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Insurance Accounting Alert

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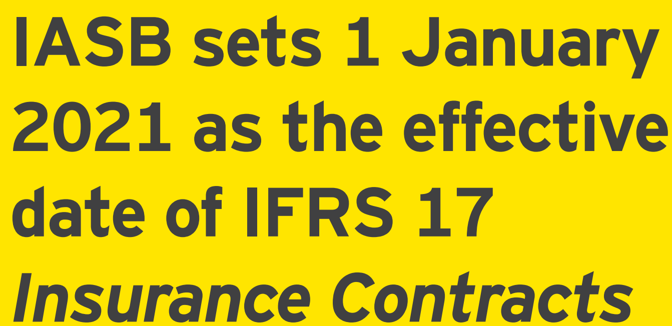

IASB sets 1 January 2021 as the effective date of IFRS 17 *Insurance Contracts*

What you need to know

- The IASB has set 1 January 2021 as the mandatory effective date of IFRS 17 with early adoption permitted if entities also apply IFRS 9 and IFRS 15.
- The IASB responded to concerns raised during field testing by making changes to the requirements for level of aggregation, transition, and application of the building block and variable fee approaches.

Overview

During its November meeting, the International Accounting Standards Board (IASB or the Board) discussed several issues that arose during the field testing and drafting processes for IFRS 17 *Insurance Contracts* and agreed on the effective date. (IFRS 17 is the name for the new standard developed as part of the IASB's insurance contracts project, IFRS 4 Phase II).

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

IASB sets 1 January 2021 as the effective date of IFRS 17 *Insurance Contracts*

The IASB agreed with the staff recommendation for the mandatory effective date of IFRS 17, i.e., an entity should apply IFRS 17 for annual periods beginning on or after 1 January 2021 (in the expectation that IFRS 17 is issued in the first half of 2017).

This will allow at least three and a half years from the issuance of IFRS 17 for implementation. Some Board members noted implementation would be longer relative to other standards but this was necessary given the complexity of proposals and extent of effort required. An entity may apply IFRS 17 before 1 January 2021, provided the entity also applies IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers*.

Responses to field testing

The IASB did targeted field testing of the proposals in a draft of the insurance contracts standard with 12 participants between July and September 2016. At this meeting, they discussed several issues that came up during both the field testing and the drafting process. The staff provided a summary of the results of the field testing and proposed responses to the findings from participants.

The external testing focused on whether entities would be likely to interpret the requirements in draft IFRS 17 consistently, and the potential operational difficulties they would encounter in applying the requirements. The test participants were selected to provide geographical representation and a range of products to be tested.

The topics that attracted most comments from the field testers were the level of aggregation for the measurement of the contractual service margin (CSM) and transition.

Level of aggregation for CSM and onerous contracts test

This topic gave respondents the greatest concern during testing, with participants believing they would have to establish a very high number of groups of contracts based on the wording in the draft of IFRS 17. Participants also questioned the operational complexity and costs that would arise and whether they would be justified by the usefulness of information provided. Participants raised concerns that granularity could result in entities reporting losses on some contracts where other contracts were profitable in cases where this did not reflect economic circumstances or the way that the business was managed.

The staff and the Board noted that the participants' interpretation of the draft standard resulted in a large volume of sub-portfolios. Several Board members commented such a high level of granularity was not intended, and noted that, in many cases, a very low level of aggregation would not impact the financial statements significantly if all the portfolios consisted of profitable contracts. Granularity was primarily important when contracts moved closer to becoming onerous.

To address this issue, the Board decided (with ten Board members in favour and one against) to make a number of changes to the requirements for aggregating contracts for the purpose of measuring the CSM and, accordingly, identifying onerous contracts. Key aspects of this change are:

- The definition of 'portfolio' in the draft IFRS 17 will be retained. A portfolio is a group of contracts subject to similar risks and managed together as a single pool. IFRS 17 will provide guidance that contracts within each product line (such as annuities or whole-life) would be expected to have similar risks, and, hence, contracts from different product lines would not be expected to be in the same portfolio.
- Entities will be required at inception to group onerous contracts separately from contracts that are not onerous. The Board asked the staff to clarify
    - that entities could measure contracts together if the entity can determine that those contracts can be grouped with others based on available information at inception.
- Entities will be required to measure insurance contracts that are not onerous at inception by dividing portfolios, at a minimum, into two groups — a group of contracts that have no significant risk of becoming onerous and a group of other profitable contracts. IFRS 17 will provide guidance for this exercise, embodying assessments of the risk of the contracts in a group becoming onerous:
    - In a manner consistent with the entity's internal reporting about changes in estimates
    - Based on the sensitivity of the fulfilment cash flows to changes in estimates which, if they occurred, would result in the contracts becoming onerous
- An entity can only group contracts issued within the same year into a single group. (i.e., this prohibits grouping contracts that are issued more than one year apart in the same group).

