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Insurance Accounting Alert

February 2018

First technical discussion of the IASB's IFRS 17 Transition Resource Group (TRG)

What you need to know

- The first technical discussion of the IASB's TRG took place on 6 February 2018.
- The TRG discussed six IASB staff papers on specific issues submitted to the Board.
- IASB staff responses to twelve further issues raised were summarised and reported to the TRG.
- The IASB staff agreed to revise, and bring to a future meeting, one of the papers covering amortisation of the contractual service margin and guidance on coverage units.
- Some TRG members expressed concern at potential operational difficulties and the cost-benefit implications of some of the interpretations.
- The next TRG meeting will be held on 2 May 2018.

Background

IFRS 17 Insurance Contracts (IFRS 17 or the standard) represents a fundamental change to accounting practice for most entities issuing insurance contracts and is expected to require significant implementation effort. Therefore, as one of the activities to support implementation of IFRS 17, the International Accounting Standards Board (IASB or the Board) has set up a Transition Resource Group (TRG).

The purpose of the TRG is to:

- Provide a public forum for stakeholders to follow the discussion of questions raised on implementation
- Inform the Board in order to help it determine what, if any, action will be needed to address the questions raised. Possible actions include providing supporting materials such as webinars, case studies and/or referral to the Board or Interpretations Committee

The TRG comprises experts directly involved in the implementation of IFRS 17: nine members are preparers of financial statements and six are audit practitioners. An additional three members with observer status represent international security regulators, insurance supervisors and actuarial organisations.

The TRG does not issue any authoritative guidance; but the IFRS Foundation will publish summaries and recordings from the meetings on the IASB's website. As such, the comments from the TRG discussion included in this publication do not reflect formal interpretations or authoritative guidance.

The first TRG meeting held to discuss implementation issues occurred on 6 February 2018. The IASB had received 27 submissions of which:

- Six were discussed in detail at this meeting
- Twelve were considered by the IASB staff but not required to be discussed in detail by the TRG as the IASB staff believed that these were matters which:
  - Can be answered by applying only the words in IFRS 17 Or
  - Did not meet the submission criteria Or
  - Are being considered through a process other than a TRG discussion (such as a proposed annual improvement)
- Four were referred to the submitter for further information
- Four were considered to be similar to other submissions
- One was deferred for discussion at the next TRG meeting

The six Issues discussed in detail by the TRG

The IASB staff had prepared detailed papers on each of the six submissions which were discussed by the TRG. The TRG discussed the implementation question and members shared their views and understanding as industry experts. At the end of each discussion, the IASB staff summarised their key take-aways.

1. Separation of components of a single insurance contract

The question

Does IFRS 17 permit the separation of insurance components of a single contract for measurement purposes?

The IASB staff paper prepared for the meeting directed insurers to look to paragraphs 4.56 and 4.62 of the Conceptual Framework Exposure Draft for guidance on when a single contract creates two or more sets of rights and obligations and may need to be accounted for as separate contracts.

The staff paper also noted that the contract is the lowest unit of account used under IFRS 17 and that overriding the contract unit of account presumption involves significant judgement and careful consideration of all relevant facts and circumstances. Combining different types of products or coverages is not, in itself, sufficient to conclude the single contract does not reflect the substance of the contractual rights and obligations.

Points made during TRG discussion

TRG members generally supported the view that separation is not an accounting policy choice, but that it may be appropriate when a single contract incorporates, in substance, two or more separate contracts.

TRG members suggested that indications that a document with the form of a single contract, but the substance of two or more separate contracts, includes cases where: (i) there is no interaction between the claim payments of the components, (ii) premiums relating to different investment components were invested in different underlying assets, (iii) the components are distinct, e.g., they do not lapse together, any combined discount is small, etc.

TRG industry representatives stated that insurers sometimes package together different types of cover into a single document for the convenience of the policyholder, but manage and reserve for the risks separately.

In response to a query from one TRG member, an IASB Board member stated that the narrative in paragraph 20 of the related IASB Staff Paper stating that a single contract could be separated if the combination of different components was 'artificially constructed', had unintended negative connotations and would not be included in the IASB summary of the meeting.

How we see it

Insurers are likely to welcome an acknowledgement that IFRS 17 does not prohibit separation of components of individual insurance contracts for measurement purposes. However, the more difficult judgement is when a single document is, in substance, two or more separate contracts.

