are therefore likely to provide more **relevant** information.

The VFA model was developed by the IASB to give a faithful representation of the different nature of the fee in participating contracts. Therefore, the inability to apply the VFA to the with-profits phase of the contract may be considered to provide **less relevant** information during that phase. However, it would have been difficult to define any exception sufficiently tightly to prevent unintended consequences. Further, any exception would probably have needed to be optional, **impairing comparability**.

Applying the VFA to the non-participating annuity phase of the contract may result in **less relevant** information as the entity's profit from an annuity is not earned as a variable fee. In the annuity pay-out phase, entities apply asset-liability matching strategies, to position themselves to satisfy their performance obligations. If contracts in the annuity pay-out phase are measured under the VFA, movements in the value of assets are reflected in profit or loss, and movements in the value of insurance liabilities will adjust the CSM, resulting in accounting volatility in profit or loss that arguably does not reflect the economic position, resulting in less **relevant** information. However, the risk mitigation option is likely to be effective in reducing these issues. In addition, as explained above, this scenario is likely to be less prevalent.

While a sophisticated user of the accounts might understand how the entity earns profit from with-profits contracts and from annuities, the impact of IFRS 17's requirements means that the accounts may be **more difficult to understand**. In addition, due to the timing of the accounting model determination, some with-profits contracts with GAOs will meet the eligibility requirements for the VFA and others will not. Entities will therefore apply different measurement models to similar contracts, potentially impairing **comparability.**

IFRS 17 requires an entity to disclose quantitative and qualitative information about amounts recognised in its financial statements, any significant judgements and changes in those judgements, and the nature and extent of risks from insurance contracts. An entity must consider the level of detail necessary to satisfy the disclosure requirements and additional disclosures could **mitigate the challenge to understandability and comparability**.

The inability to reassess the accounting model at the annuity vesting point will create the need for significant judgements, including: the likelihood of the annuity option vesting; the apportionment of CSM between the savings phase and the annuity phase; appropriate discount rates given changes in liquidity characteristics and risks between the phases of the contract. This degree of judgement may create a risk to the **comparability** and **reliability** of financial statements. However, IFRS 17 will require significant judgments in a number of areas and those required in this case do not introduce a significant level of additional judgement. A similar level of judgement is also required under current accounting and regulatory reporting.

Other comprehensive income option
IFRS 17 requirements
In accordance with IFRS 17 *Insurance Contracts*, Insurance Finance Income or Expenses (IFIE) mainly comprises the change in the carrying amount of the group of insurance contracts arising from the effect of (and changes in) the time value of money and financial risk. [IFRS 17.87 (a) and (b)] For IFIE *not* arising from Risk Mitigation activities[3], IFRS 17 allows an entity to make an accounting policy choice (the OCI Option) between: a. including IFIE for the period in profit or loss; or b. disaggregating IFIE for the period between profit or loss and Other Comprehensive Income (OCI). [IFRS 17: 88-90] An entity shall apply its choice of accounting policy to portfolios of insurance contracts. In assessing the appropriate accounting policy for a portfolio of insurance contracts, applying paragraph 13[4] of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors,* the entity shall consider for each portfolio the assets that the entity holds and how it accounts for those assets. [IFRS 17: B129] IFRS 17 prescribes three specific approaches or bases of disaggregation of IFIE between profit or loss and OCI, which depend on the method that the entity applies to account for the insurance contract (i.e. the general model, the variable fee approach or the premium allocation approach), and whether it relates to insurance contracts with direct participation features for which the entity holds the underlying items. [IFRS 17: B130-B134 and Illustrative Examples 15 and 16] For insurance contracts with direct participation features, an entity's eligibility for one of the disaggregation approaches may change depending on whether it holds the underlying items. In such circumstances, an entity would change the basis of disaggregation accordingly and IFRS 17 provides specific guidance on how to account for that change. [IFRS 17: B135-B136] ***Disclosures*** An entity shall disclose and explain the total amount of IFIE in the reporting period. In particular, an entity shall explain the relationship between IFIE and the investment return on its assets, to enable users of its financial statements to evaluate the sources of finance income or expenses recognised in profit or loss and OCI. [IFRS 17: 110] If an entity chooses to disaggregate IFIE into amounts presented in profit or loss and amounts presented in OCI, the entity shall disclose an explanation of the methods used to determine the IFIE recognised in profit or loss. [IFRS 17: 118] For contracts with direct participation features, if an entity changes the basis of disaggregation (i.e. when there is a change in whether an entity holds the underlying items), it shall disclose, in the period when the change in approach occurred:

