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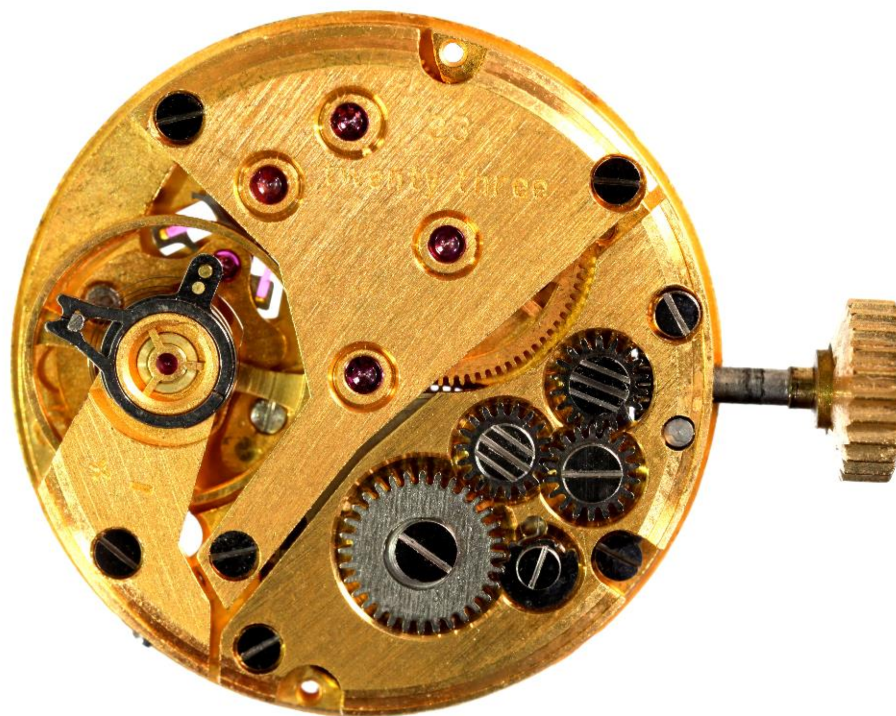

IFRS 17 Transition Resource Group meeting #3

Summary and Outcomes of Agenda Papers Discussion for the HKICPA IISG meeting on 9 October 2018

Francesco Nagari, Deloitte Global IFRS Insurance Leader | 2 October 2018

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Insurance risk consequent to an incurred claim – AP01

Profit emergence when coverage exists after claims are incurred

- The fact pattern refers to an insurance contract that has similarities with Personal Income Protection products designed to insure the risk that an individual in an income generating activity may suffer an accident that would disable his ability to carry out the activity
- These contracts have a long contract boundary and very frequently have regular premium payments that the policyholder makes over the coverage period
- The contract analysed in the paper assumes that some of the insured events that cause the individual to be unable to carry out the activity may have a temporary adverse impact on the policyholder
- When the policyholder reports the insured event, he is entitled to benefits including the suspension of the payment of premiums otherwise due
- When the adverse effects of the insured event are no longer present (e.g. the policyholder has received rehabilitating treatments and can return to his income generating activity) the policyholder should continue to pay premiums to maintain the coverage in place for another future adverse event
- Whether or not a policyholder will recover from the adverse impact of the insured event is matter of estimation by the insurer

Implementation question: is the occurrence of an insured event during the coverage period an incurred claim given the insurance coverage could restart?

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Insurance risk consequent to an incurred claim – AP01 (cont.)

