This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

# IFRS 17 Draft FEA – Issues mentioned for PIR
# Issues Paper

## Objective

1 The objective of this session is to receive input from EFRAG TEG on the treatment of topics for a post implementation review ('PIR') set out below. Almost all of these topics have been discussed by EFRAG TEG previously and has been included in the draft FEA where so instructed.

## Background

2 In the response to the DEA, many respondents mentioned topics they considered should not delay the endorsement process but should be considered in a post implementation review (PIR) of the standard at the latest.

## Description of the issue(s)

3 Respondents listed the following topics for a PIR of IFRS 17:

(a) CSM amortisation;

(b) Scope of hedging and interaction with IFRS 9;

(c) Scope of the VFA (amendment to paragraph B107);

(d) Application of the contract boundary definition to reinsurance contracts held;

(e) Treatment of reinsurance contracts;

(f) Complexity of MRA on transition;

(g) Locked-in discount rates under the general model;

(h) Disclosure of portfolios in an asset or liability position;

(i) Equivalent confidence level disclosure for the risk adjustment;

(j) Measurement of time value of options and guarantees (TVOG);

(k) Presentation of insurance premium receivables and claims payables;

(l) Contracts acquired in in their settlement period;

(m) Retrospective application of the risk mitigation option;

(n) Amounts in OCI at transition under fair value approach;

(o) Separating components from an insurance contracts;

(p) Multi-component contracts;

(q) Interaction between IFRS 17 and IFRS 9 when investing in equities;

(r) Prohibition of applying IFRS 9 to items derecognised during the comparative period;

(s) Wider application issues relating to discount rates; and

(t) Presentation of changes in fair value of puttables.

These topics are set out below.

*CSM amortisation*

4 IFRS 17 requires an entity to systematically recognise the CSM in profit or loss over the coverage period, thereby reflecting insurance contract services provided under the group of contracts. The amount is determined by identifying coverage units which consider, for each contract, the quantity of benefits provided under the contract and its expected coverage period. This is applicable for both contracts with and without direct participation features.

*Contracts without direct participation features*

5 Some insurance contracts without direct participation features provide policyholders with an investment return (investment-return service), in addition to insurance coverage, although they do not meet all the VFA criteria.

6 For insurance contracts without direct participation features, insurance contract services relate to both insurance coverage and investment-return services. Following the applicable IFRS 17 criterion, this investment-return service is reported as such only if either an investment component exists in contracts or the policyholder has a right to withdraw an amount.

7 Some have argued that the above criterion for investment-return service is too narrow as it does not take into consideration the investment service provided in certain types of contracts, e.g., deferred annuities without payment on death in the accumulation phase or the pay-out phase (or in both), and deferred capital during the term agreed (accumulation period) without death benefit. These constituents observe that they are providing investment related services under the terms of these contracts, but they will not be allowed to report the profit from such services when rendered by the insurer.

*Coverage units for contracts with direct participation features*

8 For insurance contracts with direct participation features, the coverage units, which ultimately drive the path of reporting profit from rendering of insurance services, consider quantity of benefits and expected period of both insurance coverage and investment-related service (i.e., the management of underlying items on behalf of the policyholder).

*Scope of hedging and interaction with IFRS 9*

9 The introduction of IFRS 9 combined with IFRS 17 has raised concerns that risk mitigating instruments such as derivatives may create volatility in profit or loss. Because of the lack of a risk mitigation option for contracts under the general model, some respondents have raised concerns about the ability of applying hedge accounting requirements of IFRS 9. In absence of this possibility, it is feared this will lead to volatility in profit or loss.

*Scope of the VFA (amendment to paragraph B107)*

10 The IASB amended paragraph B107 of IFRS17 in 2017 to require eligibility for the VFA to be assessed at individual contract level rather than for groups of contracts. Some argue that this is inconsistent with the recognition and measurement requirements in the standard (which are done on a group basis at the lowest) and will impede the reliability of the standard and increase costs. Furthermore, it could impact understandability as different portfolios of business (which are comprised of contracts with similar risks) are accounted for under more than one measurement model.

11 EFRAG TEG discussed this in March 2020 and noted:

(a) That practically, evidence could be built that a population of contracts meet the VFA criteria, e.g., by assessing one contract and stress testing it for variability. In this way, other contracts with the same sensitivity to the parameters could also meet the VFA criteria.

(b) The risk of a possible overly-restrict interpretation due to a literal reading of the standard and pointed to transition requirements for MRA where reasonable and supportable information should be used. The IASB provided additional guidance on the latter and should provide similar guidance on this topic in B107.

(c) That the wording ‘individual contract’ may pose an operational issue due to misinterpretation.

