Amendments to IFRS 17 from February 2019 IASB Meeting

February 2019

INTRODUCTION

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

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

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

- any amendment should not result in significant loss of useful information and should avoid:
  i. reducing the relevance and faithful representation of information;
  ii. causing reduced comparability or introducing internal inconsistency; or
  iii. increasing complexity for users of financial statements;
- any amendment should not unduly disrupt implementations processes or risk undue delays to the effective date.

A series of IASB Meetings are scheduled to discuss in more detail the 25 issues highlighted in the October 2018 meeting. At the second of these meetings on 7 February 2019, four of these issues were discussed and the IASB tentatively approved two amendments to the Standard while agreeing with the IASB Staff recommendations to retain the existing requirements in other areas. This paper provides an overview of the areas discussed and the outcomes of the discussions.

1) LOANS THAT TRANSFER SIGNIFICANT INSURANCE RISK

Certain loan-based contracts may have fallen under the scope of IFRS 17 as, under some circumstances, they could be considered to involve a transfer of significant insurance risk. Some examples of these contracts are:

- Mortgages where the outstanding loan balance is waived upon death;
- Student loans where repayment is contingent on earnings above a threshold and repayment of the loan balance is waived upon death; and
- Lifetime mortgage contracts (often referred to as "equity release mortgages") which include insurance in the form of a no-negative equity guarantee.

Concern was raised that applying IFRS 17 to these contracts may lead to many firms, which are not writing other insurance contracts and thus not preparing for IFRS 17 for other reasons, to face significant implementation costs. Furthermore, some suggested that applying IFRS 9 to these loans would be more appropriate as it would be consistent with how some entities measure standard loan contracts (i.e. those without insurance components).

The IASB Staff acknowledged these issues and determined that IFRS 9 would also provide useful information for these loan contracts. The Staff then explored different approaches suggested by industry:

- Separating the loan from the insurance contract;
- Specifically exclude these contacts from IFRS 17; and
- Providing a choice to apply either IFRS 17 or IFRS 9 to these contracts.

Ultimately, the IASB Staff recommended the third approach to allow a choice to apply either IFRS 17 or IFRS 9 with this assessment being made on a contract-by-contract basis. The Staff felt that this addressed the concerns raised while meeting the Board's amendment criteria of not resulting in significant loss of useful information and not unduly disrupting ongoing implementations.

The IASB have tentatively voted to approve this amendment with a change to make the choice at a portfolio-by-portfolio level rather than at the contract-by-contract level initially proposed by the Staff.

2) TRANSITION – OPTIONALITY AND COMPARATIVE INFORMATION

OPTIONALITY AT TRANSITION

For at transition calculations, if the full retrospective approach is not practicable, entities are permitted to choose between the modified retrospective approach and the fair value approach.

Concerns were raised that this would lead to difficulty comparing entities' performance after transition. However, this concern was anticipated by the Board and led to the following requirements that aimed to assist users:

- At future reporting dates, separately disclose information for groups of contracts measured at the transition date using the modified retrospective approach and the fair value approach.

- Provide explanation of the methods used to measure contracts that existed at the transition date.

Given that the Board considered these issues during the development of IFRS 17 and that changes to these requirements may unduly disrupt ongoing implementations, the IASB Staff recommended the Board retain the current requirements relating to the options available at transition.

The IASB voted to retain the current requirements.

COMPARATIVE INFORMATION AT TRANSITION

On initial application of IFRS 17, entities are required to restate comparative information about insurance contracts for the reporting period preceding transition. This is intended to help users of financial statements compare the impact of IFRS 17 across entities, given the diverse set of accounting approaches previously applied.

There was concern that this requirement will be challenging to accomplish within the current timeframe. There is also some concern that there might be accounting mismatches as there is not an equivalent requirement to restate comparative information about financial assets under IFRS 9.

