

Amendments to IFRS 17 from January 2019 IASB Meeting

January 2019



INTRODUCTION

Since the publication of IFRS 17 in May 2017, the insurance industry has begun the implementation process in advance of the original effective date of 1 January 2021. However, following the tentative decision of the IASB in late 2018, the effective date is likely to be postponed to at least 1 January 2022.

As the industry has begun to implement the Standard, a number of issues, both practical and theoretical in nature, have been raised. These issues have been brought to the attention of the IASB through the Transition Resource Group ('TRG'), and also through industry bodies and groups such as the CFO Forum.

At its October 2018 meeting, the IASB agreed a set of criteria by which any proposed amendment to IFRS 17 would be assessed:

- any amendment should not result in significant loss of useful information in respect of relevance and faithful representation, comparability and internal consistency and complexity and understandability; and
- any amendment should not unduly disrupt implementations processes or risk undue delays to the effective date.

At the January 2019 IASB meeting, four of these issues were discussed and the IASB tentatively approved a number of amendments to the Standard. This paper provides an overview of those amendments and the outcomes of the discussions.

1) INSURANCE ACQUISITION CASH FLOWS

Acquisition cash flows that are paid (i.e. commissions) when a group of contracts are written and that are paid on the assumption that the contracts will be renewed in the future may make a group of contracts appear to be loss making if the expected renewals of those contracts are ignored. Specifically, where the amount of any acquisition costs or commissions are higher than the initial premium received.

Currently IFRS 17 would recognise these groups of contracts as loss making and would therefore be treated as onerous at recognition. If future renewals were to occur, these subsequent groups would appear very profitable as the premium paid would not need to cover any acquisition costs.

In some cases these commissions may be refundable if the contracts do not renew. In this case, Paragraph 27 of IFRS 17 requires firms to set up an asset for the insurance acquisition costs and then derecognise this asset when the contracts renew (i.e. the subsequent premium is received) or the contracts don't renew (i.e. the commission is refunded).

Some stakeholders have argued that this is:

- a) Not reflective of the economics of the contract as the contracts are expected to renew; and
- b) Not consistent with the "similar" requirements under IFRS 15.

Although it is clear from the Board paper that the IASB Staff do not believe a change to the Standard should be made, the Staff do accept that the outcome is not ideal and that a change to the Standard could be made which would alleviate the industry's concern whilst also adhering to the criteria agreed by the IASB at the previous meeting regarding any changes to IFRS 17.

The IASB Staff recommended a change to IFRS 17 to extend the circumstances under which the Paragraph 27 applies such that it also applies to non-refundable commissions. An impairment test would need to be performed each period to ensure that the expected income from any expected renewals is sufficient to support the acquisition cash flows asset. As renewals are made the asset would be derecognised and, where renewals are not made, a loss would be recognised. Losses would be unwound where the impairment test shows improvement over time.

The IASB have tentatively voted to approve this amendment.

2) REINSURANCE ACCOUNTING MISMATCHES FOR ONEROUS UNDERLYING CONTRACTS

A key issue that has been raised by the industry following the publication of the IFRS 17 Standard is regarding the treatment of reinsurance contracts that provide coverage to groups of insurance contracts that are onerous at outset. Originally, a key measurement principle of IFRS 17 for reinsurance contracts was that they would be measured independently of the underlying insurance contracts as it was the view of the IASB that reinsurance contracts transfer insurance risk in their own right.

During the Exposure Draft phase an amendment was made (Paragraph 66(c)(ii) in the final IFRS 17 Standard) that provided a concession in the scenario where an underlying group of insurance contracts, that were covered by a reinsurance contract, became onerous *after* initial recognition such that any loss recognised in the profit or loss account could be offset by an equivalent profit from the Contractual Service Margin ('CSM') of the reinsurance contract.

Since this concession only applied to contracts that became onerous after initial recognition circumstances still exist whereby, at initial recognition, a group of contracts is onerous

but is profitable following the acquisition of reinsurance. Under IFRS 17, the loss on the underlying contracts would be immediately recognised in profit or loss and the profit on the reinsurance contract would be held as a CSM and released over the coverage period, causing a mismatch.

The IASB Staff have proposed an amendment to the Standard that expands on the concession provided by Paragraph 66(c)(ii) to include, for proportional reinsurance contracts, an offset of any recognised loss with a relative gain on the associated reinsurance contract at outset in the profit or loss account. The amendment is, however, specific to proportional reinsurance contracts that were entered into at the same time, or prior to, the underlying contract.

The IASB Staff note that this change may disrupt insurance entities that have already begun developing systems, which is strictly against one of the criteria for amending the Standard agreed by the IASB in the prior Board meeting, but that the benefit of the amendment will be welcomed by the industry and will therefore be worth the disruption. Otherwise the IASB Staff believe that the change complies with the criteria.

The Staff also recommend that the amendment applies to Premium Allocation Approach ('PAA') as well as the same mismatch could also occur.

The Staff provide an appendix to the paper that describes a number of examples to demonstrate how this amendment would work in practice.

The IASB have tentatively voted to approve this amendment.

3) REINSURANCE FOR CONTRACTS WITH DIRECT PARTICIPATION FEATURES

As IFRS 17 is currently written, neither reinsurance contracts issued nor reinsurance contracts held can be measured using the Variable Fee Approach ('VFA'), as specified in Paragraph B109 of IFRS 17. Some industry stakeholders believe that reinsurance contracts could satisfy the definition of an insurance contract with direct participation features and therefore believe that, in such cases, the VFA should be applicable to those contracts. This would also have the benefit of limiting the extent to which an accounting mismatch could occur by measuring underlying insurance contracts with a different measurement model to the associated reinsurance contract.