12 Taking into consideration the above, EFRAG TEG members did not consider that this topic should be included in the draft endorsement advice.

*Application of the definition of contract boundary to reinsurance contracts held*

13 The requirements in IFRS 17 result in determining the boundaries of a reinsurance contract solely on the basis of the contractual rights and obligations of that contract. According to some this fails to (i) achieve consistency in the way of measuring the reinsurance and the underlying contracts and thus, results in mismatches, and (ii) reflect the way the ceding entity manages and mitigates its risks.

14 Some respondents think that accounting mismatches will be created because entities will:

(a) apply different discount rates when measuring the contracts—accordingly, there will be accounting mismatches in entities’ insurance finance result;

(b) measure differently the contracts’ CSM and determine differing coverage periods and coverage units—accordingly, there will be accounting mismatches in entities’ insurance result (notably because of the difference in timing on the assessment of future cash flows between the reinsurance contracts (at inception) and the underlying direct insurance contracts (when those contracts are eventually recognised), or changes in the key assumptions used for the estimation of cash flows);

(c) apply differing risk adjustments and retain different release patterns for that risk—here again, there will be accounting mismatches in entities’ insurance finance result.

*The treatment of reinsurance contracts in general*

15 Paragraph B109 of IFRS 17 states that reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purpose of this Standard. In other words, such contracts are excluded from the scope of the variable fee approach (VFA) and are in the scope of the general model.

16 *Reinsurance held*: some reinsurance contracts held may meet the criteria in paragraph B101 and thus, could have been eligible for the VFA model had not there been the restriction set out in paragraph B109. As an entity is prohibited from applying the VFA model to the reinsurance contracts held and thus, recognises any change in the financial risk immediately in profit or loss or in OCI. Conversely, any such change in the underlying contract—to which the VFA applies—is reflected in the CSM and spread over the coverage period. In those circumstances, the combination of a reinsurance and insurance contract may lead to accounting mismatches in profit or loss or in OCI.

17 Reinsurance issued: Some respondents think that reinsurance contracts issued that meet the VFA eligibility criteria (that is, for example, the case when the terms of the treaty specify that the return of underlying items is shared between the direct insurer and the reinsurer) should be required to use the VFA model.

18 Reinsurance in net cost position: Some respondents think that the computation set out in paragraph B119D of IFRS 17 may not adequately reflect the economic loss-absorption capacity of reinsurance contracts held and thus, may lead to the recognition of a reinsurance gain even though a reinsurance contract held might represent a net cost for the cedant.

19 Applying paragraph B119D of IFRS 17, an entity will recognise a gain at initial recognition that equals the loss recognised on the underlying onerous insurance contracts multiplied by the percentage of claims that the entity expects to recover from the group of reinsurance contract held. However, this calculation disregards other relevant contractual features such as the reinsurance premium and fees. This ultimately means that such costs adjust the CSM and are spread over the lifetime of the contracts whereas the profit arising from the reinsurer's share of the claims is immediately recognised as a gain in profit or loss. In circumstances in which the reinsurance premium exceeds the expected reinsured claims—thus resulting in a net cost for the ceding company—paragraph B119D results in the recognition of a gain that does not appropriately reflect the economic effect of the reinsurance contract held.

*Complexity of the MRA on transition*

20 At transition, entities are required to apply IFRS 17 retrospectively unless impracticable. The full retrospective approach recognises and measures insurance contracts as if IFRS 17 had always been applied. When impracticable, entities can choose between applying either the modified retrospective approach or the fair value approach using IFRS 13 *Fair Value Measurement* to measure the insurance contracts.

21 The objective of the modified retrospective approach is to achieve the closest outcome to retrospective application possible using reasonable and supportable information available without undue cost or effort. IFRS 17 provides a number of simplifications on transition that meet this objective. Some respondents considered the application criteria for the modified retrospective approach too restrictive.

*Locked-in discount rates under the general model*

22 IFRS 17 requires that, under the general model, the CSM is accreted using the same discount rate that was determined at the initial recognition of a group of contracts. This is modified for contracts with direct participation features, whereby the effect of changes in the entity's share of underlying items, which comprises both the effect of the passage of time and the change in the fair value of the underlying items, is recognised in the CSM. As a result, only for contracts with direct participation features, the CSM is remeasured at each reporting period on the basis of current discount rates.

23 Some argue that insurance contracts without direct participation features should also use current rates to accrete or remeasure the contractual service margin, because using locked-in rates is not responsive to changes in economic conditions in the same way as is the case with fulfilment cash flows.