2. Boundary of contracts with annual repricing mechanisms

The question

What types of 'risk' are relevant in applying the criteria in paragraph 34(b) of IFRS 17 to determine the contract boundary of insurance contracts which can be repriced at a portfolio level?

The related staff paper contained two examples; a stepped-rated insurance contract; and, a unit-linked contract with a stepped-rated insurance rider. The paper expressed the view that the requirement in paragraph 34(b) of IFRS 17 that 'the pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date' relate only to policyholder risk and not lapse risk or expense risk.

Points made during TRG discussion

TRG members questioned the IASB staff as to whether policyholder risk includes financial risk. The IASB staff stated that 'risks' include insurance risk and financial risk that is transferred from the policyholder to the insurer, but do not include lapse risk or expense risk, because these are not risks a policyholder transfers to the insurer.

TRG members debated the effect of changes to the examples as presented. However, as the answer depends on the precise terms of a contract, there was limited ability to conclude on alternative scenarios during the meeting. It was highlighted that the outcome for the contract boundary assessment depends on the precise fact pattern and there were specific facts in the examples cited in the staff paper that may not apply to other contracts.

3. Boundary of reinsurance contracts held

The question

How to interpret the requirements of paragraph 34 of IFRS 17 regarding the boundary of an insurance contract with regard to reinsurance contracts held?

The staff paper prepared for the meeting confirmed that a substantive right of a cedant to receive services from the reinsurer ends when the reinsurer has the practical ability to reassess the risks transferred and can set a price or level of benefits to fully reflect the reassessed risk. A substantive right of the reinsurer to terminate the coverage would result in the entity not having the substantive right to receive services.

The boundary of a reinsurance contract held could include cash flows from underlying contracts covered by the reinsurance contract that are expected to be issued in the future. This would be the case if the entity has the right to receive insurance services under the reinsurance contract held for those future underlying contracts without the reinsurer having the practical ability to reassess the risks transferred to the reinsurer and set a price or level of benefit to fully reflect the reassessed risk when those future underlying contracts are recognised.

Points made during TRG discussion

TRG members agreed that the words in paragraph 34 effectively require that cash flows arising from underlying contracts an entity expects to issue in the future must be included within the contract boundary of a reinsurance contract held. However, TRG members were concerned as to the operational implications and the potential for a mismatch between the recognition and measurement of insurance contracts issued and reinsurance contracts held.

How we see it

This clarification confirms that a mismatch may be created between the date of recognition and measurement of underlying contracts issued and related reinsurance contracts held by a cedant.

Under IFRS 4, grandfathered existing accounting policies would typically not include underlying insurance contracts that have not yet been issued in the measurement of proportional reinsurance contracts held.

4. Insurance acquisition cash flows paid on an initially written contract

The question

How to account for insurance acquisition cash flows unconditionally paid for a written contract when the entity expects renewals outside the contract boundary to occur?

The IASB staff paper contained an example of a long-term contract with a one-year contract boundary, on which significant initial commissions were paid which were non refundable. The following points were made:

- The acquisition cash flows are considered in the measurement of the IFRS 17 measurement group to which the initially written contract belongs. The acquisition cash flows are directly attributable to those contracts because they are paid for each initially written contract.
- The specified insurance acquisition cash flows cannot be included in the measurement of any future IFRS 17 group(s) to which the contract, if renewed, would belong.
- The specified initial contracts cannot be in the same IFRS 17 measurement group as the specified contracts that are renewed during the same annual period, because the initially written contracts are onerous contracts at initial recognition (due to the non-refundable commission paid).

Points made during TRG discussion

TRG members were concerned with inconsistencies between the treatment in IFRS 17 and that in IFRS 15 *Revenue from Contracts with Customers*. While the analysis in the staff paper indicates that non-refundable initial commissions must be allocated to the IFRS 17 measurement grouping of initially written contracts only, IFRS 15 paragraph 95(a) allows costs to be allocated to existing and anticipated contracts. The IASB staff observed that the inconsistency between IFRS 17 and IFRS 15 is a consequence of the fact that the models are very different in a number of ways.

TRG members noted that the conclusion of the staff paper that costs relates to an individual contract have to be allocated on a contract-by-contract basis, whereas costs that relate to a portfolio, or group of contracts, must be allocated on that level, seems to conflict with the guidance that acquisition costs can be deferred at portfolio level. They noted that commissions are paid with the expectation of future renewals. The staff responded that the appropriate way to apply the guidance is to distinguish between costs which are unconditionally identified with individual contracts and more generally attributable acquisition costs which could be allocated at the portfolio level.