Profit emergence when coverage exists after claims are incurred

- The paper suggests that there is a special type of insurance risk that is caused by the occurrence of an insured event
- Such insurance risk is referred to as **“consequential insurance risk”** for which the insurer stands ready
- The risk is the discovery of the ultimate cost of the benefits due following the logic of IFRS 17 paragraph B5 on the stand ready obligation that an insurer may accept to compensate the other party for adverse development on an event already occurred
- To be noted that paragraph B5 refers to “an event” rather than “an insured event”
- The alternative view is that the occurrence of an insured event always results in the recognition of a liability for incurred claims

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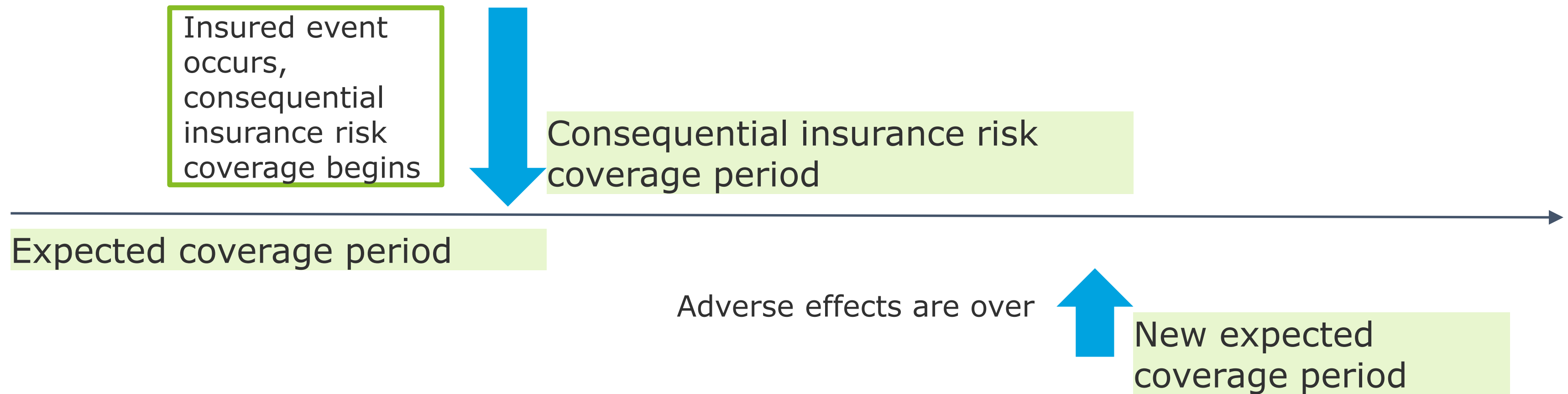
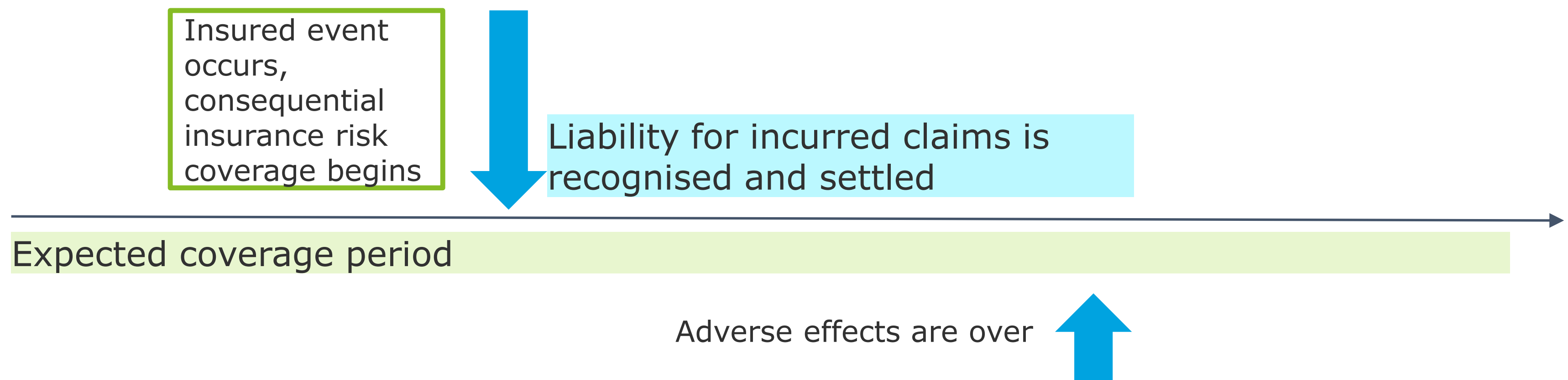
Insurance risk consequent to an incurred claim – AP01 (cont.)

