Insurance Technical Advisory Group

Meeting Summary – 16 March 2021

Meeting held virtually

Attendees

Members

Jo Clube (Aviva plc)

Richard Crooks (Legal & General Group Plc)

Stuart Reilly (Direct Line Group Plc)

Danny Clark (KPMG)

Gail Tucker (PwC)

Kevin Griffith (EY)

Mark Spencer (BDO)

Tony Silverman (AM Best)

Sian Morgan (Columbia Threadneedle Investments)

Wijdan Yousuf (Aon)

Anju Bell (Willis Towers Watson)

Vasilka Bangeova (Guy Carpenter & Company Limited)

Andrew Spooner (Deloitte)

Guests

Anne McGeachin (IASB)

Roberta Ravelli (IASB)

Gillian Starkie (M&G)

Richard Olswang (Prudential)

Observers

Andrew Murray (Bank of England)

UK Endorsement Board

Seema Jamil O'Neill (Technical Director)	UK Endorsement Board secretariat (Chair)
Pauline Wallace (Chair of UKEB)	UK Endorsement Board
Peter Drummond (Senior Project Director)	UK Endorsement Board secretariat
Justin Ryan (Project Director)	UK Endorsement Board secretariat
Dean Battersby (Project Manager)	UK Endorsement Board secretariat
Caroline Federer (Project Manager)	UK Endorsement Board secretariat

Absent

Dean Buckner (UK Shareholders' Association)

1. Welcome and update from secretariat

- The Chair welcomed attendees and the external presenters to the meeting. Anne McGeachin and Roberta Ravelli from the IASB had joined the meeting to present item 2 on the agenda on the level of aggregation in IFRS 17. Richard Olswang and Gillian Starkie had been invited to assist the TAG in its discussions on with-profits issues.

- The Chair updated the TAG on the UK Endorsement Board (Board) set up process. The recruitment for the Board was underway, with interviews completed. Appointments were the responsibility of the Department for Business, Energy and Industrial Strategy and an announcement was expected during the month.

2. IFRS 17 level of aggregation (including annual cohorts)

- International Accounting Standards Board (IASB) staff presented a paper on the IFRS 17 level of aggregation (including annual cohorts). Key points raised in the presentation were:

    - The insurance business model is one of risk-pooling and risk sharing. Measuring profitability on an individual contract level may not reflect this, therefore some level of aggregation was appropriate.

    - The annual cohort requirement is essential to ensure insurance contracts are not aggregated at too high a level, such that useful information about profitability is lost.

    - The IASB received stakeholder feedback that annual cohorts are costly and do not result in useful information in some cases because annual cohorts:

        - do not reflect profit-sharing across generations;

        - require arbitrary allocations; and

        - could inappropriately depict some cohorts as onerous.

    - Stakeholders proposed exemptions for:

        - variable fee approach (VFA) contracts to which the requirements of paragraph B67 of IFRS 17 apply, and when the entity has discretion over the timing and allocation of the total policyholders' profit share to individual policyholders;

        - contracts that are managed under cash flow matching techniques; and

        - a combination of the above.

    - The IASB concluded that annual cohorts did result in useful information for such contracts. In particular, annual cohorts do reflect profit-sharing across generations and depict cohorts as onerous when it is appropriate to do so. Allocations are required in some circumstances, but that is not unusual in applying the requirements of IFRS 17, and relatively straightforward methods of allocation can be found.

- The IASB also considered whether an exemption was justified for some contracts because of costs versus benefits. The principal reasons why the IASB did not agree with stakeholder views were that:

  - The IASB identified only a very limited population of contracts which held features that increase the costs of applying the annual cohort requirement compared to other contracts and/or reduce the usefulness of the resulting information.

  - Even for the contracts identified by stakeholders, the IASB did not conclude the costs of annual cohorts outweighed the benefits, only that the costs and benefits were finely balanced.

  - It was not possible to specify an exemption to the Standard without the use of 'bright lines' which would be arbitrary and difficult to justify, and without developing a particularly complex set of criteria. Hence, an exemption would come under pressure and would run too great a risk of a substantial loss of useful information.

  - The IASB concluded that the costs to investors of any exemption from the requirement would be excessive, in terms of the risk of the loss of critical information and the difficulty in assessing the effect of the exemption.

- The IASB had carried out extensive discussions and due process in response to feedback received on annual cohorts.[1] [2] [3]

- The following points were noted during the ensuing discussion:

  - Several TAG members expressed their support for annual cohorts, citing the key benefit that they provide information regarding profitability trends and loss-making contracts, which is useful to investors and other users of financial statements in assessing performance.