In response to a TRG query, the IASB staff clarified that the word ‘issued’ in paragraph 27 of IFRS 17, which deals with the deferral of costs incurred before a contract has been recognised, was meant to distinguish originated insurance contracts from reinsurance contracts held. As such, it did not mean that acquisition costs incurred relating to as yet unissued contracts could not be capitalised.

The IASB staff observed that, where facts are different and costs do not unconditionally relate to individual contracts, then those costs might be allocated to the entire portfolio of contracts.

5. Defining quantity of benefits for identifying coverage units

The question

How is the ‘quantity of benefits’ in paragraph B119(a) of IFRS 17 to be defined when referring to coverage units? The staff paper identified different factors that could be included in the determination of coverage units and used examples to illustrate the effect of including or excluding those factors.

The staff paper grouped factors that might be included in determining the quantity of benefits arising from insurance contracts, as follows:

- Variability across periods in the level of cover provided by the contracts in the group
- Likelihood of an insured event occurring:
    - To the extent that likelihood affects the expected duration of a contract, e.g., expectations of lapses and cancellations
    - To the extent that likelihood affects the amount expected to be claimed in a period

The paper concluded that the determination of coverage units of a group should:

- Reflect the likelihood of an insured event occurring to the extent that it affects the expected duration of contracts in the group
- In principle, reflect variability across periods in the level of cover provided by the contracts in the group (to be consistent with the treatment of contracts that provide different levels of cover), with the level of cover being the contractual maximum level of cover in each period, not the level of cover reflecting expected events
- Not reflect the likelihood of an insured event occurring to the extent it affects the amount expected to be claimed in a period

Points made during TRG discussion

TRG members were concerned that the IASB staff paper introduces new ideas and principles that are not in IFRS 17 and they were uneasy forming conclusions before seeing further examples and also before discussing contracts with investment components, which was scheduled to be discussed at the next meeting.

A TRG member expressed the view that expected level of cover, or amount actually at risk, was a better driver for amortising the contractual service margin than the maximum contractual risk in the contract.

The IASB staff agreed that the paper would be revised and resubmitted for the next TRG meeting. The IASB staff paper for the next TRG meeting will: discuss contracts with investment components; consider whether the expected level of cover is more appropriate than the contractual maximum pay-out as a driver for amortising the contractual service margin; contain revised examples and make those examples more relevant to consideration of groups of insurance contracts.

How we see it

The discussion at the TRG meeting highlights that the application of the notion of coverage units is arguably one of the most challenging implementation issues of IFRS 17, also demonstrated by the fact that the IASB staff decided it would be necessary to bring back a revised paper on this topic to the next TRG meeting. Providing further clarification around the guidance in the standard, while, at the same time, leaving sufficient room for suitable application to the wide range of insurance products that exist in practice will require careful consideration.

6. Insurance acquisition cash flows when using fair value at transition

The question

When the fair value approach to transition is applied, are insurance acquisition cash flows that occurred prior to transition date recognised as revenue and expense in the statement of financial performance for reporting periods subsequent to the transition date?

Points made during TRG discussion

TRG members agreed with the conclusions of the IASB staff paper that fair value reflects future cash flow expectations and does not reflect past cash flows, including insurance acquisition cash flows that occurred prior to the transition date. This provides the entity with a ‘fresh start’ approach to transition as intended by the IASB. Hence, insurance acquisition cash flows that occurred prior to the date of transition are not included in the measurement of the contractual service margin at the transition date, and are not included in the presentation of insurance revenue and expenses.

Twelve issues submitted to the TRG but not discussed in detail

Below are the questions with the preliminary views of the IASB staff in italics. The reference at the beginning of each paper is to the number of the question on the TRG submission log.

Questions that the IASB staff believe can be answered applying only the words in IFRS 17

S04 — Subsequent treatment of contracts acquired in their settlement period. Should insurance revenue and insurance service expense for insurance contracts acquired in conjunction with a business combination or similar acquisition reflect the entire expected claims over their settlement period?

Staff response: Revenue should reflect the entire expected claims. Para B5 of IFRS 17 states that the insured event for an adverse development cover contract is the determination of the ultimate cost of the claim. Accordingly, revenue reflects the entire expected claims (unless some are investment components).

S09 — How should the contractual service margin be allocated to coverage units provided in the current period and expected to be provided in the future applying paragraph B119(b) of IFRS 17?