Profit emergence when coverage exists after claims are incurred

- View A – there is consequential insurance risk



- View B – consequential insurance risk is not considered



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Insurance risk consequent to an incurred claim – AP01 (cont.)

Profit emergence when coverage exists after claims are incurred

- IASB Staff concluded that this is **a matter for judgment** as to which interpretation of A or B provides the most useful information about the insurance service provided by the entity to the policyholder under the contract
- Examples considered to illustrate A or B included:
  - Disability insurance; and
  - Fire insurance
- A majority of TRG members agreed with the IASB Staff that both interpretations are in line with the IFRS 17 words and supported the view that an implicit accounting policy choice exists
- However, some TRG members disagreed and expressed concerns about the risk of significant diversity in practice if this is stated as an accounting policy choice
- TRG members disagreed with a choice in the fact pattern where the entity has merely to discover the ultimate cost of a fire after it occurs. Occurrence of a fire is an incurred claim as the fire has not yet occurred at the contract's initial recognition
- One TRG member argued that the reference in the IASB Staff analysis to the discovery of the ultimate cost of claim as the insurance risk described in para. B5 was inappropriate in both fact patterns

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Insurance risk consequent to an incurred claim – AP01 (cont.)

Profit emergence when coverage exists after claims are incurred

- A significant part of the discussion focused on how to achieve a consistent application of the selected accounting policy
- TRG members found that the correct application of IAS 8 would always lead to the same accounting treatment for similar products even for different entities, others said that consistent application between entities could not be guaranteed
- TRG members agreed that, within the same entity, IAS 8 requires the same accounting treatment

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Industry pools managed by an association – AP09

Measuring the risk adjustment for insurance contracts in an industry pool

- The submission describes a risk association where insurers issuing motor insurance contracts have two pools in which they participate:
  - Pool 1 – in which some members are appointed to issue contracts on behalf of all of the members and all members are compelled to transfer to the pool all their risks within the category set out in the law establishing the pool
  - Pool 2 – in which members of the association can choose to transfer some insurance contracts they have issued

Implementation question: is the association able to determine the risk adjustment on behalf of all the members or should it be done at individual member level?

- The IASB Staff concluded that **the first pool may need to be analysed under IFRS 11 as a joint venture (equity method) or a joint operation (share of assets, revenue etc.)**
- In relation to the second pool the IASB Staff suggests that **the association may have created a reinsurance contract with each member's decision to transfer**

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Industry pools managed by an association – AP09 (cont.)

Measuring the risk adjustment for insurance contracts in an industry pool

- TRG members **agreed with the Staff analysis**. There was a **broad agreement with the second step of needing to consider the scope of IFRS 11 and other factors** relevant to the particular scenarios.
- TRG members noted the need to consider principal and agency considerations in determining who is issuing the contract, and pointed out the fact that in this specific scenario the liability of each member in each pool was joint and several, whereas in some other fact patterns, the liability is joint, but not several
- Risk adjustment for non-financial risk is different depending on whether the contracts are **written collectively or by each member entity separately**
- For contracts collectively written, the individual entity's risk adjustment for non-financial risk may not be an entity's share of the risk adjustment determined collectively by the association, it would also reflect the diversification benefits available to each of the member entities on their own

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Annual cohorts for contracts that share in the return of a specified pool of underlying items – AP10

Identification of the conditions to unlock CSM of mutualised contracts without using the annual cohort

- The submission acknowledges the effects of the so called mutualisation and enquires on how they could be done in practice on calculating CSM.

- ***Implementation question:*** There are three views commented in this paper:
  - View A – an entity is only able to unlock the CSM at portfolio level when policyholders share 100% of the returns from the underlying items;
  - View B – an entity is only able to unlock the CSM at portfolio level when policyholders share a specified percentage of the returns from the underlying items which is allocated back in a way that all existing policyholders share the amount pro-rata at the time of the allocation; and
  - View C – similar to view B but with an allocation back in a way that existing policyholders do not receive the allocation on a pro-rata basis

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Annual cohorts for contracts that share in the return of a specified pool of underlying items – AP10 (cont.)