In response to these concerns, the IASB Staff noted:

- The proposed one-year delay to implementation, which gives another year to prepare this information, eases the challenge related to the timeframe.
- Accounting mismatches can be avoided, as entities are permitted to restate comparative information applying IFRS 9 if they choose, however it is not a requirement. They note that this must be done without the use of hindsight.
- Removing comparative information would deprive users of useful information and make it difficult to understand the transition to IFRS 17.

For these reasons, the Staff recommended not to change the current requirements.

The IASB agreed with the Staff's recommendation and voted to retain the current requirements.

3) TRANSITION – RISK MITIGATION OPTIONS AND AMOUNTS ACCUMULATED IN OCI

RISK MITIGATION OPTIONS

Where entities purchase derivatives to mitigate the risks of changes in financial assumptions, an accounting mismatch could potentially arise due to:

- The change in the fair value of the derivative being recognised in profit or loss, applying IFRS 9; but
- The change in the insurance contract due to the risk that was mitigated by the derivative being accounted for through the contractual service margin, under IFRS 17.

To avoid this, there is a risk mitigation option in IFRS 17 for an entity, under certain circumstances, to recognise the effect of some changes in financial risk in the insurance contracts in profit or loss, instead of adjusting the contractual service margin.

However, there is a specific prohibition of retrospective application of the risk mitigation option.

Some stakeholders raised concerns that the risk mitigation option can only be used prospectively even though risk mitigation activities may have been in place before the date of initial application of IFRS 17 and suggested the board should amend the transition requirements to allow for this.

The IASB Staff think that applying the risk mitigation option retrospectively without using hindsight is challenging. They also think that retrospectively applying an option that is prospective by nature gives rise to "cherry picking" opportunities. Retrospective application of the risk mitigation option could also lead to unjustified inconsistency with the requirements for hedge accounting in IFRS 9 that prohibits the retrospective application of hedge accounting for the same reason.

The IASB Staff therefore recommended not to change the transitional arrangement in respect of risk mitigation options.

The IASB tentatively voted to retain the transition requirement in IFRS 17 that prohibits retrospective application of the risk mitigation option.

However, the IASB was sympathetic to the concerns raised by stakeholders and asked the IASB Staff to continue to explore alternative proposals that would address the issue of not applying the option retrospectively. An example, given by the IASB Board, of an alternative option to explore further is to allow the risk mitigation option to apply prospectively from the transition date rather than only from the implementation date.

CUMULATIVE AMOUNTS IN OTHER COMPREHENSIVE INCOME (OCI)

When an entity chooses to disaggregate insurance finance income or expenses between profit or loss and OCI, it may be permitted, or required, to determine the cumulative amount of insurance finance income or expenses recognised in OCI at the transition date as nil.

Some stakeholders raised concerns that the outcome of applying the transition requirements would result in determining the accumulated amount of insurance finance income or expenses recognised in OCI as nil, while the amount accumulated in OCI for the related assets would not be nil. They are concerned that this could significantly distort equity on transition and on the investment margin reported in profit or loss in future periods. The IASB Staff noted that IFRS 17 provides entities with a choice about whether to disaggregate insurance finance income or expenses between profit or loss and OCI. An entity is not required to apply this choice and can make this choice for portfolios of insurance contracts considering for each portfolio of contracts the assets that the entity holds and how it accounts for them.

The IASB Staff also considered the disclosure requirements adequate to provide useful information to users of financial statements on the related assets and therefore the Staff recommended no change to IFRS 17 with respect to cumulative amounts included in OCI.

The IASB tentatively voted to retain the current transition requirements relating to the cumulative amounts included in OCI.

4) TRANSITION – MODIFIED RETROSPECTIVE APPROACH

If it is impracticable to apply a full retrospective approach to transition to IFRS 17 for a group of insurance contracts, an entity may choose to apply either the modified retrospective approach or the fair value approach.

Some stakeholders have said that it would often be impracticable to apply the full retrospective approach and they would like to apply the modified retrospective approach rather than the fair value approach. They have expressed concern that the modified retrospective approach is too restrictive, making it costly and burdensome to apply in practice. Stakeholders made a number of suggestions, which the IASB Staff have reviewed.