Staff response: The CSM released in the period is affected by changes in expectations about the future. This means that allocation is done after adjusting the CSM for changes in expectations. Allocation is performed at the end of the period identifying coverage units that were actually provided in the current period and coverage units that are expected to be provided in future.

S17: Does the use of consistent assumptions for the measurement of the estimates of present value of the future cash flows for a group of reinsurance contracts held compared with those assumptions used to measure the underlying insurance contracts mean that the use of identical discount rates is required?

Staff response: Consistent does not necessarily mean identical.

S20: When using the modified retrospective approach to transition, is it required that groups of insurance contracts do not include contracts issued more than one year apart if the entity has reasonable and supportable information to do that?

Staff response: Yes, confirmed. The IASB staff did not believe that paragraphs C8 and C10 and paragraph BC392 of IFRS 17 were inconsistent.

S23: Do the words "premiums received" when applying the premium allocation approach (PAA) according to paragraph 55(a)(i) and 55(b)(i) of IFRS 17 mean premiums received, premiums due, or premiums expected?

Staff response: Confirmed that premiums received means premiums actually received.

S26: Do contracts whose return is based on an amortised cost measurement of the underlying items fail the definition of insurance contracts with direct participation features (i.e., fail the eligibility test for the variable fee approach)?

Staff response: A contract which provides a return based on an amortised cost measurement would not automatically fail the definition of an insurance contract with direct participation features.

Questions that the IASB staff believe did not meet the TRG submission criteria

S03: Would presentation of groups of insurance contracts in the statement of financial position be more appropriately done at a portfolio level?

Staff response: The existing requirement to disclose on the balance sheet groups of insurance contracts in an asset position separately from groups of insurance contracts in a liability position was confirmed and considered to be aligned with the Conceptual Framework.

S10: The requirement for classification of contracts acquired in a business combination based on conditions at the acquisition date could result in different classification of contracts for acquirer and acquiree and therefore result ion onerous system implications and various consolidation complexities.

Staff response: This is consistent with normal business combination accounting generally.

S24: The submission considers that the requirement for differing discount rates to be used for initial measurement and subsequent measurement of insurance contracts with direct participating features will result in diversity between insurance revenue recognised for insurance contracts without direct participating features but that have some asset dependent cash flows and for insurance contracts with direct participation features accounted for using the variable fee approach.

Staff response: Confirmed. The IASB rationale for this is set out in BC273 of IFRS 17.

S25: The submission queries whether the requirement in B96 of IFRS 17 for the carrying amount of the contractual service margin to be adjusted for a difference in the investment component as a result of the delay or acceleration of repayment is appropriate as it appears to be in conflict with the principle underpinning revenue as set out in paragraph B120 of IFRS 17.

Staff response: Confirmed. The IASB rationale for this is set out in BC235 of IFRS 17.

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

S06: There is an inconsistency between the requirements to determine classification of contracts acquired in a transaction at the transaction date in IFRS 17, which seem to apply to any business combination which has occurred in the past, and the Agenda paper 2C of February 2017 which implies that the requirement only applies to business combinations occurring after IFRS 17 is effective.

Staff response: This question will be considered as part of the annual improvements project.

S16: Which discount rate is to be used to adjust the contractual service margin of reinsurance contracts held applying paragraph B66(c) of IFRS 17?

Staff response: The discount rate should be the rate determined on initial recognition and an editorial correction will be made to add a reference to B72(c) in B66(c).

Comments from TRG Members on other questions submitted

The TRG members acknowledged that the responses of the staff correctly reflect the interpretation of the requirements of the standard. However, the TRG members consider that there are a number of instances where those interpretations are operationally onerous and appeared to have minimal benefit to users of the financial statements. These include: the treatment of acquired claims in their settlement period (S04); the use of premiums received rather than due in applying the PAA (S23); and presentation of groups of insurance contracts in an asset position separately from groups in a liability position (S03).

What's next

The next meeting of the TRG will be held on 2 May 2018. This meeting will include a follow-up discussion on the definition of the quantity of benefits for amortising the contractual service margin.

Look out for further publications from EY on IFRS 17, which will be published over the coming months.

