Request for Feedback

Financial Reporting Council

August 2019

FRC STAFF DRAFT RESPONSE TO IASB ED/2019/4 AMENDMENTS TO IFRS 17

The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

This is the staff draft of the Financial Reporting Council's response to the IASB's Exposure Draft ED/2019/4 *Amendments to IFRS 17 (ED)*. The draft response outlines the FRC staff's tentative conclusions on issues raised in this ED. We do not ask questions on the proposals or the staff draft, but would welcome stakeholders' views to inform the FRC's final response to the IASB's ED.

Please provide any written comments no later than 5 September to Susanne Pust Shah (IFRS17@frc.org.uk). We will also hold a roundtable event at the FRC on 5 September to discuss the proposals in the ED and the FRC's response. You can sign up for this event on the FRC website.

As part of the UK's preparation to exit the European Union, the Department for Business, Energy and Industrial Strategy is in the process of setting up a new, independent body to adopt and endorse International Accounting Standards for use in the UK. The views expressed in this staff draft are not those of the new body and the new body will not be bound by this draft or any final response to the ED by the FRC. However, any input we receive from constituents will be made available for consideration by the new body.

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Submitted electronically

Xx September 2019

Dear Board Members,

Exposure Draft ED/2019/4 *Amendments to IFRS 17*

I am writing on behalf of the UK Financial Reporting Council (FRC) to comment on the Exposure Draft ED/2019/4 *Amendments to IFRS 17* (ED).

Significant progress towards the implementation of IFRS 17 has been made since the standard's publication. Concerns around the use of the standard are not unexpected given the complexities of insurance accounting and the divergence between existing accounting practices around the world.

We welcome these proposals to address some of the most pressing issues that were raised around the implementation of IFRS 17. We appreciate the IASB's efforts and flexibility to consider the concerns promptly and develop innovative solutions. We concur with the IASB that the proposals need to avoid undue disruption of ongoing implementation and thereby not delay the introduction of IFRS 17. We believe it should be the IASB's priority to finalise the amendments in accordance with the published timetable.

We agree with the majority of the proposals in this ED. Where we believe a proposed solution could be improved, we have suggested alternatives. We have concerns with the proposal that addresses accounting mismatches between reinsurance contracts held and onerous underlying insurance contracts. We recommend considering an alternative approach that in our view would better reflect the economics of the transactions.

We considered stakeholders' concerns regarding the annual cohort requirements and the IASB's arguments for deciding against a change. There are practical challenges of implementing the annual cohort requirement, especially for contracts that share risk. For these types of insurance products the allocation of cash flows between the groups could be judgemental and may not necessarily be representative of how the contracts are managed.

We are not opposed to an alternative solution, but proposals that define the scope along the lines of paragraph 67 of IFRS 17 are not sufficiently specific to clearly define any exception to the use of annual cohorts. We do not support open portfolios that allow for new contracts to be added indefinitely as this could mask profitability trends. Any alternative solution would possibly have to be exposed for comment, which would make it impossible to finalise these amendments by mid-2020. For these reasons we reside with the IASB and believe no change can be made to IFRS 17. A post-implementation review of IFRS 17 may reconsider the concerns and possible solutions again.

Our detailed responses to the questions are included in the Appendix to this letter.

If you would like to discuss these comments, please contact me or Susanne Pust Shah (s.pustshah@frc.org.uk) on 020 7492 2495.

Yours sincerely

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Appendix: Questions

Question 1—Scope exclusions—credit card contracts and loan contracts that meet the definition of an insurance contract (paragraphs 7(h), 8A, Appendix D and BC9–BC30)

(a) Paragraph 7(h) proposes that an entity would be required to exclude from the scope of IFRS 17 credit card contracts that meet the definition of an insurance contract if, and only if, the entity does not reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer.

Do you agree with the proposed amendment? Why or why not?

(b) If not excluded from the scope of IFRS 17 by paragraphs 7(a)–(h), paragraph 8A proposes that an entity would choose to apply IFRS 17 or IFRS 9 to contracts that meet the definition of an insurance contract but limit the compensation for insured events to the amount required to settle the policyholder's obligation created by the contract (for example, loans with death waivers). The entity would be required to make that choice for each portfolio of insurance contracts, and the choice for each portfolio would be irrevocable.

Do you agree with the proposed amendment? Why or why not?