The Board also clarified that an entity is permitted to divide profitable portfolios into more than two groups. For example, an entity may choose to divide the portfolios into more groups if the entity's internal reporting provides information that distinguishes, at a more granular level, the different risks of contracts becoming onerous. Entities can also choose to have cohorts covering periods of less than one year.

Board members agreed that, while the approach above may lose some granularity, it keeps the primary objective of identifying onerous contracts and contracts that are at risk of becoming onerous. They also agreed that while it moves away from a more principles-based approach and the notion of 'similar risks' and 'similar profitability' for aggregation, it strikes a balance between operational and cost concerns on the one hand, and achieving the objectives set out on the other.

While Board members generally preferred a principles-based approach, the use of annual cohorts would, in their view, be a clearer and safer way to ensure that entities do not use the CSM as an everlasting pot of reserves to draw on and dip into.

The staff plans to incorporate more guidance in the drafting about mutualisation and how to apply it as an enforceable component of the contract within the context of measuring the CSM and identifying onerous contracts.

The Board confirmed that the CSM for a group of contracts must be allocated over the current and expected remaining coverage period on the basis of the passage of time. The allocation must be based on coverage units, reflecting the expected duration and size of the contracts in the group.

The Board also decided that an entity should be permitted to use a weighted average discount rate for the accretion of interest, with an averaging period of up to one year. All Board members were in favour.

Transition

Most field test participants expressed concerns about the operability of transitioning existing business to the IFRS 17 requirements on the date of initial application of the standard. In response, the Board decided to adapt several aspects of the existing transition proposals. The existing proposals require a fully retrospective approach to be used. If such an approach were impracticable, then a simplified retrospective approach could be used. Finally, a fair value approach could be used to determine the liability and CSM at transition if the other two approaches were impracticable. The Board agreed the following changes, addressing four key concerns from the field testing participants:

Issue 1 - The need to demonstrate impracticability before using the modified and fair value approaches

- An entity should apply the requirements of IFRS 17 retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to groups of insurance contracts, unless retrospective application is impracticable.
- For insurance contracts for which an entity cannot identify a group retrospectively, and for groups of insurance contracts for which retrospective application is impracticable, an entity is permitted to choose between a modified retrospective approach and a fair value approach. However, if a modified retrospective approach is impracticable, the entity must apply the fair value approach.

Issue 2 - Simplifications to retrospective application:

- The objective of a modified retrospective approach (previously referred to by the IASB as the simplified retrospective approach) is to achieve the closest outcome to retrospective application that is possible using reasonable and supportable information.
- An entity is allowed to use a number of specified modifications, but must use the minimum modifications necessary to achieve the above objective without undue cost or effort. For example, an entity will not be prohibited from grouping contracts issued more than one year apart into a single group.
- When applying a modified retrospective approach, an entity maximises the use of information that would have been used to apply a fully retrospective approach, but need only use information available without undue cost or effort.

Issue 3 – The date for determining the contractual service margin for contracts with direct participation features

- An entity must determine the contractual service margin using permitted modifications for the variable fee approach, determined at the beginning of the earliest period presented (rather than at the date of initial application).

Issue - Concerns with the Fair Value approach

- An entity will be allowed to make the following assessments either as at inception of a contract or as at the beginning of the earliest period presented under the fair value approach (consistent with the modifications recommended for the modified retrospective approach):
  - Whether a contract is eligible for the variable fee approach
  - How to group contracts
  - How to determine the effect of discretion on estimated cash flows for contracts subject to the general model
- The entity can make the above assessments either as at inception of a contract based on reasonable and supportable evidence for what the entity would have determined given the terms of the contract and the market conditions at inception, or at the beginning of the earliest period presented.
- Also consistent with the modifications recommended for the modified retrospective approach, the entity when applying the fair value approach is:
  - Not prohibited from grouping contracts issued more than one year apart into a single group; and
  - Permitted to use the discount rate at the beginning of the earliest period presented:

- To accrete and adjust the resulting CSM for groups of contracts to which the entity applies the general model
- To determine the finance income or expenses in profit or loss when the entity makes an accounting policy choice to disaggregate the insurance finance income or expenses between profit or loss and other comprehensive income for non-participating contracts

All Board members voted in favour of the above decisions.