3 IFRS 17 paragraphs B115-B118 provide specific requirements to the presentation of IFIE arising from Risk Mitigation activities, which dictate the presentation in profit or loss depending on the type of instruments used for risk mitigation (i.e. derivatives, non-derivative financial instruments measured at fair value through profit or loss or reinsurance contracts held). However, this are not in the scope of this assessment.

4 IAS 8, paragraph 13, states '*An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless IFRS specifically requires or permits categorisation of items for which different policies may be appropriate. If an IFRS requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category*'.

a. the reason why the entity was required to change the basis of disaggregation;
b. the amount of any adjustment for each financial statement line item affected; and
c. the carrying amount of the group of insurance contracts to which the change applied at the date of that change. [IFRS 17: 113]

Accounting impact

The measurement of insurance contracts under IFRS 17 results in possible accounting mismatches because of the different possible bases of accounting for assets backing the insurance contracts. The OCI Option enables entities to reduce any such accounting mismatches.

If disaggregated, the amount in profit or loss is based on a systematic allocation of the expected IFIE over the duration of the group of insurance contracts. This would allow the partial offset in profit or loss of the IFIE arising from financial assets held by the entity. The remaining amount of IFIE (the impact of changes in financial assumptions, e.g. for interest rates) is presented in OCI. For insurance contracts with direct participation features for which the entity holds the underlying items, an amount that eliminates accounting mismatches is included in profit or loss rather than an amount based on a systematic allocation.

We do not expect the disaggregation of IFIE in profit or loss and OCI to be widely adopted in the UK as we understand that most UK insurers account for the majority of their financial assets at fair value through profit or loss.

Tentative assessment against the technical accounting criteria

In circumstances when it enables insurers to reduce or in certain cases eliminate accounting mismatches between insurance liabilities and their supporting investment assets, disaggregating IFIE between profit or loss and OCI will provide **more relevant and understandable** information. Aligning the accounting treatment of investment assets (which in some cases are accounted for at amortised cost or at fair value through OCI under IFRS 9 *Financial Instruments*) and related insurance liabilities will reduce volatility in profit or loss and enable performance to be interpreted more clearly.

A potential consequence of the OCI Option is that profit or loss becomes a less complete measure of an insurer's economic position and hence could be seen as less **reliable**. Isolating the effect of changes in financial assumptions and reporting it in OCI might make an insurer's profit or loss appear more stable. Investors and other users of financial statements might need to perform additional analysis to fully understand an insurer's overall performance, and entities may need to introduce new accounting ratios or performance measures.

However, the disclosure requirements (including the explanation of the disaggregation methods used to determine the amount of IFIE presented in profit or loss and OCI) will **mitigate this risk to reliability**, enabling users to compare approaches and performance more easily between insurers. Further, the use of OCI to report certain effects of financial reporting is not unfamiliar to users of financial statements (for example, under IAS 39, IFRS 9 or other IFRS Standards), so the accounts should be **understandable**.

The IASB introduced the OCI Option as an accounting policy choice to allow entities to avoid the costs and complexity of using OCI when the benefits of doing so do not outweigh those costs. Any optionality within a standard reduces **comparability**. Similar accounting ratios calculated for different entities may disguise different underlying performance depending on whether the option is adopted. This may impede users from adequately comparing the results of different insurers. Furthermore, the OCI Option is applicable on a portfolio-by-portfolio basis. This means that performance between portfolios will be **less comparable**.