*Disclosure of portfolios in an asset or liability position*

24 IFRS 17 requires an entity to present separately in the statement of financial position portfolios of insurance contracts issued that are assets and those that are liabilities. When developing IFRS 17 a more granular approach (at group level instead at portfolio level) was initially considered but subsequently amended, primarily to reduce operational complexity.

25 The switch between an asset and liability position is not necessarily related to the profitability of the insurance contract. Rather, contracts in an asset or liability position are affected by the timing of cash flows received and paid for insurance contracts.

26 Some respondents argued that the principle of IFRS 17 to disclose a portfolio of insurance contracts as a bundle of rights and obligations (without separate presentation of premium receivables and payables) results in one aggregated amount reported on the face of the statement of financial position, rather than components of that bundle (such as premiums receivable) being presented separately. Those respondents are concerned that relevant information, in particular the information about premiums receivable and payable may be lost.

*Equivalent confidence level disclosure for the risk adjustment*

27 Entities have to disclose the confidence level used to determine the risk adjustment irrespective of the technique used to estimate the risk adjustment. This information is meant to enable users to compare entities in order to assess how the entity-specific risk assessment might differ from entity to entity. Some respondents noted that the technique of relying on a confidence level does not allow to provide comparable results.

*Measurement of TVOG*

28 Some consider that for insurance contracts measured under the VFA, the change in the measurement of options and guarantees (the “Time Value of Financial Options and Guarantee (TVOG)”), which adjusts the CSM tends to overestimate the short-term effect of the profitability based on the current actuarial methodologies. They therefore consider that this does not adequately reflect the behaviour of long-term contracts under specific and temporary economic conditions. In stressed market conditions, the increase in the TVOG will immediately reduce the CSM of these contracts, overriding their long-term profitability. In that regard, such a downside volatility is procyclical. If, IFRS 17 was applicable for the first quarter of 2020, the financial results would probably have limited the ability to support the overall economy. Therefore, they consider that this treatment should be further investigated on the basis of in-depth actuarial studies focusing on technical reserves modelling. This should help to determine a measurement better reflecting the performance assessment of the insurance savings business.

*Presentation of insurance receivable and payables, and collateral reinsurance deposits*

29 There is no requirement to disaggregate and hence no requirement to separately present in the statement of financial position insurance premium receivables and reinsurance premium payables.

30 Some respondents argued that the principle of IFRS 17 to disclose a portfolio of insurance contracts as a bundle of rights and obligations (without separate presentation of premium receivables and payables) results in one aggregated amount reported on the face of the statement of financial position, rather than components of that bundle (such as premiums receivable) being presented separately. Those respondents are concerned that relevant information, in particular the information about premiums receivable and payable may be lost.

31 This issue is also applicable to collateral deposits related to reinsurance contracts, which correspond to a guarantee and not to a prepayment, and thus should not be treated as such.

*Contracts acquired in their settlement period in a business combination or portfolio transfer*

32 Insurance contracts in settlement phase acquired in a business combination/transfer - IFRS 17 requires an entity to classify a liability for settlement

of claims as a liability for remaining coverage if the entity acquired the insurance contract during the claim settlement period and, at the acquisition date, the amount of claims is still uncertain. The requirement applies to contracts acquired both in a business combination within the scope of IFRS 3 and in a transfer of insurance contracts that do not form a business (for example, in a portfolio transfer). This implies that the liabilities for incurred claims (LIC) previously generated in the acquiree's statement of financial position become liabilities for remaining coverage (LRC) in the acquirer's accounts, with the consideration received on the business combination / transfer used as a proxy for the premiums received.

33 From the operational point of view, transforming liabilities for claims settlement acquired into liabilities for remaining coverage may require significant additional cost and efforts as it implies developing calculation and accounting models proper to the General Measurement Model for the portfolios that otherwise should have been treated using a simplified method.

*Retrospective application of the risk mitigation option*

34 The risk mitigation option cannot be applied retrospectively. Some preparers are concerned that if they were not allowed to apply the risk mitigation option retrospectively at transition, the changes in the fair value of the risk mitigating instruments would adjust the CSM. However, as retrospective application is not allowed, the changes in these instruments are recognised in retained earnings rather than CSM.

*Amounts to be recognised in OCI at transition under the fair value approach*

35 Entities have the possibility of setting OCI on the insurance liabilities to nil when the insurance contracts have direct participation features and the entity holds the underlying items and applies the current period book yield to them. An option to set the OCI-balance to nil such as the one that is available for the liability is not available to assets accounted for at FVOCI under IFRS 9.

36 Under the fair value approach, the amount that would have been accumulated as a liability OCI balance is immediately transferred to retained earnings. However, the OCI balance on the assets may only be transferred to retained earnings over time. As a result, this would affect the financial result in the profit or loss statement in future years subsequent to transition. Hence, entities applying this approach would prefer to have the possibility to also set the asset OCI balance to nil at transition.