The Board asked the staff to emphasise in the drafting that entities should still try to get as close to full retrospective application as possible. Several Board members noted that some of the decisions, such allowing a choice between the modified retrospective approach and the fair value approach, represented a significant change to the proposals and viewed these changes as very generous concessions. The Board therefore decided, in line with the staff's recommendation, to require the IFRS 17 disclosures regarding the CSM, insurance contracts revenue and insurance finance income or expense separately for insurance contracts:

- That existed at the beginning of the earliest period presented
- Written after the beginning of the earliest period presented

The Board also decided that an entity should explain how it determined the measurement of insurance contracts at transition for all periods in which disclosures are provided for insurance contracts that existed at the beginning of the earliest period presented when the entity first applies IFRS 17. This explanation is intended to help users understand the nature and significance of the methods used and judgements applied. Furthermore, an entity will have to provide a reconciliation from the opening to the closing balance of the cumulative amounts included in other comprehensive income (OCI) for financial assets measured at fair value through OCI, if those assets are related through the entity's asset-liability management to insurance contracts for which an entity determines the finance income or expenses in profit or loss using the discount rate at the beginning of the earliest period presented (rather than the discount rate at inception of the contracts).

Experience adjustments

Some field testing respondents found it difficult to determine if a change in estimate of the present value of future cash flows related to an experience adjustment arising in the current period or not. If it did, the entire effect of the experience adjustment would be recognised in the CSM. Some noted that, under the general model, the majority of experience adjustments would cause a change in the estimates of the present value of future cash flows and would, therefore, adjust the CSM (rather than be recognised in profit or loss). Some questioned if this was the Board's intent. Others noted operational challenges, for example, if systems do not identify the causes of change in estimates.

In response, the Board decided that, when an experience adjustment directly causes a change in the estimate of the present value of future cash flows, the combined effect of the experience adjustment in the current period and the change in the estimate of the present value of the future cash flows should not adjust the CSM, but should be recognised in profit or loss instead. The Board agreed to add guidance to the new standard that explains that an experience adjustment directly causes a change in the estimate of the present value of future cash flows only when it causes a change in the future rights and obligations for the group of contracts, and not just the measurement of those rights and obligations. As such, a change in the measurement only of existing rights and obligations is not directly caused by an experience adjustment.

Similarly, the Board decided that, for contracts measured under the variable fee approach, experience adjustments arising from non-financial risk that do not affect the underlying items, and any directly caused changes in the estimates of the present value of future cash flows should not adjust the CSM but should be recognised in profit or loss.

Mitigating financial risks

The draft IFRS 17 permits entities to recognise the effects of changes in financial options and guarantees in profit or loss instead of the CSM when an entity applies the variable fee approach and mitigates that risk with a derivative to avoid potential accounting mismatches. Test participants acknowledged that an option not to include the effects of specified financial risks in the CSM (e.g., for financial options and guarantees) is helpful but asked the IASB to broaden the approach, with some participants asking for it to be extended to contracts outside the variable fee approach.

The Board decided to restrict the application to contracts within the scope of the variable fee approach, but permit an entity that uses a derivative to mitigate any financial risks arising from those contracts to exclude the effect of those changes in financial risk from the CSM when specified criteria are met. This decision extends the risk mitigation option from risks related to financial options and guarantees to all financial risks reflected in insurance contracts accounted for under the variable fee approach.

All Board members voted in favour.

Other sweep issues

The staff raised 21 other issues that arose in the drafting process and external field testing.

The Board agreed with the staff recommendations and did not raise any other topics for staff to bring back at a future meeting.

How we see it

The decisions made during the November meeting appear to mark the completion of the IASB's re-deliberations after many years of discussion. This is a clear signal of the IASB's dedication to issue the final standard in the first half of 2017.

Many of the decisions made during the November meeting were clearly driven by the feedback received from the field testing, demonstrating the Board's willingness to consider and respond to input on the clarity and operability of its proposals. The revised proposal on the level of aggregation will be seen by many as a clear move towards a top-down approach for determining the grouping of contracts, with some reservations left around onerous contract identification at inception and the application of mutualisation that need to be resolved as part of drafting. The transition requirements remain complex, but the changes made during the November meeting should provide companies with increased optionality that is better tailored to their specific circumstances.

Based on publication of the final standard in the first half of 2017, the effective date of 2021 will give insurers approximately three-and-a-half years for implementation. Whilst the IASB notes 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?

Following the decisions made at this meeting, the Board completed its re-deliberations on IFRS 17. The staff will continue drafting to reflect the decisions made in the November 2016 meeting in a revised draft of IFRS 17 plans to ask selected external parties to perform a fatal flaw review of an updated draft of IFRS 17.

The Board expects to issue IFRS 17 in the first half of 2017

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