The IASB agreed with the IASB Staff's recommendations and voted to:

- Retain the transition requirements of the modified retrospective approach set out in IFRS 17 that:
- Prohibit an entity from using a specified modification to the extent that the entity has reasonable and supportable information to apply the related IFRS 17 requirement retrospectively; and
- Permit an entity to use a specified modification only when the entity has reasonable and supportable information to apply that modification.
- Retain the transition requirements in IFRS 17 for the modified retrospective approach, without an amendment that would permit an entity to develop its own modifications that it regards as consistent with the objective of the modified retrospective approach.
- Amend the transition requirements in IFRS 17 for liabilities that relate to the settlement of claims incurred before an insurance contract was acquired as follows:
  a) To add a specified modification so that an entity classifies such liabilities as a liability for incurred claims. Consistent with the other specified modifications, an entity would be permitted to use this specified modification only to the extent that it does not have reasonable and supportable information to apply a retrospective approach.
  b) To permit an entity applying the fair value approach to choose to classify such liabilities as a liability for incurred claims.
- Retain without amendment the specified modification relating to the use of cash flows that are known to have occurred, instead of estimating retrospectively cash flows that were expected to occur.
- Retain the modified retrospective approach for insurance contracts with direct participation features, without an amendment that would permit an entity to apply to such contracts the specified modifications permitted for insurance contracts without direct participation features.

However, the Board noted the importance of the clarification that the existence of specified modifications does not prohibit an entity from:

- Making estimates that are necessary in retrospectively applying an accounting policy; or
- Making estimates when applying a specified modification in the modified retrospective approach.

It was also noted that further education on the modified retrospective approach to transition might be useful.

SUMMARY

In summary, at its February 2019 meeting, the IASB tentatively voted to:

- Amend IFRS 17 and IFRS 9 to enable an entity to apply either IFRS 17 or IFRS 9 to contracts for loans with insurance elements that settle some or all of the obligations under the contract;
- Retain the transition requirement in IFRS 17 that provides optionality with respect to the modified retrospective and fair value approaches;
- Retain the transition requirement in IFRS 17 to present restated comparative information for the reporting period prior to the initial date of application of IFRS 17;
- Retain the transition requirement in IFRS 17 that prohibits retrospective application of the risk mitigation option;
- Retain the current transition requirements relating to the cumulative amounts included in OCI; and
- Retain the transition requirements of the modified retrospective approach set out in IFRS 17, with the exception of the following:
- Amend the transition requirements in IFRS 17 for liabilities that relate to the settlement of claims incurred before an insurance contract was acquired as follows:

a) To add a specified modification so that an entity classifies such liabilities as a liability for incurred claims. Consistent with the other specified modifications, an entity would be permitted to use this specified modification only to the extent that it does not have reasonable and supportable information to apply a retrospective approach.

b) To permit an entity applying the fair value approach to choose to classify such liabilities as a liability for incurred claims.

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

FURTHER READING

Milliman IFRS 17 update: January 2019 IASB meeting

The IASB's brief summary of the February 2019 meeting

The full Staff papers for the February 2019 IASB meeting

HOW CAN MILLIMAN HELP

Milliman has a wide range of experience in global insurance markets and, in particular, in Solvency II and IFRS 17. Milliman's experts have, and continue to, closely follow the development and implementation of both regimes.

Milliman can provide a range of services to assist with all aspects of IFRS 17, including:

- Methodology development and implementation;
- Training;
- Gap analysis;
- Implementation of an IFRS 17 systems solution through our award-winning Integrate platform which can be implemented with cashflow output from any actuarial system. For more information see: IFRS 17: The Integrate Solution.

If you would like to discuss any of the above, or anything else, with us, or if you have any questions or comments on this paper then please contact one of the named consultants below or your usual Milliman consultant.

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