However, it is anticipated that the OCI Option will be more appropriate for certain types of business, depending on the accounting policy applied to the assets backing the insurance liabilities. Therefore, in practice the option may be applied consistently by type of business or by entities employing similar asset/liability strategies. This could mitigate the extent to which **comparability** is compromised across insurers on these bases.

The mechanism for determining the disaggregation between profit or loss and OCI is potentially complex. Entities will need to apply a significant degree of judgement, introducing a risk to the **reliability** and **comparability** of financial statements. However, the standard's requirements do not result in a degree of judgement that is inconsistent with that required under other IFRS Standards, and the disclosure requirements referred to above should serve to mitigate these risks.

Any risks to comparability or reliability need to be balanced against the **enhanced relevance** of the financial information in cases when use of the OCI Option enables entities to reduce or eliminate accounting mismatches. The specific disclosures required by IFRS 17 should also mitigate these risks. Users of insurers' accounts are likely to need to become familiar with new performance measures in any event, as IFRS 17 introduces significant change in a number of areas.

Transition requirements
IFRS 17 requirements
IFRS 17 *Insurance Contracts* requires an entity to restate comparative information about insurance contracts for the annual period immediately before the date of initial application [IFRS 17: C1]. Unless it is impracticable to do so, IFRS 17 requires an entity to apply the Standard retrospectively [IFRS 17: C3]. If, and only if, it is impracticable to apply IFRS 17 fully retrospectively an entity can adopt: a) the modified retrospective approach, or b) the fair value approach. [IFRS 17: C5] The choice of transition method is made at the level of a group of contracts [IFRS 17: C5]. The modified retrospective approach (MRA) permits specific modifications to retrospective application. 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 contractual service margin (CSM) or loss component of the liability for 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]. ***Disclosures*** 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]. An entity is required to disclose separate reconciliations of the contractual service margin and insurance revenue for: c) insurance contracts that existed at the transition date to which the entity has applied the modified retrospective approach; d) insurance contracts that existed at the transition date to which the entity has applied the fair value approach; and e) all other insurance contracts [IFRS 17: 114]. Additional disclosures are required for groups of insurance contracts for which the entity disaggregates insurance finance income or expenses between profit or loss and other comprehensive income [IFRS 17: 116].
Accounting impact
The FVA may result in more significant measurement differences compared to the full retrospective approach (FRA) or MRA. IFRS 13 *Fair Value Measurement* indicates that the fair value includes the profit margin required by a market participant to accept the obligations under the insurance contracts. Therefore, a CSM is likely to arise under the FVA, whereas if the same groups of contracts were measured under the FRA or MRA no CSM might be recognised. An entity's choice between transition approaches will impact shareholder's equity on transition and the release of profit in subsequent periods from the insurance contracts in force at transition. Profits from some groups of insurance contracts may be recognised as an adjustment to equity on transition, bypassing profit or loss. Profits on other groups may be recognised in profit or loss twice, once under IFRS 4 and again through the CSM under IFRS 17.