Contacts

Global

Kevin Griffith	+44 20 7951 0905	kgriffith@uk.ey.com
Martina Neary	+ 44 20 7951 0710	mneary@uk.ey.com
Martin Bradley	+44 20 7951 8815	mbradley@uk.ey.com
Conor Geraghty	+44 20 7951 1683	cgeraghty@uk.ey.com
Hans van der Veen	+31 88 40 70800	hans.van.der.veen@nl.ey.com

Europe, Middle East, India and Africa

Philip Vermeulen	+41 58 286 3297	phil.vermeulen@ch.ey.com
Thomas Kagermeier	+49 89 14331 25162	thomas.kagermeier@de.ey.com
Belgium Katrien De Cauwer	+32 2 774 91 91	katrien.de.cauwer@be.ey.com
France Frederic Pierchon	+33 1 46 93 42 16	frederic.pierchon@fr.ey.com
Germany Thomas Kagermeier	+49 89 14331 25162	thomas.kagermeier@de.ey.com
Germany Martin Gehringer	+49 6196 996 12427	martin.gehringer@de.ey.com
Germany Robert Bahnsen	+49 711 9881 10354	robert.bahnsen@de.ey.com
India Rohan Sachdev	+91 226 192 0470	rohan.sachdev@in.ey.com
Italy Matteo Brusatori	+39 02722 12348	matteo.brusatori@it.ey.com
Israel Emanuel Berzack	+972 3 568 0903	emanuel.berzack@il.ey.com
Netherlands Jasper Kolsters	+31 88 40 71218	jasper.kolsters@nl.ey.com
Portugal: Ana Salcedas	+351 21 791 2122	ana.salcedas@pt.ey.com
South Africa Jaco Louw	+27 21 443 0659	jaco.louw@za.ey.com
Spain Ana Belen Hernandez-Martinez	+34 915 727298	anabelen.hernandezmartinez@es.ey.com
Switzerland Roger Spichiger	+41 58 286 3794	roger.spichiger@ch.ey.com
Switzerland Philip Vermeulen	+41 58 286 3297	phil.vermeulen@ch.ey.com
UAE Sanjay Jain	+971 4312 9291	sanjay.jain@ae.ey.com
UK Brian Edey	+44 20 7951 1692	bedey@uk.ey.com
UK Nick Walker	+44 20 7951 0335	nwalker1@uk.ey.com
UK Shannon Ramnarine	+44 20 7951 3222	sramnarine@uk.ey.com

Americas

Argentina Alejandro de Navarette	+54 11 4515 2655	alejandro.de-navarrete@ar.ey.com
Brazil Eduardo Wellichen	+55 11 2573 3293	eduardo.wellichen@br.ey.com
Brazil Nuno Vieira	+55 11 2573 3098	nuno.vieira@br.ey.com
Canada Janice Deganis	+1 5195713329	janice.c.deganis@ca.ey.com
Mexico Tarsicio Guevara Paulin	+52 555 2838687	tarsicio.guevara@mx.ey.com
USA Dana D'Amelio	+1 212 773 6845	dana.damelio@ey.com
USA John Santosuosso	+1 617 585 1867	john.santosuosso@ey.com
USA Evan Bogardus	+1 212 773 1428	evan.bogardus@ey.com

Asia Pacific

Jonathan Zhao	+852 6124 8127	jonathan.zhao@hk.ey.com
Martyn van Wensveen	+6 0374958632	martyn.van.wenveen@my.ey.com
Australia Kieren Cummings	+61 2 9248 4215	kieren.cummings@au.ey.com
China (mainland) Andy Ng	+86 10 5815 2870	andy.ng@cn.ey.com
China (mainland) Bonny Fu	+86 135 0128 6019	bonny.fu@cn.ey.com
Hong Kong Jonathan Zhao	+852 6124 8127	jonathan.zhao@hk.ey.com
Hong Kong Steve Cheung	+852 2846 9049	steve.cheung@hk.ey.com
Hong Kong Tze Ping Chng	+852 2849 9200	tze-ping.chng@hk.ey.com
Hong Kong Peter Telders	+852 9666 2014	peter.telders@hk.ey.com
Korea Mi Namkung	+852 2849 9184	mi.namkung@hk.ey.com
Korea Suk Hun Kang	+82 2 3787 6600	suk-hun.kang@kr.ey.com
Malaysia Martyn van Wensveen	+6 0374958632	martyn.van,wensveen@my.ey.com
Singapore Patrick Menard	+65 6309 8978	patrick.menard@sg.ey.com
Singapore Sumit Narayanan	+65 6309 6452	sumit.narayanan@sg.ey.com

Japan

Hiroshi Yamano	+81 33 503 1100	hirishi.yamano@jp.ey.com
Norio Hashiba	+81 33 503 1100	norio.hashiba@jp.ey.com
Toshihiko Kawasaki	+81 80 5984 4399	toshihiko.kawasaki@jp.ey.com

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