37 Respondents note that this asymmetrical treatment may significantly distort equity at transition and future results: assets will generate a yield based on the historical effective interest rate, whilst liabilities will unwind at the market rate at transition date. Also this asymmetrical treatment may affect the dividend capacity of these entities if dividends are determined on the basis of IFRS accounting.

*Separating components from an insurance contract; exclusion of investment components from revenue and claims*

38 IFRS 17 requires any differences between expected and actual amounts of the investment component payable in the period to be recognised in the CSM. This is because acceleration or delay in repayments of investment components only gives rise to a gain or loss for the entity to the extent that the amount of the repayment is affected by its timing.

39 Some respondents have noted that the application of this requirement is complex. In addition, some consider that presenting insurance revenue and incurred claims excluding investment components does not lead to understandable information.

*Multi-component contracts – contracts that change nature over time*

40 Certain products change significantly in nature during their life due to the exercise of an option by the policyholder. As the classification between general model and

VFA is done at inception and is irrevocable, certain products may be measured using the VFA whereas, after the execution of the option, the VFA model is no longer suitable.

*Interaction between IFRS 17 and IFRS 9 when investing in equities*

41 Applying IFRS 9, an entity measures investments in equity instruments at fair value. Paragraphs 4.1.4 and 5.7.5 of IFRS 9 specify that at initial recognition of an investment in an equity instrument that is neither held for trading nor contingent consideration recognised by an acquirer in a business combination, an entity may make an irrevocable election to present in OCI subsequent changes in the fair value of that investment ('presentation election'). Paragraph B.5.7.9 of IFRS 9 states that amounts presented in OCI shall not be subsequently transferred to profit or loss ('recycling prohibition').

42 Some respondents think that amounts presented in OCI shall subsequently be transferred to profit or loss.

*Prohibition of applying IFRS 9 to items derecognised at the date of initial application*

43 Paragraph C3 of IFRS 17 requires an entity to apply IFRS 17 retrospectively unless impracticable, subject to some exceptions described in paragraphs C3(a) and C3(b) of IFRS17. IFRS 17 also requires an entity to present adjusted comparative information, applying the requirements of IFRS 17, for the period immediately before the date of initial application of IFRS 17. An entity may also present adjusted comparative information applying IFRS 17 for any earlier periods presented but is not required to do so.

44 Paragraph 7.2.1 of IFRS 9 requires an entity to apply IFRS 9 retrospectively, in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, subject to some exceptions listed in that paragraph. Paragraph 7.2.1 of IFRS 9 prohibits an entity from applying IFRS 9 to items that have already been derecognised at the date of initial application of IFRS 9. Paragraph 7.2.15 of IFRS 9 permits, but does not require, an entity to restate prior periods. An entity may restate prior periods if, and only if, it is possible without the use of hindsight.

45 Some respondents note that entities that will initially apply IFRS 17 and IFRS 9 at the same time may wish to restate prior periods to reflect the requirements in IFRS 9. However, the requirement in paragraph 7.2.1 of IFRS 9 that prohibits entities from applying IFRS 9 to items that have already been derecognised practically deter those entities from restating prior periods—this is because this requirement is burdensome to apply and may result in non-comparable accounting treatments in the comparative period in areas where IFRS 9 and IAS 39 have dissimilar requirements.

*Wider application issues relating to discount rates*

46 Respondents have noted a number of issues arising in the use of discount rates:

(a) the use of a locked in discount rate for the CSM in general model;

(b) in the situation where the BEL component of the insurance liability is an asset and the CSM component is a liability, inconsistencies arise due to the different discount rates for BEL and CSM.

(c) there is uncertainty regarding whether changes in asset mix will result in changes to the discount rate using a top-down approach.

*Presentation of changes in the fair value of puttable financial instruments*

47 Insurers hold financial instruments that impose on the entity that issued those instruments an obligation to deliver to the holder a pro rata share of the net assets of the entity only on liquidation ('puttable financial instruments').

48 In many cases, those puttable instruments represent investments in funds that hold financial assets that are SPPI and are hold within a business model whose objective (i) is to hold those assets in order to collect contractual cash flows, or (ii) is achieved by both collecting contractual cash flows and selling those assets. Accordingly, the funds subsequently measure those assets at amortised cost or at fair value through OCI (FVOCI). If insurers were to hold those assets directly (ie not through a fund), they would subsequently measure them at amortised cost or at FVOCI. Considering the long-term holding of such instruments by insurers, some respondents think that the presentation of changes in the fair value of puttable financial instruments in profit or loss is not relevant and introduces unnecessary volatility.