The higher the CSM on transition, the lower the accumulated profit from groups of insurance contracts recognised in shareholders' equity and the more profit to be recognised in future periods. This may impact the ability of insurers to pay dividends, meet solvency capital requirements or the determination of tax payments. There may also be implications for users of financial statements, in terms of assessing performance of the entity on transition and at future dates. The cost and complexity of the different transition approaches will depend on an entity's circumstances. It is likely to be more expensive to apply the FRA or MRA to insurance contracts issued a significant time before the transition date, whereas the FVA may be more complex than the FRA or MRA for short term contracts and contracts issued close to transition, where the availability of information is greater.
Tentative assessment against the technical accounting criteria
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. Retrospective application is considered to result in **relevant and reliable** information because insurance contracts would be recognised and measured as if IFRS 17 had always been applied. The MRA is not considered to result in significantly less relevant or reliable information than the full retrospective approach because it enables entities to achieve the closest outcome to a full retrospective application, without undue cost or effort. The conditional alternatives permitted under the transition requirements can give rise to a possible **impact on comparability** because of the resulting diversity in practice. The FVA is not a proxy for the FRA or MRA and therefore will not result in an application that is directly comparable. Whilst the MRA intends to achieve an outcome as close to the full retrospective approach as possible, using specified simplifications, the fair value approach aims to determine the CSM in the absence of historical cash flow information. For example, when measuring groups of onerous contracts at the transition date, applying the market participant's view under the FVA is likely to result in recognition of a CSM, because the market participant will need to be compensated to take on the insurance obligations. Therefore, future profits will be recorded on these previously onerous groups of contracts. These profits would not have arisen had a retrospective approach been followed. The availability of the FVA option may reduce the application of the MRA, as preparers elect to apply the FVA, avoiding the need to obtain historical cash flow information and incur associated costs. There is a potential risk that the availability of a choice between the MRA and the FVA will reduce the **reliability** of financial information because preparers may have an incentive to apply an approach because of the impact it has on reported performance. Further, it may be **difficult to measure reliably** the fair value of insurance contracts under the FVA because there is a lack of observable market inputs and the FVA will require a high degree of judgement. The IASB acknowledged that the choice of transition methods would reduce comparability, but noted that if an entity has relatively little reasonable and supportable information available, and would therefore need to use many of the permitted modifications, the cost of the MRA might exceed the benefits [IFRS 17: BC373]. The comparability effects are therefore mitigated by the benefits in terms of practicality, which significantly **enhance reliability** because reliable information cannot be provided in the absence of the required information.

In addition, the reduced comparability could be mitigated by the separate disclosures required for each transition approach that an entity applies. Disclosures are required to enable users to understand the nature and significance of the methods used and judgements applied. These will increase the **reliability, understandability** and **comparability** of the financial statements because they require the separate presentation of different groups of contracts, facilitating analysis and comparison. 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. The IASB has proposed a narrow-scope amendment to IFRS 17 for addressing such a misalignment and to enable entities to improve the usefulness of the comparative information presented on initial application of IFRS 17 and IFRS 9. The proposed amendment is currently under consultation and is expected to be finalised before the end of 2021.

Other VFA issues: (i) Ineligibility of reinsurance contracts for VFA

IFRS 17 requirements

The variable fee approach (VFA) was introduced to account for insurance contracts with direct participation features. In these contracts, the insurer shares in the performance of underlying items with the policyholders. The VFA modifies the general measurement model (GMM) in IFRS 17 to reflect that these contracts are substantially investment-related service contracts, and that the entity charges a fee for those services, based on its share of the fair value of the underlying items.

IFRS 17 defines insurance contracts with direct participation features [IFRS 17: B101] and requires the VFA eligibility assessment to be performed at an individual contract level.

Reinsurance contracts held and reinsurance contracts issued cannot be insurance contracts with discretionary participation features under IFRS 17 [IFRS 17: B109] and are therefore ineligible for the VFA. The IASB noted that an entity and the reinsurer do not share in the returns on underlying items, so reinsurance contracts held do not meet the VFA eligibility criteria in paragraph B101 of IFRS 17. Furthermore, the IASB considered that a reinsurance contract held should be accounted for separately from the underlying insurance contracts issued [IFRS 17: BC248].

Disclosures

Entities applying the VFA are required to make additional disclosures about the composition of the underlying items and their fair value [IFRS 17: 111].

If an entity chooses to apply the risk mitigation option in paragraph B115 of IFRS 17, it is required to disclose the effect of that choice on the adjustment to the CSM in the current period [IFRS 17: 112].

Accounting impact

Reinsurance contracts held are measured under the GMM. 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. Under the VFA, the impact of changes in financial risks (including the time value of money) adjust the CSM [IFRS 17: 45; B113], whereas under the GMM the impact of such changes are recognised directly in profit or loss.

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, when applying the VFA an entity may choose not to recognise in the CSM the effect of some or all of the changes in 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.

The RMO may be applied when reinsurance contracts held are used to mitigate financial risk as part of a previously documented risk-management objective and strategy [IFRS 17: B116].

