

Industry responses to the 2019 IFRS 17 Exposure Draft

October 2019



Introduction

Following the publication of the IFRS 17 Standard (**‘the Standard’**) in May 2017, the industry identified a number of issues during implementation programmes. During the first quarter of 2019, the IASB considered a range of issues that were raised by industry participants and it issued an Exposure Draft (**‘ED’**) in June 2019 outlining a number of proposed amendments. Milliman consultants produced summary papers covering each of the proposed amendments, the links to which can be found at the end of this paper.

The consultation period for the ED closed on the 25 September 2019. The IASB received 119 individual responses to the ED. In this paper we briefly discuss the main themes from these responses.

Of those that responded, two of the key stakeholder organisations that have issued comment letters were:

- the European Financial Reporting Advisory Group (**‘EFRAG’**), the organisation responsible for advising the European Commission on the endorsement of IFRS 17 within the European Union (**‘EU’**)¹; and,
- the European Insurance CFO Forum (**‘the CFO Forum’**), a body representing the views of 23 of Europe’s largest insurance companies, written in collaboration with Insurance Europe, the European insurance and reinsurance federation that represents the 37 national insurance associations within the EU².

This note summarises some of the key points and remaining issues raised during the consultation and, in particular, those raised by EFRAG and the CFO Forum, which included:

- Further extension of the ability for reinsurance to offset losses on onerous contracts, in particular around the definition of “proportional”;
- Reinsurance qualifying for Variable Fee Approach (**‘VFA’**);
- Annual cohorts – particularly for mutualised contracts;
- Presentation: frequency for solo and group entities;
- Transition modifications, including use of other simplifications; and retrospective application of the risk mitigation option on transition; and
- Further extension to the effective date of IFRS 17.

¹ IASB ED/2019/4 Amendments to IFRS 17 – EFRAG comment letter

The following sections describe each of these issues in further detail.

Reinsurance on onerous contracts

The treatment of reinsurance contracts held under IFRS 17 is fundamentally different to the existing accounting treatment of such contracts in many cases. Under IFRS 17 entities are required to account for, and assess the profitability of, reinsurance contracts held entirely separately to the underlying contracts that have been reinsured.

One key issue that arose from the original wording of IFRS 17 was where an entity has written loss making insurance contracts which become profitable when a reinsurance contract is taken into account. This could happen where a reinsurer has more data upon which to price the contracts and/or can take greater credit for diversification reducing the reinsurer’s cost of capital.

Where a group of insurance contracts are onerous at initial recognition they are recognised as a loss in the P&L, however, where such contracts are reinsured, any gain on the reinsurance contract is recognised over the coverage period of the reinsurance contract, leading to mismatches in profit recognition.

Paragraph 66(c)(ii) of IFRS 17 does allow an insurer to recognise offsetting profit from a reinsurance contract should the underlying contracts become onerous *after* initial recognition and so the IASB proposed to extend this paragraph to allow the same offset for underlying contracts that are onerous *at* initial recognition. However, this only applies for reinsurance contracts held that provide “proportionate” coverage and where the reinsurance contract was written at the same time as, or before, the underlying contracts.

Although the industry has welcomed this proposal, and the fact that it goes some way to resolve the accounting mismatch, there is concern over the scope of this amendment. In particular, regarding the definition of proportional. The proposed wording looks to only include contracts for which a fixed percentage of all claims on an underlying contract is reinsured, however, this excludes a large number of reinsurance contracts for which the same principles would apply. For example, a contract where the fixed percentage only applies after an initial threshold level is breached or a single reinsurance contract that covers a range of underlying groups of insurance contracts.

Both comment letters mention this point and suggest alterations to the definition of “proportionate” reinsurance contracts. Without such an alteration the general feeling is that the amendment

² IASB ED/2019/4 Amendments to IFRS 17 – CFO Forum / Insurance Europe comment letter

would not be able to be applied in practice in many cases leaving the issue of accounting mismatches very much alive.

Reinsurance qualifying for the VFA

A further accounting mismatch arises under IFRS 17 as a result of the restriction to the scope of the VFA in respect of reinsurance contracts. This occurs where the underlying contracts are measured using the VFA but the reinsurance contract held is measured using the General Model. The mismatch arises as the Contractual Service Margin ('CSM') behaves differently depending on the measurement model applied leading to an accounting mismatch rather than an economic mismatch.