Identification of the conditions to unlock CSM of mutualised contracts without using the annual cohort

- The IASB Staff noted that the submission has produced examples for View A and View B. View C is a more complex version of View B where the allocation is not done on a pro-rata basis
- The IASB Staff concluded that **when there is risk-sharing that is not fully applied to the returns of the underlying items the CSM of the contracts at group level (including the annual cohort dimension of the group) may be different from a CSM measured at a higher level, such as the portfolio level**
- This conclusion and the TRG discussion **suggest that the IASB Staff favours a narrow view in the interpretation of the IFRS 17 requirements in paragraph B68 (and paragraph BC138 in the Basis for Conclusions) when applied to the example quoted in the agenda paper**

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Annual cohorts for contracts that share in the return of a specified pool of underlying items – AP10 (cont.)

Identification of the conditions to unlock CSM of mutualised contracts without using the annual cohort

- One TRG member pointed out that contracts with policyholders that do not fully share risks **could cause the entity to be affected by the expected cash flows of each contract issued.** There are therefore scenarios in which it does not affect the entity and hence, measuring the CSM at a higher level than an annual cohort level would achieve the same accounting outcome as measuring the CSM at an annual cohort level.
- One TRG member pointed out that full risk sharing **does not necessarily mean that 100% of the returns on the pool go to the policyholders**. There are scenarios in which the entity has a share, however that share is unaffected by the cash flows of the pool due to mutualisation and the policyholders would still fully share the risks. In that case the CSM would be greater than zero in all groups.

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Annual cohorts for contracts that share in the return of a specified pool of underlying items – AP10 (cont.)

Identification of the conditions to unlock CSM of mutualised contracts without using the annual cohort

- TRG members agreed that determining **CSM at a higher level than annual cohorts is only permitted if at the outset it is expected that it would always result in the same answer as determined at the group level** (regardless of how expectations or experience develop)
- Most TRG members were concerned with the examples in the paper being unrealistic and too extreme. In particular, Example 2 does not consider the application of IFRS 17:B70 while in practice IFRS 17:B70 would be applied to determine the cash flows before IFRS 17:B68 is applied to account for the impact of mutualisation

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Commissions and reinstatement premiums in reinsurance contracts issued – AP03

Presentation in the insurance revenue or the insurance expense line of the profit or loss

- Ceding commissions are categorised in two types:
  - Contingent on claims or
  - Not contingent on claims

Implementation question 1: for each type of commission is the presentation in the insurance revenue or insurance expense line?

Implementation question 2: can these commissions meet the definition of acquisition costs?

Implementation question 3: when would an investment component be present if a reinsurance contract has ceding commissions?

- Reinstatement premiums are considered under two categories:
  - Mandatory, or
  - Voluntary

Implementation question: how should reinstatement premiums be presented in the profit or loss?

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Commissions and reinstatement premiums in reinsurance contracts issued – AP03 (cont.)

Presentation in the insurance revenue or the insurance expense line of the profit or loss

- **Ceding commissions not contingent on claims** have an economic effect equivalent to a lower premium from the reinsurance contract. Based on this the IASB Staff concluded that they should be **part of the insurance revenue presentation as a deduction from the premium amount** that the form of the contract indicated to be due by the cedant
- **Ceding commission not contingent on claims and non-refundable** are still **part of the insurance revenue presentation as a deduction from the premium amount** and they would make the reinsurance contract issued onerous if the reinsurer does not expect a sufficient volume of cessions to be in excess of the unavoidable cash outflow
- **Ceding commission not contingent on claims** are an investment component if and only if they are **repaid** to the cedant in **all circumstances**
- **The commissions paid upfront to the cedant and non-refundable are not an investment component because there is no repayment of cash previously received**

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Commissions and reinstatement premiums in reinsurance contracts issued – AP03 (cont.)