The IASB Staff paper considers reinsurance contracts held and reinsurance contracts issued separately and provide separate recommendations for each.

REINSURANCE CONTRACTS HELD

The IASB Staff were presented with two options:

- a) expand the scope of the VFA to include reinsurance contracts held; and,
- b) expand the risk mitigation option in the VFA that currently applies to derivatives to also apply to reinsurance contract held.

The IASB Staff's view is that reinsurance contracts held, by definition, do not satisfy the requirements of the VFA and therefore extending the scope of the VFA to reinsurance contracts held (option a) above) would not be an appropriate amendment.

The risk mitigation option that is available in the VFA allows insurance entities that purchase (or have purchased) derivatives for the purposes of hedging some (or all) of the financial risk associated with a group of insurance contracts, such as non-linear insurance guarantees, to recognise changes in the measurement of that financial risk in profit or loss rather than by adjusting the CSM, as would otherwise be required under the VFA.

The IASB Staff's view was that extending the scope of the risk mitigation option to include reinsurance contracts held, where such contracts mitigate the financial risk on the underlying contracts (option b) above), would be an appropriate approach to resolve the potential accounting mismatch that could exist by measuring the reinsurance contract using the General Model ('GM').

The IASB tentatively voted to approve this amendment.

REINSURANCE CONTRACTS ISSUED

The IASB Staff's view was that, although there may be circumstances whereby a reinsurance contract issued could satisfy the conditions of the VFA, the Board felt that this is not the purpose for which the VFA was designed. Therefore the IASB Staff proposed that the IASB do not change the Standard for reinsurance contracts issued.

4) INVESTMENT RETURN SERVICE UNDER GENERAL MODEL

As written in IFRS 17, in both the VFA and the GM, the CSM is released to profit or loss in line with coverage units that are determined with consideration to the provision of insurance services to the policyholder. In the June 2018 meeting the IASB tentatively agreed to amend IFRS 17 to allow the CSM for contracts measured under the VFA (i.e. contracts that have direct participation features) to be released to profit or loss in line with coverage units that are determined with reference to both the provision of insurance services and the provision of investment services to the policyholder.

Some industry stakeholders still expressed some concern that there were many examples of contracts that would fall within the scope of the GM (i.e. without direct participation features) that

still have periods of coverage which only provide investment services and not insurance services. There is concern that this could lead to unintended profit release patterns. The most obvious example is that of a deferred annuity contract where there is a material accumulation phase but the insurance coverage only begins once the annuity part of the contract vests.

The IASB Staff point out that IFRS 17 defines an investment component and distinguishes between investment components for contracts with direct participation features and those without. Specifically, an investment component on a contract with direct participation features is defined as the underlying assets of the contract that are effectively being managed by the insurance entity in exchange for a fee. In contrast, for a contract without direct participation features it is treated as any other investment whereby the investment earns a return and is returned to the policyholder at the end of the investment period but no service is specifically provided by the insurer (i.e. there is no management service provided by the insurer).

The IASB Staff have been convinced that an insurance entity could be considered to be providing a service to the policyholder beyond or before any insurance coverage is provided on the grounds that an investment return is being provided that would not otherwise be available to that policyholder due to the liquidity, complexity and expertise required to achieve such an investment return. They call this service and “investment return service”. The Staff have therefore recommended that coverage units can be defined in the context of the delivery of insurance services and also any investment return services, under the GM.

Further, the Staff recommend that any other cash flows related to the fulfilment of the investment return service should be included in the fulfilment cash flows. This would include any investment expenses that are incurred in order to achieve that investment return.

Further, the Staff’s recommendations include:

- restricting the provision of investment return services to contracts that possess a non-distinct investment component;
- ensuring that any judgement that is applied in determining whether an investment return service exists for the determination of coverage units is applied consistently and to not provide any objective or criteria for that determination (the Board did instruct the Staff to include some analysis in the Basis for Conclusions);
- establishing that the investment return services should be considered to have ended once all investment component payments have been made and that they should not include any period of payments to future policyholders (i.e. smoothing of payments across cohorts of policyholders);
- the relative weighting of benefits provided by insurance coverage and investment return services should be made on a systematic and rational basis;

- extending the amendment to require the investment return service to be included in the assessment of the one-year eligibility criterion of the PAA (potentially reducing the number of contracts eligible for the PAA).

The IASB tentatively voted to approve these amendments.

SUMMARY

In summary, at its January 2019 meeting, the IASB tentatively voted to approve the following:

- allow insurance acquisition cash flows (including commissions) for insurance contracts that are priced on the expectation that they will renew to be allocated to future renewals by extending the requirements in Paragraph 27;
- allow the circumstances under which Paragraph 66(c)(ii) applies to be extended to underlying contracts that are onerous at initial recognition;
- extend the risk mitigation option that is available under the VFA to apply to reinsurance contracts held where the underlying insurance contracts are onerous and the reinsurance contract transfers the financial risk of the underlying contract; and
- allow insurance contracts that are measured under the GM to determine coverage units in line with “investment return service” as well as insurance service (as is currently the case).

All of these changes will be subject to due process which will involve a public consultation.

The IASB will be discussing a further four issues at its February 2019 meeting, papers for which can be found [here](#).

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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;
- Training;
- Gap analysis;
- 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 consultants below or your usual Milliman consultant.



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