The IASB are of the view that reinsurance contracts held do not meet the eligibility criteria for the VFA and therefore did not propose to expand the scope of the VFA to include such contracts. Instead the IASB proposed to extend the scope of the risk mitigation option in IFRS 17 to include reinsurance contracts held that mitigate the financial risk on the underlying contracts, in addition to derivative contracts (as is currently the case).

Responses to the ED indicate that many industry participants still feel that there are cases where reinsurance contracts held meet the criteria for the VFA. This is particularly in relation to intra-group reinsurance where the reinsurer holds the underlying assets. However, currently Paragraph B109 specifically disallows this approach.

Annual cohorts

The requirement of the Standard for companies to use annual cohorts for the valuation of insurance contracts has been a contentious one. The IASB considers that the use of annual cohorts is necessary to both avoid a loss of useful information about trends in profitability, and reduce the possibility that the CSM could outlast the coverage period of the contract [see BC173 of the ED].

Industry had argued that the requirement to use annual cohorts significantly increases the cost and complexity of implementation without commensurate benefit to the users of the financial statements. The additional cost and complexity arises from the need to calculate the CSM at cohort level and therefore the additional cohorts that companies will have to calculate and track over time. Companies can also have significant data challenges in allocating historic cashflows to annual cohorts as the cashflows may not have been recorded at this level in companies' systems.

Some stakeholders proposed a more principles-based approach, whereby companies could combine cohorts if they have reasonable and supportable information for concluding that contracts issued more than one year apart would be classified in the same profitability bucket.

In addition, some stakeholders proposed that contracts using the VFA, or groups of contracts that share returns on assets across generations (e.g. with-profits business) be exempt from the requirement to use annual cohorts. The basis for this is that in some cases a group of contracts can only become onerous if the entire portfolio is onerous.

In the basis for conclusions on the ED, the IASB explained that it had considered these points and concluded that the additional information provided by the use of annual cohorts was sufficiently useful to justify the additional costs.

EFRAG considers that the requirement to use annual cohorts leads to unnecessary costs in some cases, particularly for contracts with profit/risk sharing. Most of these contracts in Europe are eligible for the VFA. In other cases the issue relates to contracts that would apply the general model and where cash flow matching techniques are applied across generations.

In addition to the concerns over costs and complexity, industry also noted that:

- The splitting of mutualised business into annual cohorts is artificial and not in line with how the business is managed and the economics of the contracts;
- The use of annual cohorts does not reflect how such contracts are priced and how their risks are managed; and
- There would be issues in applying the transition exception to use annual cohorts for such business.

EFRAG believes that it is worth reconsidering the requirement to use annual cohorts for such contracts and recommends that the IASB consider developing an appropriate solution for them. EFRAG also proposed additional disclosures to enhance the information provided for contracts that might be in scope of the solution including disclosure of:

- The grouping criteria;
- Profitability trends; and
- Information on the actuarial techniques used to compute the CSM effect of new business and the method used for assessing the value of new business and profitability trends.

Presentation

The IASB proposed to amend paragraph 78 of the Standard, which requires companies to separately present in the statement of financial position the value of groups of insurance contracts that are assets and those that are liabilities as at the reporting date.

The proposed change would instead require companies to present the value of portfolios of insurance contracts that are assets and those that are liabilities. Therefore companies would

only need to carry out the assessment at a portfolio, instead of group, level.

EFRAG's view is that the proposed change significantly simplifies the reporting process and will reduce the cost of implementation without significantly reducing the information available. A majority of users that EFRAG contacted did not object to this change.

Transition issues

The presentation of the balance sheet on the transition to IFRS 17 is an important objective. The levels of the CSM, risk adjustment and other comprehensive income and retained earnings as per the transition give insight in the potential future dividends and financial performance. The default solution for the determination of the amounts is the full retrospective approach. That approach requires that companies reconstruct the historical balance sheets and income statements from the initial recognition of blocks of business. The full retrospective approach requires a significant amount of data and models. If the condition of impracticability (paragraph C5) is met, an alternative approach can be applied (either the modified retrospective approach or the fair value approach to transition).