Notes to Question 1(a):

1. *With this amendment the IASB is seeking to address concerns about the IFRS 17 accounting for certain credit card contracts. In particular those contracts where the credit card issuer is required to indemnify the customer for supplier failure. Unlike IFRS 4, IFRS 17 does not permit the credit card loan balance to be treated separately from the insurance component. The whole contract is subject to IFRS 17. Under the proposed amendment the entire credit card contract would be accounted for under IFRS 9, subject to conditions. This applies regardless of whether the credit card issuer is legally required to provide insurance coverage or not.*

Notes to Question 1(b):

2. *With this proposed amendment the IASB responds to concerns that under IFRS 17 loans that transfer significant insurance risk would be accounted for as insurance contracts in their entirety. Common examples of such contracts include mortgages or other loans with a death waiver, student loans that are forgiven if certain earning thresholds are not met and equity release mortgages with a no negative equity guarantee.*

3. *As noted above, IFRS 17 is more restrictive in terms of separation of non-insurance components from insurance contracts than IFRS 4. Under the proposal entities that issue loans which transfer significant insurance risks would have the option to apply IFRS 17 or IFRS 9 to such contracts. In order to provide a degree of comparability between similar contracts, the choice is irrevocable and has to be applied to all contracts in the same portfolio (IFRS 17 defines a portfolio as contracts subject to similar risks and managed together).*

4. *The IASB is proposing to make consequential changes to some of the IFRS 9 transitional requirements. The proposed changes would permit entities that already apply IFRS 9 not to restate comparative information in respect of balances to which the proposed exemptions apply. Entities would also have the ability to change the designation of financial liabilities measured at fair value through profit and loss to avoid new accounting mismatches.*

FRC staff draft response:

A1 We agree with the proposal in (a). We believe it addresses the concerns raised by stakeholders adequately and the proposed accounting provides relevant information.

A2 We have reservations regarding the proposal in (b). Although we agree with the scope of the exemption, we believe a better solution would be to require the use of IFRS 9, instead of providing an option to apply IFRS 9 or IFRS 17.

A3 The use of the same accounting requirements for the same type of contracts supports consistency and comparability between entities and mandating the use of one standard is preferable. The contracts in scope of the exemption are financial assets and the accounting under IFRS 9 is well understood. The application of IFRS 17, however, is not as clear and the resulting information could be less useful. It seems reasonable to assume that IFRS 9 will be the preferred accounting standard by banks and many insurers for these financial assets. We therefore have a clear preference for mandating the use of IFRS 9.

A4 In addition to our suggestion to mandate the use of IFRS 9, we propose a drafting change to paragraph 8A of IFRS 17, to clarify that the contracts need to be financial instruments.

"~~Some contracts~~ Those financial instruments that meet the definition of an insurance contract but …"

A5 We concur with the proposed changes to the IFRS 9 transitional requirements for those entities that already apply IFRS 9.

Question 2—Expected recovery of insurance acquisition cash flows (paragraphs 28A–28D, 105A–105C, B35A–B35C and BC31–BC49)

Paragraphs 28A–28D and B35A–B35C propose that an entity:

(a) allocate, on a systematic and rational basis, insurance acquisition cash flows that are directly attributable to a group of insurance contracts to that group and to any groups that include contracts that are expected to arise from renewals of the contracts in that group;

(b) recognise as an asset insurance acquisition cash flows paid before the group of insurance contracts to which they are allocated is recognised; and

(c) assess the recoverability of an asset for insurance acquisition cash flows if facts and circumstances indicate the asset may be impaired.

Paragraphs 105A–105C propose disclosures about such assets.

Do you agree with the proposed amendments? Why or why not?

Notes to Question 2:

1. *In practice it is not uncommon that commission payments are high compared to the initial premium. The payments are commercially justified because the insurer expects the customer to renew the contract in the future, possibly more than once. Nevertheless, where the commission is non-refundable, under IFRS 17 the commission cost can only be allocated to the original contracts, not expected future renewals. This could have the effect that a group of initial contracts is deemed onerous, whilst future renewed contracts appear more profitable, because they do not bear a share of the cost. Stakeholders raised concerns that this accounting does not reflect economic realities.*

2. *IFRS 17 defines insurance acquisition cash flows as the costs of selling, underwriting and starting a group of insurance contracts that are directly attributable to a portfolio of insurance contracts. The insurance acquisition cash flows are allocated to the groups of insurance contracts in the portfolio. The proposal, applies to insurance acquisition cash flows that can be directly attributed to a group of insurance contracts, but not those insurance acquisition cash flows that can be directly attributed to a portfolio, but not directly attributed to a group.*