Feedback received notes that there are instances of reinsurance transactions in the UK when the reinsurer is responsible for tracking and providing the benefits that are ultimately paid under the underlying VFA contracts. This might occur, for example, in intra-group reinsurance arrangements or when a book of with-profits business is disposed of and reinsurance is put in place prior to a formal legal transfer becoming effective. In such instances, some stakeholders consider the reinsurance contracts might meet the VFA eligibility criteria described in paragraph B101 of IFRS 17, but this would be overridden by the prohibition imposed by paragraph B109 of IFRS 17.

Tentative assessment against the technical accounting criteria
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**. However, accounting for reinsurance contracts held independently from the corresponding underlying contracts issued appropriately reflects the entity's separate contractual rights and obligations, thereby ensuring a more faithful representation and **enhancing reliability**. Accounting for the reinsurance contract held under the VFA simply because the underlying contracts were eligible for the VFA would not give a faithful representation of the entity's contractual position (because the entity and the reinsurer do not share in the returns on underlying items) and hence could impair reliability. When reinsurance is a means of transferring the economic risk and reward of the underlying VFA portfolio to the reinsuring entity, such contracts could meet the VFA eligibility criteria set out in IFRS 17. However, the specific prohibition on measuring reinsurance under the VFA may result in such contracts being accounted for under a measurement model that does not reflect the intended economic effect of the transaction. In such instances the information is likely to be less **relevant**. However, application of the RMO is expected to eliminate most of the accounting mismatches that could arise from applying the VFA to the underlying insurance contracts and the GMM to the reinsurance contracts held, although it may not remove them entirely. IFRS 17 therefore provides a means to **mitigate this risk to relevance.** Furthermore, if such mismatches arise from intra-group arrangements they are unlikely to affect the consolidated accounts prepared for investors and other external users of the accounts. If residual mismatches arise in connection with disposals, they are likely to be short-term and if material can be explained by way of additional disclosures. Removing the prohibition on applying the VFA to reinsurance contracts might give rise to other unintended consequences that would need addressing.

Other VFA issues: (ii) Prohibition of retrospective application of the risk mitigation option
IFRS 17 requirements
Under the VFA, the impact of changes in financial risk on the entity's share of underlying items adjusts the CSM. If an entity uses certain contracts to mitigate financial risk, however, the impact of changes in financial risk on those items is recognised directly in profit or loss. Subject to certain conditions in paragraph B116 of IFRS 17, the standard permits an entity, when using the VFA, to apply the risk mitigation option (RMO) to reduce such accounting mismatches. Applying the RMO, an entity may choose not to recognise in the CSM the effect of some or all of the changes in the time value of money and financial risk. The effect is instead recognised directly in profit or loss [IFRS 17: B115]. 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, B116]. 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: C3(b)]. If certain conditions are met, an entity that could otherwise apply IFRS 17 retrospectively is permitted instead to apply the fair value transition approach to groups of insurance contracts with direct participation features. The conditions are that the entity must choose to apply the RMO to the groups prospectively from the transition date and, prior to the transition date, the entity must have been using derivatives, reinsurance contracts held or non-derivative financial instruments measured at fair value through profit or loss to mitigate financial risk arising from the group of insurance contracts [IFRS 17: C5A]. **Disclosures** If an entity chooses not to adjust the CSM for some changes in the fulfilment cash flows, applying paragraph B115 (i.e. applying the RMO), it must disclose the effect of that choice on the adjustment to the CSM in the current period.
Accounting impact
The inability to apply the RMO in periods before the transition date may result in mismatches between changes in the value of assets and liabilities, even though entities may have adopted risk mitigation strategies. The impact of changes in financial variables on insurance liabilities will be recognised in the CSM on transition, but the corresponding impact of changes in measurement of related assets will be recognised in retained earnings. Applying the fair value approach to transition, this mismatch 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 instruments) will be measured at fair value. Therefore, equity on the transition date reflects the impact of previous changes in financial variables on both the fulfilment cash flows and the fair value of the financial instruments.
Tentative assessment against the technical accounting criteria
Stakeholders have expressed concerns that the inability to apply the RMO to periods prior to transition will lead to a distortion of brought-forward amounts, in particular retained earnings and the CSM. Mismatches between changes in value of assets and liabilities may arise on transition even when entities are adopting risk mitigation strategies. The

presence of these accounting mismatches may make financial statements less **understandable** to users.