Presentation in the insurance revenue or the insurance expense line of the profit or loss

- **Payment of ceding commissions contingent on claims** have an economic effect equivalent to a higher claim incurred from the reinsurance contract. Based on this the IASB Staff concluded that they should **be part of the insurance expense presentation as an addition to the claim amount** that the form of the contract indicated to be due to the cedant

- **Ceding commission contingent on claims** are an investment component if and only if they are **repaid** to the cedant in **all circumstances**

- **Reinstatement premiums that are mandatory are always contingent on claims.** They have an economic effect equivalent to a lower claim incurred from the reinsurance contract. Based on this the IASB Staff concluded that they should **be part of the insurance expense presentation as a deduction from the claim amount** that the form of the contract indicated to be due to the cedant

- **Reinstatement premiums that are voluntary are never contingent on claims.** They have an economic effect equivalent to an additional premium paid to extend the coverage beyond the occurrence of a claim. Based on this the IASB Staff concluded that they should be **part of the insurance revenue presentation**

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Commissions and reinstatement premiums in reinsurance contracts issued – AP03 (cont.)

Presentation in the insurance revenue or the insurance expense line of the profit or loss

- TRG members **agreed with the Staff analysis** in the paper of treating such premiums and commissions **based on economic effects** rather than their **formal contractual definition in a contract**
- There are practical implications from implementing this approach, for example, the **need for monitoring the type of each commission/reinstatement premium**
- The same analysis would apply to direct insurance contracts issued, provided there are such payments/receipts to/from policyholder
- There was further discussion and clarification on the definition of an investment component:
  - It is an amount that must be paid back to a policyholder in all cases – i.e. not just in the event of no claims, but also on cancellation
  - It arises when cash flows are first paid to insurer and then they become due to be paid back to the policyholder in all circumstances, rather than net-settled

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Cash flows that are outside the contract boundary at initial recognition – AP05

The reassessment of the contract boundary is only for changes in the practical ability to fully reprice the risks

- The paper considers the situations where the contract boundary is shorter than what would be the legal duration of a contract e.g. when the issuer has the unconditional right to fully reprice with a 90 days notice but the policyholder/cedant is compelled to pay for a longer period of time if the issuer does not exercise that right

Implementation question: is the reassessment of the contract boundary also considering the assessment of whether or not the issuer has exercised its repricing option that would fully reprice the risks?

- Options to reprice fully the risks are integral to the requirements of paragraph 34 (at individual policyholder level for 34(a) and at portfolio level for 34(b))
- The IASB Staff concluded that **the reassessment of the contract boundary in paragraph B64 must not include the assessment of whether or not the option to reprice has been exercised or not**. Any event occurring beyond that point would be a new contract under IFRS 17 even if they come from a single legal contract
- **The reassessment required in paragraph B64 is solely focused on changes surrounding the practical ability to fully reprice**