3. *For these directly attributable insurance acquisition cash flows, the IASB proposes to require allocation not just to the initial group of insurance contracts, but also any future renewed contracts. The insurance acquisition cash flows not yet allocated to a group will be presented as an asset on the balance sheet, which is subject to a recoverability assessment and possibly, impairment. Insurance acquisition cash flows are derecognised as and when they are allocated to the renewed contracts. The allocated insurance acquisition costs are included as cash outflows into the calculation of the contractual service margin of the group that includes the renewed contracts. The insurance acquisition cash flows will be recognised as an expense as the contractual service margin is released to profit and loss.*

4. *For insurance contracts accounted for under the premium allocation the proposal retains the choice to immediately expense all insurance acquisition cash flows or account for them as set out in this proposal.*

5. *The proposed disclosures are intended to provide insight into the expected derecognition and any impairment of the unallocated insurance acquisition cash flows recognised as an asset.*

FRC staff draft response:

A6 We agree with the proposals in (a), (b), and (c), although we note that the proposal increases complexity for preparers and arguably for users. However, we believe the additional complexity is justified because a deferral better reflects the economic substance of the transactions and hence provides more relevant information.

A7 We concur that a deferral should be required, regardless of whether up-front commissions make the initial contracts onerous or not. In respect of the proposed impairment requirements, we note that they are inconsistent with the accounting for expected cash flows under IFRS 17. Changes in expectations about the recoverability of the deferred contract acquisition cash flows would usually affect the contractual service margin of those groups that the costs are directly attributable to. Nevertheless, we acknowledge the complexity of such a solution and therefore agree with the proposed impairment accounting.

A8 We believe the proposed disclosures are appropriate. We note the flexibility around determination of appropriate time-bands for the disclosure of the expected derecognition of the unallocated insurance acquisition cash flows. This disclosure will be useful if there is some consistency in presentation between entities to allow comparison. We believe the IASB should assess the disclosure requirement and its effectiveness as part of the IFRS 17 post-implementation review.

Question 3—Contractual service margin attributable to investment-return service and investment-related service (paragraphs 44–45, 109 and 117(c)(v), Appendix A, paragraphs B119–B119B and BC50–BC66)

(a) Paragraphs 44, B119–B119A and the definitions in Appendix A propose that an entity identify coverage units for insurance contracts without direct participation features considering the quantity of benefits and expected period of investment-return service, if any, in addition to insurance coverage. Paragraph B119B specifies criteria for when contracts may provide an investment-return service.

Do you agree with the proposed amendment? Why or why not?

(b) Paragraphs 45, B119–B119A and the definitions in Appendix A clarify that an entity is required to identify coverage units for insurance contracts with direct participation features considering the quantity of benefits and expected period of both insurance coverage and investment-related service.

Do you agree with the proposed amendment? Why or why not?

(c) Paragraph 109 proposes that an entity disclose quantitative information about when the entity expects to recognise in profit or loss the contractual service margin remaining at the end of a reporting period. Paragraph 117(c)(v) proposes an entity disclose the approach used to determine the relative weighting of the benefits provided by insurance coverage and investment-return service or investment-related service.

Do you agree with the proposed disclosure requirements? Why or why not?

Notes to Question 3:

1. *The contractual service margin (CSM) is the unearned profit in a group of insurance contracts. IFRS 17 requires recognition of the CSM as income in profit and loss based on coverage units. For that purpose an entity determines the total number of coverage units in a group of contracts and allocates the CSM equally to the coverage units provided in the period and expected to be provided in the future.*

Notes Question 3(a):

2. *For insurance contracts without direct participation features, IFRS 17 limits the services that can be provided under the contract to insurance services. If the entity provides other services any profit earned on these services is recognised in accordance with the formula determined for the insurance services.*

3. *Some stakeholders asserted that the profit recognition patterns do not reflect the economic reality of how profits are earned. A typical example are deferred annuity contracts, where under IFRS 17 no profit could be recognised until the start of the annuity payments. However, premiums include a margin for carrying out investment activities during the accumulation phase. The result is back-loaded profit recognition.*

4. *With the proposal the IASB seeks to address these concerns and introduces the notion of an investment return service, in addition to insurance service. Certain conditions have to be met to demonstrate that an investment return service is being provided to the policyholder. The IASB also confirmed that costs associated with the provision of*

investment return services are incorporated into the fulfilment cash flows of the group of insurance contracts.

Notes to Question 3(b):

5. *This amendment is intended to be a clarification that insurance contracts with direct participation features provide both insurance services and investment related services. The insurer is therefore required to determine the coverage units for both elements of the contract and allocate the CSM to both services.*

Notes to Question 3(c):

6. *The relative weighting of insurance services and the investment return services or investment related services and the allocation of the CSM to those services requires judgement. The IASB is proposing additional disclosures of the entity's approach.*

FRC staff draft comments:

A9 In respect of proposal (a), we concur that insurance contracts without direct participation features may provide investment return services. We believe that an allocation of the contractual service margin to these services will provide more relevant information, especially when the timing of insurance services and investment return services differ.