The RMO was introduced to more effectively represent the economic effects of the entity's transactions and therefore to reduce accounting mismatches arising from the treatment of insurance liabilities and the instruments used to hedge them. The inability to apply the RMO retrospectively could result in less **relevant** information as accounting mismatches could arise on transition to IFRS 17.

However, consistent with the transition requirements for hedge accounting in IFRS 9 *Financial Instruments*, the IASB concluded that retrospective application of the RMO would give rise to the risk of use of hindsight. This risk is heightened by the fact that the application of the RMO is optional and documentation after the event would enable entities to elect the risk mitigation relationships to which they would apply the option (IFRS 17: BC393). Therefore, prohibiting retrospective application of the RMO reduces the risk of bias and results in **more reliable** financial information.

The prohibition of retrospective application of the RMO has the potential to **reduce comparability** between the accounting for groups of insurance contracts for which entities apply risk mitigation before and after the transition date (IFRS 17: BC393B). The RMO can be applied prospectively, reducing accounting mismatches arising on or after the transition date, but accounting mismatches present prior to transition will not be eligible to be mitigated.

However, if it had been permitted, retrospective application of the RMO would have been optional, so might have given rise to other concerns about comparability in any event. Further, the option to apply the fair value approach to transition under IFRS 17: C5A will enable entities to avoid the distortion related to risk mitigation activities from previous periods. This option may be appropriate in some circumstances and for some types of contracts, mitigating concerns over the relevance of financial information.

Other VFA issues: (iii) Eligibility for VFA when there are mutualised cash flows
IFRS 17 requirements
IFRS 17 requires insurance contracts with direct participation features to be accounted for under the VFA. Contracts with direct participation features are substantially investment-related service contracts under which an entity promises an investment return based on underlying items. These contracts are characterised by: the policyholder participating in a share of a clearly identifiable pool of underlying items; the expectation that the policyholder will receive a substantial share of the fair value returns on the underlying items; and the payments to policyholders varying with the change in fair value of the underlying items [IFRS 17: B101]. Paragraph B107 of IFRS 17 requires an entity to perform the assessment for VFA eligibility at a contract level, rather than at the level of the group of insurance contracts. If insurance contracts in a group affect the cash flows to policyholders of contracts in other groups, when assessing whether an insurance contract meets the eligibility requirements for the VFA, the Standard requires an entity to consider the cash flows that the entity expects to pay the policyholders determined by applying paragraphs B68-B70 [IFRS 17: B103]. 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. The fulfilment cash flows of Group A would include the payment of CU100 (i.e. would be CU 350) and the fulfilment cash flows of Group B would exclude the amount of CU100.
Accounting impact
The eligibility assessment under IFRS 17: B101 determines whether contracts are measured using the VFA. In the case of mutualised insurance contracts, two opposing views have arisen to determine the cash flows the entity expects to pay to the policyholder when performing the VFA eligibility assessment: • *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 CU250 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). Stakeholders suggest that Approach 2 (performing the VFA eligibility assessment based on pre-mutualisation cash flows) will result in more contracts being eligible for the VFA than Approach 1. On transition to IFRS 17, the date of assessment for VFA eligibility of a contract depends on the transition approach applied. The assessment date used may also affect whether or not a contract meets the VFA eligibility requirements. For example, a savings contract with investment guarantees which are in-the-money at the transition date but not in the money