  - One TAG member noted that, for life insurance contracts, measurement of the contractual service margin (CSM) on initial recognition can be determined in a straightforward way, using a marginal approach. However, separate

[1] Agenda paper 2A: March 2019 IASB Board meeting https://cdn.ifrs.org/-/media/feature/meetings/2019/march/iasb/ap2a-amendments-to-ifrs-17.pdf

[2] Agenda Paper 2B: February 2020 IASB Board meeting https://cdn.ifrs.org/-/media/feature/meetings/2020/february/iasb/ap2b-amendments-to-ifrs.pdf

[3] Article by Hans Hoogervorst: Why annual cohorts? https://cdn.ifrs.org/-/media/project/amendments-to-ifrs-17/inbrief-ifrs17-factsheet-april2020.pdf?la=en

measurement of the CSM for individual annual cohorts is highly complex to maintain for subsequent measurement.

  - European with-profits funds are largely based on amortised cost returns and retain some intergenerational mutualisation. After policyholder guarantees and fees are deducted, the returns on the underlying assets are shared equally across all cohorts. As these funds are managed on an aggregate level the profit attribution to each annual cohort would require complex, iterative calculations at each measurement period. The TAG member considered this to be operationally onerous and not outweighed by the benefits provided by annual cohorts.

  - By comparison, UK with-profits products have different characteristics and, in general, are managed at a more granular level. As a consequence, annual cohorts do not present the same operational challenges in the UK.

  - The one-year duration of an annual cohort aligns with the frequency of annual financial reporting. Although the duration may be arbitrary, it would be difficult to define a more appropriate time period and still maintain the reporting of useful information about performance.

  - One TAG member commented on the stakeholder proposal for an exemption for contracts managed under cash flow matching techniques. They expressed concern that the definition was too broad. Asset-liability matching is fundamental to life insurance contracts and such an exemption would therefore capture a significant number of contracts and result in an unacceptable loss of useful information.

  - A TAG member agreed with the IASB that it would be difficult to define the scope of any exemption.

3. Non-profit business in a with-profit fund

- The secretariat noted that this paper had been brought to the TAG in January 2021 but that discussions regarding it had not been completed. This is therefore a continuation of the previous discussion.

- The paper considered non-profit business written in a with-profit fund that was open to new business. It considered scenarios where surpluses of the non-profit business accrued to with-profit policyholders as well as where surpluses accrued to the inherited estate. Each of these scenarios led to different concerns but in each case the difficulties stemmed from the fact that the non-profit contracts functioned as underlying items for the with-profit fund.

- The paper focused on non-profit annuities written in the with-profit fund. Key points raised in the paper were:

  - There was uncertainty over the accounting for the non-profit annuity contracts written in the with-profit fund, including whether the risk adjustment and CSM should reflect the risk and profit from the whole contract or only the shareholders' share.

- In cases where profits from the non-profit business accrued to the inherited estate, IFRS 17's requirements would appear to result in the shareholders' interest (and potentially also the policyholder's interest) being recognised as profit before shareholders had any right to it.

- In cases where profits from the non-profit business accrued to with-profit policyholders, a mismatch would arise between the measurement of the non-profit contracts using IFRS 17 principles and their valuation as underlying items for the with-profit contracts (at fair value).

- The secretariat confirmed that on balance, the majority of TAG members had agreed:
  - The CSM and risk adjustment ("RA") of the underlying items (in this case, the annuity contracts), should be measured at a contract level and not just the shareholders' share; and
  - Profits arising on such contracts should be recognised in equity, however there was uncertainty surrounding the measurement of that profit.

- The main issues raised in the paper but not covered in January were:
  - The accounting outcome of a subsequent distribution out of the inherited estate; and
  - The mismatch that arose in cases where profits from the non-profit annuity accrued to with-profit policy holders.

- The paper set out the view that IFRS 17 appears to result in 100% of the profit from the non-profit annuity being recognised in shareholders' equity, as there is no clear mechanism to recognise the profits accruing to the inherited estate as a liability (for example using IFRS 17 paragraph B71).

- A subsequent distribution from the inherited estate, which includes the profits noted above, would by necessity lead to an increase in fulfilment cash flow liabilities as the amount had already been recognised in equity. This would result in a loss which seemed inappropriate based on the view that the profits should not have been recognised originally.