A10 Under the proposal all insurance contracts without direct participation features must be assessed whether they contain an investment return service or not. This new requirement could have an effect on ongoing implementation and could increase cost and complexity. However, we do not believe it would be appropriate to provide an option, because it would unduly reduce consistency and comparability. We therefore agree with the proposal.

A11 We agree with the conditions set out in proposed paragraph B119B, however, we have concern about the practical application. Meeting the conditions in paragraph B119B is necessary, but, as drafted, would not be sufficient to demonstrate that an investment return service exists. It is not clear from the proposal what additional criteria would need to be assessed to conclude that an investment return service exists or does not exist. We believe the conditions set out in B119B are necessary and sufficient and therefore suggest the requirement is redrafted as follows:

Insurance contracts without direct participation features ~~may~~ provide an investment-return service if, and only if: …

A12 We concur with proposal (b) and the IASB's clarification in respect of investment related services in contracts with direct participation features.

A13 We agree with the additional disclosures proposed in (c) because significant judgement is needed to determine the relative weighting of the benefits provided. We note that the IASB is also proposing to remove the choice for entities to qualitatively explain when the remaining contractual service margin will be recognised in the future. We are not aware users have called for this amendment and are not convinced it is necessary as part of this proposal. This disclosure requirement could be reassessed as part of the post-implementation review of IFRS 17.

Question 4—Reinsurance contracts held—recovery of losses on underlying insurance contracts (paragraphs 62, 66A–66B, B119C–B119F and BC67–BC90)

Paragraph 66A proposes that an entity adjust the contractual service margin of a group of reinsurance contracts held that provides proportionate coverage, and as a result recognise income, when the entity recognises a loss on initial recognition of an onerous group of underlying insurance contracts, or on addition of onerous contracts to that group. The amount of the adjustment and resulting income is determined by multiplying:

(a) the loss recognised on the group of underlying insurance contracts; and

(b) the fixed percentage of claims on the group of underlying contracts the entity has a right to recover from the group of reinsurance contracts held.

Do you agree with the proposed amendment? Why or why not?

Notes to Question 4:

1. *Insurance contracts issued and reinsurance contracts held are accounted for as separate contracts under IFRS 17, but a consistent measurement approach applies. Nevertheless, there are also some accounting differences. One difference arises from the recognition of the contractual service margin. For insurance contracts issued, IFRS 17 prohibits a negative contractual service margin which arises when the group of insurance contracts is onerous. The loss is recognised immediately in profit or loss. A positive contractual service margin is recognised as a liability and released to profit and loss over the coverage period. For reinsurance contracts held, the contractual service margin represents the net cost of purchasing reinsurance. The contractual service margin can be a net cost or a net gain. A net cost arises when the reinsurance premium exceeds the expected reinsurance benefits and a net gain arises when the reinsurance premiums are less than the expected reinsurance benefits. The contractual service margin in a reinsurance contract is recognised over the coverage period as services are received regardless of whether the contractual service margin on the reinsurance contract is a net gain or net cost.*

2. *The consequence of the asymmetric treatment of the contractual service margin for insurance contracts and reinsurance contracts is that losses on underlying insurance contracts have to be recognised immediately, even if the entity has in place reinsurance which covers all or some of that loss and even when the contractual service margin on the reinsurance contract is a net gain. Some stakeholders criticised this accounting as not portraying appropriately the economic substance of the transactions.*

3. *It should be noted that this accounting mismatch only arises on the initial recognition of an onerous group of insurance contracts or when new onerous contracts are added to a group. When underlying insurance contracts become onerous after initial recognition and there is a corresponding adjustment to the cash flows of the reinsurance contract, that change will also be recorded in profit and loss and therefore there is no net effect in profit or loss and no mismatch.*

4. *To address the concerns about the mismatch the IASB is proposing that when a group of contracts is onerous on initial recognition or new onerous contracts are added to a group, a gain should be recognised on the reinsurance contracts. This has the effect that the loss recognised on underlying onerous insurance contracts will be fully or partially offset. However, this is restricted to reinsurance contracts held that provide for the recovery of a fixed percentage of claims incurred. An entity that has no reinsurance in place on recognition of onerous contracts or holds reinsurance that provides recovery on any other*

basis than a fixed percentage, will not be able to offset the losses on the underlying insurance contracts.

FRC staff draft response:

A14 Insurance contracts and reinsurance contracts are related, but give rise to different rights and obligations. We therefore agree that despite that link between underlying insurance contracts and reinsurance contracts, they should be accounted for separately under IFRS 17. The separation of the two contracts is consistent with the accounting requirements for other non-insurance contracts.