at inception might satisfy the variability criterion under B101(c) if assessed at inception but not if assessed at the transition date. The VFA eligibility assessment is particularly relevant to UK with-profits business. Although most UK with-profits funds are closed to new business, there are still significant assets under management within with-profits funds where there is mutualisation of cash flows.
Tentative assessment against the technical accounting criteria
The **relevance** and **understandability** of financial information is increased if insurance contracts are accounted for under an accounting model that is designed for the characteristics of the insurance contracts. The VFA eligibility criteria help ensure that the VFA is applied only to contracts that are substantially investment-related service contracts with direct participation features. Stakeholder feedback indicates that Approach 2 above is likely to lead to appropriate accounting outcomes for many products. IFRS 17 may be open to interpretation when determining which estimated cash flows to include when performing the VFA eligibility assessment. There is a risk that the different interpretations of the standard's requirements will result in a divergence in practice, **reducing comparability**, because insurance contracts sharing similar characteristics will be accounted for under different measurement models by different entities. However, the assessment of VFA eligibility is already an area of significant judgement so this particular aspect of the assessment may not result in a material additional impairment of comparability. Further, stakeholder feedback suggests that, when facts and circumstance align, there is likely to be industry consensus on the applicable approach, mitigating concerns about comparability. The fact that different approaches to transition may affect the VFA eligibility assessment also has the potential to result in inconsistent application in practice, **reducing comparability**. However, when an entity does not have reasonable and supportable information to apply a fully retrospective transition approach, the choice of which date to apply the VFA eligibility assessment on transition permits entities to apply judgement and measure the contracts under the measurement model that more closely aligns with the characteristics of the contracts, thereby **enhancing relevance**.

Other VFA issues: (iv) Non-profit contracts written by a with-profits fund

IFRS 17 requirements

As noted above (see *Other VFA issue (iii): Eligibility for VFA when there are mutualised cash flows*), IFRS 17 requires insurance contracts with direct participation features to be accounted for under the VFA. Contracts with direct participation features are substantially investment-related service contracts under which an entity promises an investment return based on underlying items.

These contracts are characterised by: the policyholder participating in a share of a clearly identifiable pool of underlying items; the expectation that the policyholder will receive a substantial share of the fair value returns on the underlying items; and the payments to policyholders varying with the change in fair value of the underlying items [IFRS 17: B101].

For insurance contracts with direct participation features, the CSM is adjusted by the change in the amount of the entity's share of the fair value of the underlying items [IFRS 17: 45(b)]. The entity's obligation to the policyholder is the net of (a) the obligation to pay the policyholder an amount equal to the fair value of the underlying items and (b) a variable fee that the entity deducts from (a). [IFRS 17: B104]

In some cases, non-participating insurance contracts ('non-profit contracts') have been written by with-profits funds. Under these arrangements, profits and losses from such non-profit contracts sometimes accrue to an inherited estate, and sometimes to the with-profits policyholders. In the latter case, this means that the non-profit contracts function as underlying items for the with-profits contracts.

IFRS 17 does not include any specific requirements addressing this scenario.

Accounting impact

In cases when surpluses from non-profit contracts accrue to with-profits policyholders, as 'underlying items' for the with-profits contracts the non-profit contracts must be measured at fair value for the purpose of the VFA accounting. This may result in an accounting mismatch with the measurement of the non-profit contracts as insurance contracts in their own right under IFRS 17.

For example, the measurement of the non-profit contracts as insurance contracts will generally involve the release of risk adjustment and CSM to profit as revenue. These amounts are unlikely to precisely match (offset) the change in their fair value as underlying items, reflected in the VFA accounting for the with-profits contracts and included as insurance finance expense. While ultimately a timing issue which unwinds, the mismatch will impact reported profit for the periods affected.

Tentative assessment against the technical accounting criteria

Stakeholders acknowledged the likelihood of accounting mismatches arising under IFRS 17, as described above. In principle, accounting standards should avoid creating accounting mismatches, as they can **impair relevance and understandability**.

However, mismatches in some specific cases are an inevitable consequence of the mixed measurement framework that underpins IFRS.

In discussions with stakeholders at the UKEB's Insurance Technical Advisory Group, members of that group noted that such an accounting mismatch might also occur with other types of underlying items, whenever such investment assets were not accounted for at fair value. Further, these stakeholders noted that accounting mismatches occurred in other areas of accounting so the scenario was not unique.

In considering this issue during the finalisation of the standard, the IASB decided not to create exceptions to the normal requirements because doing so would add significant complexity to the standard and would risk unduly disrupting implementation.

We understand that this specific issue affects only a very small number of entities and, overall, risks to relevance and understandability need to be balanced against the objective of reducing complexity.