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Insurance Accounting Alert

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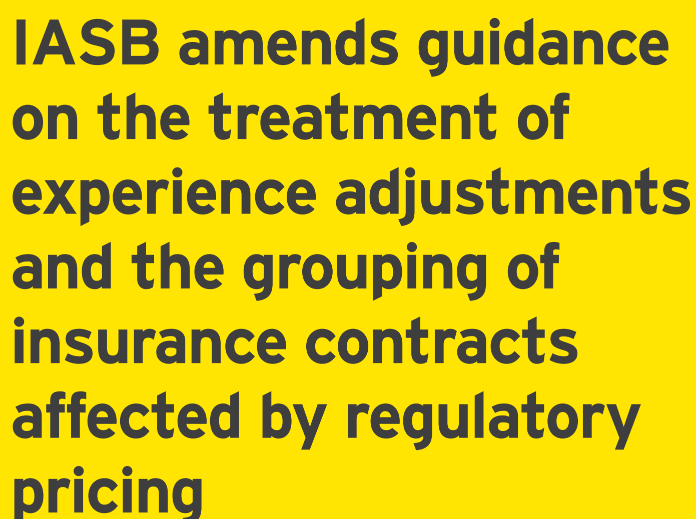

IASB amends guidance on the treatment of experience adjustments and the grouping of insurance contracts affected by regulatory pricing

What you need to know

The IASB responded to findings from an external editorial review of draft IFRS 17. Key tentative decisions made were:

- All changes in estimates of future cash flows arising from non-financial risks, including those directly caused by experience adjustments, will be adjusted against the CSM (with two specific exceptions noted).
- The definition of an experience adjustment was changed to exclude investment components.
- The order for determining the amount of CSM released to profit or loss for services provided in the period under the general model was not changed.
- A narrow exemption will be provided to allow an insurer to include contracts in the same group, if the only reason for them being in different groups is regulation or law constraining the entity's practical ability to set different price and benefit levels for policyholders with different characteristics.

Overview

During its February meeting, the International Accounting Standards Board (IASB or the Board) completed its discussions on the findings from the external editorial review draft of IFRS 17 *Insurance Contracts* (IFRS 17). The review took place in December 2016, and the IASB discussed the responses proposed by staff to its findings.

The story so far

The IASB website provides information about tentative decisions made on the insurance contracts accounting model prior to this meeting, including:

- The cover note and papers for the meeting which contain an overall summary to date of the progress on the project and an overview of the tentative decisions
- Further information on the project and the proposed model can also be found here

Experience adjustments

In response to comments received on the external editorial review draft of IFRS 17, the IASB revisited some of its tentative decisions made during the November 2016 IASB meeting regarding the treatment of experience adjustments.

At the November 2016 meeting, the IASB decided that, if a change in estimate of future cash flows is directly caused by an experience adjustment, the combined effect of the adjustment and the directly caused change in the estimate of future cash flows should be recognised in profit or loss. At that time, this approach was viewed as an appropriate compromise that would avoid the recognition of a loss or gain in the current period and a consequential gain or loss in future periods when a claim is incurred earlier or later than expected.

However, the editorial review raised questions as to whether this treatment resulted in a workable compromise for when to combine, and where to recognise, the combined effect of experience adjustments and directly caused changes in estimates of the present value of future cash flows (in profit or loss or to adjust the contractual service margin (CSM)). There were other comments on operational challenges, particularly regarding the recording and tracking necessary to produce insurance contract revenue figures in future periods, if the November decision were to be implemented. It was also noted that, while this treatment had been introduced as an exception that would avoid recognition of loss or gain in the current period and a consequential gain or loss in future periods, it would also be applied in many scenarios where the effects would not actually be off-set in this way.

General model:

In response to these concerns, the Board tentatively decided that, for contracts measured under the general model, all changes in estimates of the present value of future cash flows arising from non-financial risks, including those that are directly caused by experience adjustments, will be adjusted against the contractual service margin. Exceptions to this are where those changes to estimates:

i. Relate to incurred claims

ii. Result in increases in the insurance liability that exceed the carrying amount of the CSM or result in decreases in the insurance liability that needs to be allocated to loss components (recognised in profit and loss in the past) in which case, the changes are recognised in profit or loss.

Some Board members commented that previous tentative decisions (such as separating experience adjustments and changes in estimates, and moving away from the unit of aggregation being an individual contract) made it impossible to get to a perfect answer for the treatment of experience adjustments, with some compromises being inevitable. The Board had attempted to address complexity in this area at the November 2016 meeting, but acknowledged and addressed the additional concerns from the editorial review and, therefore, agreed with the staff proposal unanimously.

Variable fee approach:

The Board also tentatively decided to align the treatment of experience adjustments arising from changes in non-financial risks for contracts measured under the variable fee approach to the above treatment for contracts accounted for under the general model. The staff commented the amended treatment of the experience adjustments would fit in quite naturally within the objective and mechanics of the variable fee approach.

Exclusion of investment component:

The Board amended the definition of experience adjustments to exclude the investment component of claims incurred. As a result, an acceleration or delay in the repayment of investment components will not be part of experience adjustments and will adjust the CSM rather than be recognised immediately in profit or loss.