A15 The proposal limits the off-set to reinsurance contracts that provide coverage for claims on a fixed percentage basis. These "plain vanilla" reinsurance arrangements might be rare in practice. Proportionate reinsurance may contain excess clauses or apply an upper recovery limit. Under so called surplus line reinsurance not all claims are shared on the same fixed percentage basis, but a variable percentage applies. These arrangements, as well as excess loss reinsurance, would fall outside the proposed exception. Since the scope is so narrow, the proposed exemption may be of very limited use in practice.

A16 The adjustment and resulting income for off-set against the loss is determined by multiplying the fixed claim recovery percentage with the loss on the onerous contracts. This formula disregards that other expenses or the risk adjustment could contribute to a loss on the group of underlying insurance contracts, which are non-recoverable from reinsurance. We therefore have reservations against the assumption underlying this proposal that all losses arise from claims (BC79 of the ED).

A17 In addition to our concern highlighted above, we note the proposed methodology disregards whether the reinsurance contract has a net gain or a net cost contractual service margin. However, we believe this is relevant for the assessment. A reinsurance contract with a net gain contractual service margin would reduce the overall loss on the insurance and reinsurance contract if added together. A reinsurance contract with a net cost contractual service margin would increase that overall loss, because the expected recoveries from the reinsurance are less than the net reinsurance premium paid. We believe recognising income on a reinsurance contract with a net cost contractual service margin is counterintuitive and could be misleading. It also offers the incentive to buy reinsurance to off-set a loss, with the cost of the reinsurance being deferred into the future.

A18 Despite our reservations against the proposal, we agree that a solution which would remove the timing asymmetry between loss recognition on underlying insurance contracts and the recognition of a gain on a reinsurance contract, could provide more relevant information. However, we believe any solution needs to limit the loss off-set to the lower of the loss on the underlying group of insurance contracts and any net gain on the reinsurance. We acknowledge the difficulties in developing an appropriate methodology or principle that avoids an arbitrary allocation of reinsurance premiums to a group of underlying insurance contracts, which would be necessary to determine the contractual service margin on the reinsurance contracts.

A19 If a principle or other methodology for the allocation of reinsurance premiums could be found, we are not convinced that a solution needs to be limited to reinsurance that operates on a proportionate basis. In the example cited in BC80 of the ED the loss on the underlying insurance contracts is CU50 and the excess loss is CU100. This type of reinsurance was excluded from the scope of the proposal because it would not be clear how much of the CU50 loss is covered by the reinsurance because the first CU100 are not ceded. However, we believe a solution that determines the loss off-set as the lower of CU50 and any net gain on the reinsurance, would set an adequate limit for income recognition.

A20 Should it not be possible to find an alternative solution that could be more widely applied in practice and limits income recognition to reinsurance contracts that contribute to a loss reduction on the group of underlying insurance contracts, we would prefer no change to IFRS 17 instead, because the current proposal could have unintended consequences.

A21 We note that any solution, including making no change to IFRS 17 would not be consistent with the existing exception in paragraph 66(c)(ii) of IFRS 17. We believe it would be preferable to have the same requirements for onerous contracts at inception and those that become onerous subsequently. However, bringing in new restrictions to paragraph 66(c)(ii), would disrupt ongoing implementation and we therefore do not recommend alignment. Nevertheless, this should be an area of review during the post-implementation review of IFRS 17.

Question 5—Presentation in the statement of financial position (paragraphs 78–79, 99, 132 and BC91–BC100)
The proposed amendment to paragraph 78 would require an entity to present separately in the statement of financial position the carrying amount of portfolios of insurance contracts issued that are assets and those that are liabilities. Applying the existing requirements, an entity would present the carrying amount of groups of insurance contracts issued that are assets and those that are liabilities. The amendment would also apply to portfolios of reinsurance contracts held that are assets and those that are liabilities. Do you agree with the proposed amendment? Why or why not?