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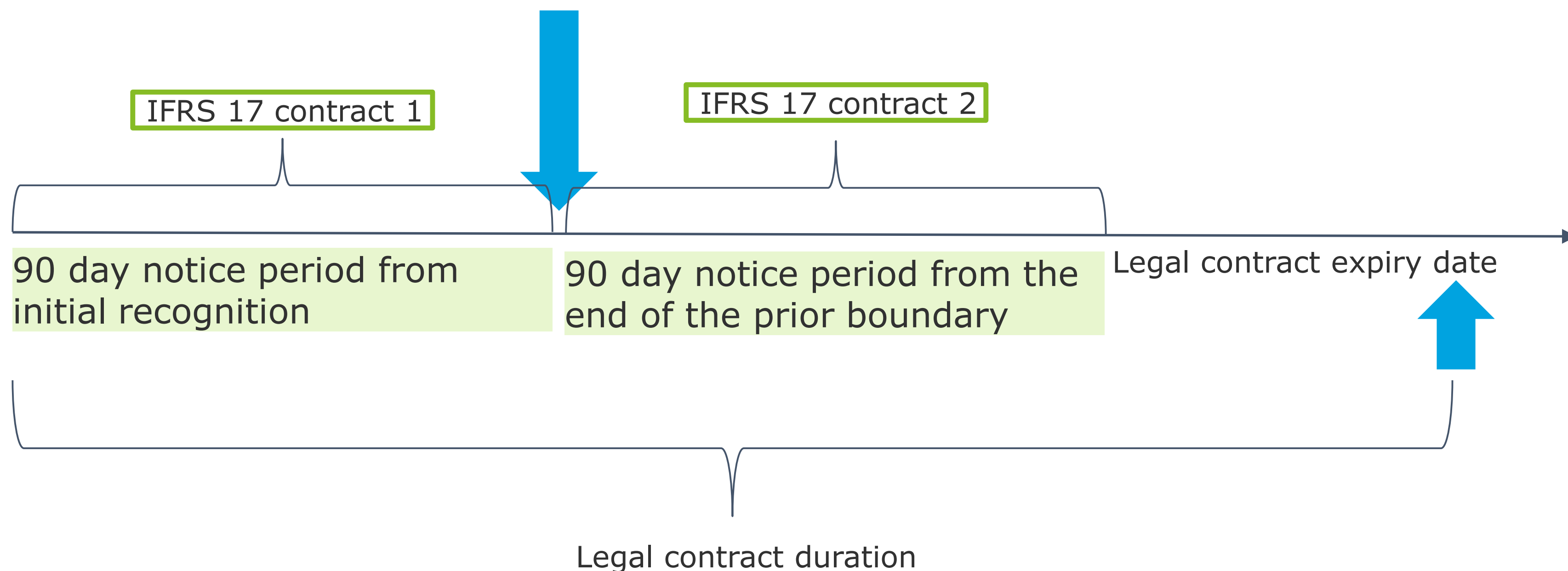
Cash flows that are outside the contract boundary at initial recognition – AP05 (cont.)

The reassessment of the contract boundary is only for changes in the practical ability to fully reprice the risks

- Example of a reinsurance contract with a 90 days notice for full repricing



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Cash flows that are outside the contract boundary at initial recognition – AP05 (cont.)

The reassessment of the contract boundary is only for changes in the practical ability to fully reprice the risks

- The majority of the **TRG members agreed with the IASB Staff analysis in the paper and considered it as helpful to clarify the possible conflict between IFRS 17 para. 35 and B64**
- There was a general agreement with the Staff analysis on the examples in the paper relating to a renewal/termination option of the contract. However, there were differing views on the fact pattern when an additional rider was exercised
- For some TRG members, the main concern in applying the Staff analysis was to **treat as a new contract an exercise of a rider that was always in the original terms of the existing contract,** but was initially thought not to convey substantive right and obligations thus considered outside the original contract boundary
- Some TRG members felt the **paper does not consider some of the wider implications of a contract modification** and results in a treatment that is inconsistent between modifying a contract by adding a renewal option and the exercise of an existing renewal option which would be treated as a new contract

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Premium experience adjustments related to current and past service – AP04

When an experience variance from premium must be reported in profit or loss, if ever?

- The paper considers the experience variance for premiums that relates to past or current periods (e.g. premium adjustments to reflect the actual coverage received in a past period) and those related to future periods (e.g. caused by lapse behaviours)

Implementation question: When an experience variance from premium must be reported in profit or loss, if ever?

- The IASB Staff concluded as follows
  - **Experience variances from events like retrospective premium adjustments** will be reported in profit or loss because they do not refer to future coverage periods; and
  - Experience variances from **lapse behaviours would adjust the CSM** (see B96(a)) or adjusts the LfRC under the PAA

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Premium experience adjustments related to current and past service – AP04 (cont.)

When an experience variance from premium must be reported in profit or loss, if ever?