Order of CSM release:

Some commentators on the external editorial review draft questioned why a change in the estimate of future cash flows, not directly caused by an experience adjustment that would only effect future cash flows, should affect the amount of CSM recognised in profit or loss in the current period. They argued that the allocation of CSM to coverage units in the current period should be determined before updating the amount of CSM, as a change in non-financial assumptions becomes effective from the date the revised assumption is first used to measure fulfilment cash flows.

Most Board members agreed with staff that measurement should reflect currently available best estimates, and that a change in assumptions at the end of a period would likely represent a change in conditions over time rather than just at the end of the period. They added that complexity would increase if the allocation of the CSM is calculated after adjusting the CSM and the number of coverage units to reflect the effects of experience up to the end of the period, but before making changes in the estimates of the present value of future cash flows that are not directly caused by experience adjustments. This would require a run of actuarial models both before and after making changes in estimates to future cash flows not directly caused by experience adjustments.

One Board member highlighted that the approach in the external review draft could lead to inconsistencies in certain circumstances, but other Board members saw this as an unavoidable consequence of previous decisions to recognise experience adjustments in profit or loss. The staff also noted that allocating the CSM before changing estimates of future cash flows not directly caused by experience adjustments would create a difference compared with the variable fee model – under the variable fee model, the CSM is allocated after the CSM has been adjusted for changes in the entity's share of underlying items.

The Board concluded that there was no compelling argument to change its previous decision that the release should be based on allocating the remaining contractual service margin after all other adjustments have been made to the amount of the contractual service margin at the start of the period. The Board, therefore, unanimously agreed with the staff proposal not to make changes in response to concerns about the order for determining the amount of CSM released in profit or loss for services provided in the period under the general model.

Grouping of insurance contracts affected by regulatory pricing

The Board considered the effect of law or regulation in light of the Board's November 2016 decisions on the grouping of contracts. Prior to its November meeting, the Board had decided not to provide an exemption to the requirements for the level of aggregation when regulation constrains the pricing or benefits. However, this decision was taken in the context of earlier decisions about the level of aggregation prior to the tentative decision to distinguish at least between those groups that are onerous at initial recognition, those that have no significant risk of becoming onerous, and other remaining contracts.

The Board had tentatively decided that insurers need to determine how to divide contracts that disregard a specified characteristic of pricing into different groups, even if the reason an insurer disregards that specified characteristic is because of law or regulation. However, many commentators on the external editorial review draft questioned the usefulness of the information that would be obtained from separating contracts that an entity is required by law or regulation to group together for determining the pricing or level of benefits. For example, if an insurer that issues motor policies is forced by regulation to set the same price for young male and female drivers, would it be useful to recognise onerous contract losses at initial recognition of policies for young male drivers if the combined group of young male and female drivers is expected to be profitable. Those commentators would argue such disaggregation would be artificial rather than reflecting the economic fact that law and regulation affect the pricing.

In response to these comments, the staff proposed a narrow exemption that would allow an insurer to include contracts in the same group if contracts within a portfolio would fall into different groups, only because the law or regulations constrain the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, and to disclose that fact.

Several Board members noted their general reluctance to introduce additional exemptions to the standard due to the associated increase in complexity. However, these Board members also recognised the need to resolve the specific concerns about the grouping of insurance contracts affected by regulatory pricing, which has been a topic of discussion over an extended period and a sensitive issue for the standard.

In response, the staff explained the aim is to introduce a narrow exemption that applies if, and only if, specific constraints in law or regulation would result in contracts being recognised in different groups. The staff emphasised that it should not be extended by analogy to other items (e.g., when applying the other aggregation criteria in the standard, or when accounting for regulatory-affected transactions accounted for in accordance with other standards).

Eleven of 12 Board members agreed and one disagreed with this decision.

Other findings from the external editorial review draft

The staff presented the other findings of the external editorial review of draft IFRS 17 and other sweep issues and its proposed responses to those findings. After providing some matters to be considered as part of drafting (for example, with regard to the level of aggregation, the scope of the variable fee approach and 'mutualisation'), all 12 members of the Board agreed with the staff's recommendations. Board members did not raise any other topics for consideration at a future meeting.

How we see it

A number of Board members clearly stated during the meeting that they valued highly feedback in the form of the external editorial review draft of the standard. Accordingly, the main decisions made during the February meeting were driven by that feedback, demonstrating the Board's continued willingness to consider and respond to input on the clarity and operability of its proposals.

The Board's decision during the February meeting on the treatment of experience adjustments reflects that there is no single perfect solution to the treatment of experience adjustments and the mechanics of adjusting and releasing the CSM. The changes regarding the regulatory pricing effects on the level of aggregation will be welcomed by many insurers as an important step to appropriately reflect these effects in the grouping of contracts.

The effective date of 1 January 2021 will give insurers an implementation period of around three and a half years after issuance of the standard. Whilst the IASB noted in a previous meeting this implementation period is relatively long compared with other standards, the complexity of IFRS 17 will be such that companies cannot afford to wait and will need to start preparing for implementation soon.

What's next?

With the decisions made at this meeting, the Board completed its discussions on the comments from the external editorial review draft and the staff will continue drafting.

The Board expects to issue IFRS 17 in May 2017.

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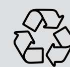

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