Notes to Question 5:

1. *The unit of account for IFRS 17 is a group of insurance contracts. The recognition, measurement, presentation and disclosure requirements in IFRS 17 are based on the unit of account, ie groups of insurance contracts.*

2. *When determining the contractual service margin (ie the deferred profit) in a group of insurance contracts, all the future cash inflows and outflows within the boundary of each contract in the group are taken into account. Those future cash flows include premiums expected to be received and claims and expenses expected to be paid.*

3. *The insurance contract liability or asset of a group of contracts can be disaggregated into two components: a liability for remaining coverage (which includes the fulfilment cash flows and the contractual service margin related to future coverage) and a liability for incurred claims (which includes the fulfilment cash flows relating to claims for insured events that have occurred). IFRS 17 requires that an entity presents separately the carrying amount of groups of insurance contracts issued that are assets and groups of insurance contracts issued that are liabilities. The same applies to reinsurance contracts.*

4. *In order to comply with IFRS 17 an insurer has to determine whether a group of insurance contracts is an asset or a liability, allocating all cash flows to individual groups of insurance contracts. It was noted that in practice insurers typically manage premiums receivable and claims payable at a higher level of aggregation than groups. Significant cost would be incurred for setting up the necessary infrastructure to capture cash flows at a lower level of aggregation. Stakeholders asserted that cash flow allocation at group level is not needed to comply with the IFRS 17 measurement requirements. The IASB was persuaded by these arguments and proposes to permit presentation of insurance assets and liabilities based on a portfolio level.*

FRC staff draft comments:

A22 We acknowledge the concerns the IASB seeks to address and agree with the proposed amendment, even though it is a departure from the unit of account in IFRS 17. Provided there is no need for a more granular allocation of cash flows for measurement purposes, allocation of cash flows at a portfolio level will provide relevant information.

Question 6—Applicability of the risk mitigation option (paragraphs B116 and BC101–BC109)
The proposed amendment to paragraph B116 would extend the risk mitigation option available when an entity uses derivatives to mitigate financial risk arising from insurance contracts with direct participation features. That option would apply in circumstances when an entity uses reinsurance contracts held to mitigate financial risk arising from insurance contracts with direct participation features. Do you agree with the proposed amendment? Why or why not?

Notes to Question 6:

1. *The variable fee approach applies to insurance contracts with direct participation features. Insurance contracts with direct participation features are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items. The insurer is remunerated through a variable fee. Although the basic measurement requirements for the determination of the contractual service margin are the same under the general model and the variable fee approach, there are differences regarding the recognition of subsequent changes in the contractual service margin or profit and loss.*

2. *The variable fee approach includes what is referred to as the "risk mitigation option". This option is linked to the accounting for changes resulting from financial risk under the variable fee approach. In the variable fee approach changes to financial risk are recorded in the contractual service margin. This can give rise to an accounting mismatch when the insurer uses derivatives to mitigate the financial risk. Fair value changes on the derivative are recorded in profit and loss, whilst the corresponding change in the future cash flows is recorded in the contractual service margin. Under the risk mitigation option this mismatch can be reduced or eliminated. The risk mitigation option is subject to few conditions.*

3. *Reinsurance contracts held and issued are not permitted to be accounted for under the variable fee approach. This can create an accounting mismatch when underlying insurance contracts are accounted for under the variable fee approach, but the reinsurance contract held is accounted for under the general model. The IASB rejected calls from stakeholders to make the variable fee approach available to reinsurance contracts to avoid an accounting mismatch. The IASB is instead proposing to include reinsurance contracts held in the risk mitigation option to reduce the accounting mismatch between underlying insurance contracts and reinsurance.*

4. *Stakeholders have also asked for an expansion of the risk mitigation option to financial instruments, other than derivatives.*

FRC staff draft response:

A23 We concur with the IASB's proposal to include reinsurance contracts in the risk mitigation option.

A24 The IASB rejected the inclusion of financial instruments, other than derivatives, in the risk mitigation option. We believe the IASB could explore whether financial instruments measured at fair value through profit or loss could be included. The same accounting mismatch identified for derivatives arises for financial instruments measured at fair value through profit or loss.

A25 We also note the IASB's empirical view that reinsurance contracts held or issued cannot be contracts with participation features. However, it should be further explored whether such reinsurance contracts do in fact exist, as asserted by some stakeholders. We do not believe there is a conceptual argument against the inclusion of reinsurance contracts in the variable fee approach, provided they meet the conditions of contracts with direct participation features.

Question 7—Effective date of IFRS 17 and the IFRS 9 temporary exemption in IFRS 4 (paragraphs C1, [Draft] Amendments to IFRS 4 and BC110–BC118)
IFRS 17 is effective for annual reporting periods beginning on or after 1 January 2021. The amendments proposed in this Exposure Draft are such that they should not unduly disrupt implementation already under way or risk undue delays in the effective date. (a) The proposed amendment to paragraph C1 would defer the effective date of IFRS 17 by one year from annual reporting periods beginning on or after 1 January 2021 to annual reporting periods beginning on or after 1 January 2022. Do you agree with the proposed amendment? Why or why not? (b) The proposed amendment to paragraph 20A of IFRS 4 would extend the temporary exemption from IFRS 9 by one year so that an entity applying the exemption would be required to apply IFRS 9 for annual reporting periods beginning on or after 1 January 2022. Do you agree with the proposed amendment? Why or why not?