- TRG members agreed with the **Staff analysis that premium experience adjustments** that relate to current or past service are recognized immediately in profit or loss
- Some TRG members struggled with the presentation of revenue resulting from premium experience adjustments. The note disclosure requirement in IFRS 17:106 is very precise as to how revenue should be disaggregated, however there is no line item for premium experience adjustments for current or past coverage
- One TRG member **suggested to add such a line item to IFRS 17:106 as part of the amendments** that are proposed to IFRS 17 in the Annual Improvements cycle. **This was supported by several TRG members**

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Recovery of insurance acquisition cash flows – AP06

Confirmation of the accounting for the impact of changes in acquisition costs

- The analysis considers the possible relationship between inflows and acquisition costs (AC)

Implementation question 1: is there an implicit recoverability of acquisition expenses from the inflows expected from the group of contracts?

Implementation question 2: how should changes in assumptions and experience variances from acquisition costs be accounted for?

- IASB Staff concluded that

a) **Any reduction in CSM or increase of LC because premiums are lower than outflows will impact insurance revenue;**

b) **Changes in the expectations of AC adjusts the CSM** and are reflected in insurance revenue and expenses according to paragraph B125; and

c) **Experience adjustments related to AC affect insurance revenue** based on paragraph B123 and B125 and insurance expenses according to paragraph B125

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Recovery of insurance acquisition cash flows – AP06 (cont.)
Confirmation of the accounting for the impact of changes in acquisition costs

- The IASB Staff also implicitly confirmed that the Loss Component includes only expected outflows
- TRG members **agreed with the Staff analysis though it may be difficult to know whether insurance acquisition cash flows relate to future or current and past coverage**
- The IASB Staff included an additional point on paragraph B65(h) indicating that those trail commissions described there are not AC under IFRS 17
- References to para. B65(h) were made to clarify that when looking at trail commissions, the portion of the commission that relates to the costs of selling and starting a group of insurance contracts is an acquisition cash flow, regardless of when it is paid

Group insurance policies – AP08

An example of the substance over form override of a single legal insurance contract and the application of contract boundary

- The submission considers group insurance for associations' members and credit insurance offered to borrowers of a bank

Implementation question 1: which party is the IFRS 17 policyholder: the association/bank or the member/borrower?

Implementation question 2: if the insurer and the association/bank have a right to cancel all contracts to the members/borrowers with a 90 days notice, what is the contract boundary?

- The IASB Staff concluded that the **substance over form could apply to this type of insurance contract** and the individual member/borrower transfer or risk would be treated as a separate contract under IFRS 17
- The IASB Staff c**oncluded that the boundary is 90 days given the insurer has full control on its stand-ready obligation** and the members/borrowers cannot stop that decision to terminate coverage

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Group insurance policies – AP08 (cont.)

An example of the substance over form override of a single legal insurance contract and the application of contract boundary

- All the TRG members **felt that this was a helpful paper and agreed with the analysis for the specific fact patterns provided**
- However, careful consideration of the specific facts and circumstances should be given when considering other arrangements
- TRG members noted that the **three step process** used in the analysis:

  a) Identify the policyholder

  b) Determine the number of contracts; and

  c) Assess their contract boundary

- The three criteria used to determine the number of contracts were:

  a) coverages priced and sold separately

  b) coverages being optional; and

  c) certificate holders not being related

- These are useful considerations, however they are just indicative and not determinative

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Determining discount rates using a top-down approach – AP02

Impact of changes in the assets used as the reference portfolio

- The principles on the calculation of the discount yield curve allow the use of the insurer's own financial assets as the reference portfolio to determine the curve
- IFRS 17 also requires the insurer to calculate the required "top-down" adjustments to reflect the characteristics of the insurance contract cash flows that need to be discounted

Implementation question: what is the impact on the discount rate from the inclusion of more or less illiquid assets in the reference portfolio derived from the actual assets held?

- **View A** – changes in the assets held should not change the discount rates if the liquidity characteristics of the contracts are not changed; or
- **View B** – changes in the assets held could impact the discount rate subject to the relevant "top-down" adjustments
- The IASB Staff concluded that view B is appropriate and explained that **the "top-down" adjustments should not include the adjustment for "differences in liquidity characteristics of the insurance contract and the reference portfolio" (see paragraph B81)**

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Determining discount rates using a top-down approach – AP02 (cont.)