For contracts with direct participating features, the amount of CSM and retained earnings is impacted by the application of the risk mitigation option as specified in paragraphs B115 and B116. The IASB proposes to allow entities to apply the fair value approach as the default option for portfolios with direct participating features if the entity chooses to apply the risk mitigation option prospectively from the transition date and has used derivatives or reinsurance to mitigate financial risk before the date of transition.

This option reduces the complexity of the transition which may be caused by the full retrospective approach for products with direct participating features. The VFA, which is applied for products with direct participating features, will likely be applied by many entities. For entities which also hold the underlying items, the transition will become more balanced because the amount of OCI of the liabilities can be set equal to the OCI of the assets.

On the other hand, for entities that prefer to apply the modified retrospective approach because that approach is a better reflection of the financial position of the entity, the Standard does not allow the risk mitigation option to be applied retrospectively. This will likely lead to different amounts for the CSM and retained earnings.

The feedback received from the industry is that they welcome the proposal from the IASB, but are of the opinion that the modified retrospective approach is too strict and should leave more room for the industry to determine the amounts at the transition. That includes how the risk mitigation was applied in

the past and the accounting of the results. Another comment is that, although the definition of risk mitigation now includes reinsurance, hedging is also done with non-derivatives. Especially for business with high guarantees, fixed income instruments may have been used to hedge the interest rate risk. The inclusion of non-derivatives will reduce the volatility of the CSM for business with high guarantees.

Another proposal of the IASB is related to liabilities for claims incurred for acquired business or business combinations. The ED provides the option to categorise the liability for these claims as a liability for incurred claims instead as liability for remaining coverage.

Generally, an important objective of acquisitions is to integrate portfolios going forward, but also in relation to incurred claims. The original requirement to separate the acquired business led to more complexity and an increased financial burden.

The industry welcomes this proposal and notes that the option to categorise the claims as liability for incurred claims should be available after the transition for future acquisitions.

Effective date

Following lobbying from the industry, the IASB proposed that the effective date of IFRS 17 be delayed from the original date of 1 January 2021 to 1 January 2022, allowing in-scope entities an additional year to complete their implementation programmes. Further, the IASB proposed to extend the temporary exemption from IFRS 9 for a further year for those entities implementing IFRS 17.

In its comment letter, EFRAG disagreed with this proposal indicating that such a delay was not sufficient and that it considers a delay of two years, to 1 January 2023, to be more realistic. It also suggested that the effective dates of IFRS 17 and IFRS 9 should continue to be aligned, thereby implying that a further extension to the temporary exemption from IFRS 9 would be necessary.

Previously the IASB had indicated that it was reluctant to defer the implementation of IFRS 9 for insurance entities any further, given that non-insurance entities have been applying IFRS 9 since 1 January 2018 and have therefore suggested that, given the difficulties it would introduce if IFRS 17 and IFRS 9 had different effective dates for insurance entities, it was unlikely that they would agree to a further extension to the effective date of IFRS 17 beyond 1 January 2022.

Clearly, as this feedback has been received from EFRAG, it could have implications on the endorsement of IFRS 17 in the EU and therefore this issue could become a political one. For now, firms will need to wait and see what the IASB's response is to the ED feedback as to whether they need to factor in a further year into implementation plans.

Next steps

The IASB Staff will now collate the feedback, which will be discussed in the coming months by the IASB with an aim to issue final amendments to the Standard in mid-2020.

FURTHER READING

[Milliman IFRS 17 update: January 2019 IASB meeting](#)

[Milliman IFRS 17 update: February 2019 IASB meeting](#)

[Milliman IFRS 17 update: March 2019 IASB meeting](#)

[Milliman IFRS 17 update: April 2019 IASB meeting](#)

[Full list of comment letters](#)

HOW CAN MILLIMAN HELP

Milliman has a wide range of experience in global insurance markets and, in particular, in Solvency II and IFRS 17. Milliman's experts have, and continue to, closely follow the development and implementation of both regimes.

Milliman can provide a range of services to assist with all aspects of IFRS 17, including:

- Methodology development and implementation;
- Independent review;
- Training;
- Gap analysis and impact assessment;
- Financial modelling
- Implementation of an IFRS 17 systems solution through our award-winning Integrate platform which can be implemented with cashflow output from any actuarial system. For more information see: [IFRS 17: The Integrate Solution](#).

If you would like to discuss any of the above, or anything else, with us, or if you have any questions or comments on this paper then please contact one of the named consultant(s) below or your usual Milliman consultant.



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