Notes to Question 7:

1. *The IASB is proposing that the effective date of IFRS is delayed by one year to 1 January 2022. The IASB agreed this change on the basis that the reconsideration of aspects of IFRS 17 created some uncertainty for implementation. The IASB is also proposing to extend the existing temporary deferral of IFRS 9 for certain insurers in IFRS 4 and delay the application date of IFRS 9 to 1 January 2022.*

2. *Some stakeholders suggested that the IASB should permit the adoption of IFRS 17 without the need to provide comparative information in the year of adoption. They argued this would align the first-time adoption requirements in IFRS 17 and IFRS 9. Under IFRS 9 comparative information may be provided, unless doing so would require hindsight. The IASB rejected these calls.*

FRC staff draft comments:

A26 The implementation of IFRS 17 is a complex process and requires extensive resources. We therefore welcome the IASB's proposal to extend the effective date and allow more time for the implementation of IFRS 17, including these proposed amendments to the standard. Despite the practical challenges, we believe that there is an urgent need to replace IFRS 4 and the introduction of improved insurance accounting requirements should not be unnecessarily delayed. We believe that the one-year deferral strikes the right balance between these competing objectives.

A27 The IASB's deliberations about possible changes to IFRS 17 disrupted the European endorsement process and the newly proposed effective date may not provide enough time for the timely endorsement in the EU We have heard that software which especially smaller and medium-sized insurers rely on to implement IFRS 17, is not yet fully developed. Timely implementation by 2022 may therefore be a challenge for these insurers. Despite these issues, we do not believe that the IASB should delay the effective date beyond the currently proposed date.

A28 We concur with the IASB that it is preferable for IFRS 9 and IFRS 17 to be adopted together. We therefore agree with the proposed extension of the IFRS 9 deferral in IFRS 4. However, we would not support any further delay to the adoption of IFRS 9, in the event that the effective date of IFRS 17 is extended beyond 2022.

A29 We agree with the IASB that the option to adopt IFRS 9 without providing comparatives is not a reason to allow a similar exemption in IFRS 17. Accounting mismatches can be avoided by applying IFRS 9 in the comparative period. Therefore we believe a better solution would be to mandate the use of IFRS 9 in the comparative period, provided the IASB could introduce such a change without delaying the finalisation of these amendments. We believe application of IFRS 9 in the comparative period would enhance comparability between insurers and non-insurers who already apply IFRS 9. Some changes would be needed to the transitional requirements of IFRS 9. For example, the relief from applying IFRS 9 to items that have been derecognised at the date of initial application instead to those de-recognised at the date of transition.

A30 Regardless of any decision by the IASB on the transition requirements of IFRS 9 for insurers, we would request the IASB to finalise sooner than mid-2020 the proposals to defer the effective date of IFRS 17 and IFRS 9 for insurers. Earlier release of these amendments would provide greater certainty for implementation and should enable timely endorsement of the necessary amendments to IFRS 4 in the European Union.

Question 8—Transition modifications and reliefs (paragraphs C3(b), C5A, C9A, C22A and BC119–BC146)
(a) Paragraph C9A proposes an additional modification in the modified retrospective approach. The modification would require an entity, to the extent permitted by paragraph C8, to classify as a liability for incurred claims a liability for settlement of claims incurred before an insurance contract was acquired. Paragraph C22A proposes that an entity applying the fair value approach could choose to classify such a liability as a liability for incurred claims. Do you agree with the proposed amendments? Why or why not? (b) The proposed amendment to paragraph C3(b) would permit an entity to apply the option in paragraph B115 prospectively from the transition date, rather than the date of initial application. The amendment proposes that to apply the option in paragraph B115 prospectively on or after the transition date, an entity would be required to designate risk mitigation relationships at or before the date it applies the option. Do you agree with the proposed amendment? Why or why not? (c) Paragraph C5A proposes that an entity that can apply IFRS 17 retrospectively to a group of insurance contracts be permitted to instead apply the fair value approach to that group if it meets specified criteria relating to risk mitigation. Do you agree with the proposed amendment? Why or why not?