Impact of changes in the assets used as the reference portfolio

- TRG members noted **that it is necessary to use an appropriate reference portfolio of asset to determine the discount rate**
- The **liquidity characteristics** of the insurance contracts should be reflected in the discount **rate after the 'top-down' adjustments are calculated**
- The use of a simplification in a 'top-down approach' allowing not to eliminate any liquidity premium difference would mean that changes in the composition of a reference portfolio of assets result in a change to the insurance contracts' discount rate
- A small change in a discount rate might have a significant impact. **Appropriate disclosures should be made with respect to that**

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Premium waivers – AP07

Premium waivers do not qualify for exclusion in the contract classification test under IFRS 17

- The submission considers premium waivers when the policyholder is disabled or injured. Premiums are paid for another risk other than that associated with the waiver

Implementation question: is the waiver of a premium as a result of an uncertain event that occurred after the contract a condition that allows the entity to exclude the premium waiver from the IFRS 17 classification for significant insurance risk?

- The IASB Staff concluded that **this clause relates to a pre-existing risk and although it may not be the primary insurance risk transferred to the insurer it is nevertheless insurance in nature**
- The contract classification would include this set of cash flows. In addition, the entity would need to consider the associated insurance benefit (the waiver benefit) in calculating the coverage units to allocate CSM in profit or loss
- TRG members **agreed with the Staff analysis**
- Further clarification was made on premium waiver meaning no recognition of revenue/premium for that period, and it does not allow grossed up presentation by imputing premium and then recognizing its waiver as a claim

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Other submissions – AP11

A number of clarifications on contract boundary, coverage units and mutual insurance companies

Questions that can be answered by applying the words in IFRS 17

- **Contract boundary of cedant and reinsurer when rights are different** – IASB Staff concluded that the boundary is the same even if the reinsurer has the right to reprice with 90 days notice that is not matched by an equivalent cancellation right by the cedant (see Paper 3 for a different fact pattern)
  - The TRG members asked IASB Staff whether the analysis points to the boundary always being the same for reinsurer and cedant. The staff **confirmed that the principle in determining the contract boundary is the same**. This is because the same right to compel the policyholder to pay premiums for the twelve months duration of the contract that creates an obligation for the cedant creates an enforceable right for the reinsurer, resulting in the twelve months contract boundary for both.
  - The IASB Staff also confirmed that the words in IFRS 17:34 mean that the entity **must choose always the longest boundary** from the compulsion of premium payment and the analysis of the practical ability to reprice fully the insurance risk.

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Other submissions – AP11
A number of clarifications on contract boundary, coverage units and mutual insurance companies

Questions that are considered through a process other than a TRG discussion

- **Mutual insurance companies** – IASB Staff noted that a booklet with education material had been published in July 2018
  - Several TRG members expressed a desire to participate in a group discussion to input into the development of these materials. The IASB Staff confirmed that if they received any questions that were not directly answered by the Standard, these would be presented to the TRG.
- **Coverage units for indirect participating contracts** – **This is the issue debated at the IISG in May and June 2018**. IASB Staff explained that the debate in the TRG meetings held in February and May 2018 have led to an amendment of IFRS 17 that IASB approved in June that will explain the treatment of investment-related services from an insurance contract. IASB Staff noted that examples 13 and 16 of the May TRG paper 5 are relevant to understand their decision on the submission
  - The TRG members expressed a view that the issue of coverage period and recognition of investment services is still **unresolved** for contracts that **do not meet the direct participating contracts definition**. The IASB Staff confirmed that this issue is to be addressed by the IASB, and it is not for the TRG discussion. However, the IASB Staff asked to provide fact patterns of contracts that fall just either side of the dividing line of the direct participating contract definition and the issue created by recognising CSM over the relevant coverage period.

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Next steps

IASB

- The next TRG meeting will be held on **4 December 2018** in the IASB office in London
- The deadline for submissions of issues and comments is **26 October 2018**, with earlier submissions allowing for earlier publication of agenda papers
- However, the IASB Staff has announced that the date may be revised and it may be rescheduled to early 2019 to accommodate a longer period for submissions to be made

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