- So far as the shareholders' share was concerned, it was unclear whether this should be treated as a distribution or whether a CSM should be recognised which would unwind over the life of the contract. However, in order to recognise a CSM, a loss must be recorded which would again seem inappropriate.

- The following points were noted during the ensuing discussion:
  - One TAG member raised the point that this issue arises where non-profit annuities "back" the estate, which was a rare occurrence.

- A TAG member noted that while profits from the non-profit annuities might properly be recognised as equity, explanations as to why this was so would be needed for users to understand the position.

- One TAG member noted that once the distribution obligation arises, a loss will be recognised which is a 'contra' to the prior period credit recognised and, as such, is required to appropriately account for such transactions.

- One TAG member highlighted that the expectation would be for profits under the annuity contract to be recognised as equity and that, as profits were earned and payments to policyholders were made, the fair value of the contracts would decrease. In cases where profits from the annuity contracts accrued to the with-profit policyholders, this would result in an increase in the with-profits insurance contract liability under the VFA model. There may therefore be a degree of offset between the accounting for the annuity contracts and the with-profit contracts; however, there was likely to be some remaining mismatch.

- So far as the recognition of a liability for the policyholders' share of the annuity profits was concerned, some TAG members argued that this situation should not be treated differently to other insurance contracts. In their view, the mutualisation paragraphs in IFRS 17 did not need to be engaged to permit a liability to be recognised. Any distributions made should not cause losses to be recorded at the point the distribution obligation arose as the distribution was expected at inception of the contract. In other words, this would have been included in the initial measurement of the liability as part of the fulfilment cash flows.

- One TAG member noted that disclosure should be made for amounts which insurers cannot access. Another TAG member agreed that a distinction could be made in equity for these types of insurance contracts.

- TAG members agreed if a liability for the policyholders' share of the annuity profits could be recognised in such instances, the issues set out in the paper would not arise. However, if this could not be done, the best solution would be for qualitative, explanatory disclosures to be made.

- There was acknowledgement that the accounting recognition of profit from the non-profit annuities may give rise to tax liabilities. TAG members noted that IFRS 17, as a complete standard, will give rise to tax consequences as UK corporation tax is generally based on accounting profits. However, TAG members considered that this was a tax policy issue and did not require an accounting solution.

- TAG members agreed that an accounting mismatch does arise in cases where profits from the non-profit annuity accrued to with-profit policy holders. However, it was not possible currently to form a view as to the size of the potential mismatch.

Conclusion

- The Chair highlighted the complexity of this issue. She requested that a worked example should be drafted to allow the TAG to test the questions and conclusions that had arisen from the discussions on this topic so far. It was agreed that a worked example will be brought to a future TAG meeting for discussion.

4. Minutes of previous meeting

- The minutes of the previous meeting were presented for approval by the TAG. TAG members had had only limited opportunity to comment on the minutes. The secretariat asked for any remaining comments to be submitted before the 19 March for inclusion in the final minutes.

5. Draft endorsement criteria assessment – structure

- The secretariat presented a paper which set out the proposed structure of the draft endorsement criteria assessment (DECA) and asked TAG members for comments.
- The following points were noted during the ensuing discussion:
    - TAG members were generally supportive of the proposed structure.
    - TAG members supported adopting an exceptions-based approach to the reporting of the assessment against the four qualitative characteristics but noted that the assessment within the DECA should be balanced. Additionally, they emphasised the need for this approach to be explained clearly in the executive summary, highlighting when topics have been discussed because they are integral features of the Standard, to ensure adequate due process, and to confirm they do not raise endorsement concerns.
    - TAG members questioned whether it was appropriate to include conclusions for each technical topic area throughout the DECA, or whether there should be one overall conclusion.
    - The DECA should emphasise that IFRS 17 introduces a step change in disclosure requirements from IFRS 4.
    - As part of the assessment of the standard, the DECA should include discussion about whether the resulting financial statements will assist users in assessing the stewardship of management.
    - Where necessary, the assessment of true and fair view should consider both individual entity and consolidated financial reporting.

6. Forward agenda

- The secretariat highlighted to the TAG members that volunteers were still sought to assist with the topics relating to transition. TAG members were reminded that papers could be prepared in conjunction with another TAG member.
- TAG members suggested that certain accounting issues faced by Lloyds of London entities and mutuals should be added to the forward agenda. The secretariat agreed to consider the extent to which these topics raised endorsement concerns.
- TAG members were invited to direct any other comments on the forward agenda to the secretariat by email.

7. AOB

- The secretariat intended to publish short biographies of TAG members on the UKEB website soon.

End of meeting