Notes to Question 8:

1. *IFRS 17 provides for three transition methods, which has been criticised because it increases complexity and reduces comparability. Given the long-term nature of some insurance contracts, retrospective application of IFRS 17 will in a number of instances simply not be feasible and therefore there is a need for alternatives.*

2. *The preferred method of transition is a retrospective application of all IFRS 17 requirements, however, it should be noted that IFRS 17 prohibits restatement for the risk mitigation option (see Question 6 above). If retrospective application is impracticable, there is a choice to apply the modified retrospective approach or the fair value approach. The modifications in the modified retrospective approach are limited to ensure the closest outcome to retrospective application. The use of each modification is subject to: (i) not having reasonable and supportable information available to apply the retrospective approach, and (ii) the insurer needs to have reasonable and supportable information available to apply the modification. If there is no reasonable and supportable information to apply a modification, the use of the fair value approach is required.*

3. *The IASB was informed that some stakeholders prefer the application of the modified retrospective approach over the fair value approach. They assert that applying IFRS 17 retrospectively to the extent possible will provide more useful information, because determination of the contract profitability pre and post transition is better aligned and hence an insurer can provide better trend information. The modified retrospective approach, however, is considered too restrictive, making it costly and burdensome or even impossible to apply in practice. The IASB was requested to consider additional modifications and to remove the requirements for reasonable and supportable information. Stakeholders have also asked the IASB to permit the use of the risk mitigation option retrospectively.*

4. *The IASB is proposing some amendments to the transitional requirements. The IASB rejected the call for retrospective application of the risk mitigation option, but the amendments proposed in (b) and (c) are alternative solutions. The IASB rejected the request to remove the need for supportable and reasonable information in order to use the modifications in the modified retrospective approach.*

FRC staff draft comments:

A31 We agree with the proposal in (a). We believe this simplification should ease implementation challenges and should not result in a significant loss of useful information.

A32 The IASB rejected suggestions that the risk mitigation option should be applied retrospectively. We carefully considered the arguments for and against retrospective application and reflected on possible solutions around mandating retrospective application to limit the ability to "cherry pick". We concluded that on balance optional retrospective application is our preferred approach.

A33 The use of the risk mitigation option under paragraph B116 of IFRS 17 is subject to some, but very limited conditions. The ability to stop and re-start the use of the risk mitigation option without many constrains means that mandating retrospective application would have virtually no effect. We further considered whether there should be restrictions to the amounts that can be off-set on retrospective application. We concluded that it would not be feasible to introduce restrictions for retrospective application beyond those in paragraph B116 of IFRS 17.

A34 We accept that there is a risk of "cherry picking", but although it is a concern, we are less convinced that it would be the dominating consideration for entities when choosing the risk mitigation option. Disclosures around the use of the risk mitigation option and its effect on the contractual service margin, could give an indication of how profitability could be affected in the future. We therefore give greater weight to the argument that retrospective application would provide more relevant information because it makes pre- and post-transition reporting of the contractual service margin more consistent and comparable.

A35 If the IASB would develop a solution that allows for retrospective application of the risk mitigation option, the proposals in (b) and (c) would be redundant. Should the IASB retain its view that retrospective application should not be permitted, we concur that the proposals in (b) and (c) may limit the accounting mismatches and would be supportive.

A36 We concur with the IASB that the use of the modifications in the modified retrospective approach should be subject to reasonable and supportable information. Removal of this requirements could impair the reliability of the information. We belief BC143 of the ED is helpful, as it reaffirms our understanding of the application of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. In addition, we suggest a simple change to paragraphs C6 and C8 of IFRS 17 to clarify "reasonable and supportable information <u>and estimates</u>" should be used.

A37 We also note the Board's explanations in BC144 of the ED regarding the requirements in paragraph C12 of IFRS 17. The Board confirms that estimates are expected to be used as proxies for known cash flows. If this is the Board's intention, we believe it should be made clear in paragraph C12 and the word "known" deleted.

Question 9—Minor amendments (BC147–BC163)
This Exposure Draft also proposes minor amendments (see paragraphs BC147–BC163 of the Basis for Conclusions). Do you agree with the Board's proposals for each of the minor amendments described in this Exposure Draft? Why or why not?

A38 [This section is to be drafted.]

Question 10—Terminology
This Exposure Draft proposes to add to Appendix A of IFRS 17 the definition 'insurance contract services' to be consistent with other proposed amendments in this Exposure Draft. In the light of the proposed amendments in this Exposure Draft, the Board is considering whether to make a consequential change in terminology by amending the terms in IFRS 17 to replace 'coverage' with 'service' in the terms 'coverage units', 'coverage period' and 'liability for remaining coverage'. If that change is made, those terms would become 'service units', 'service period' and 'liability for remaining service', respectively, throughout IFRS 17. Would you find this change in terminology helpful? Why or why not?

A39 Although we do not believe a change is essential to the understanding of IFRS 17, we concur it would make it clearer that an insurance contracts can provide more than just insurance cover.

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