STAFF PAPER

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Project	**Insurance Contracts**
Paper topic	Results - external testing of draft IFRS 17

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Purpose of this paper

1. This paper discusses the findings from topic-based testing (external testing) on a draft of IFRS 17 *Insurance Contracts* (draft IFRS 17). The methodology of the external testing is described in Agenda paper 2A.

2. This paper is provided for information only; the Board is not asked to make any decisions.

3. Agenda paper 2C-2G consider the issues arising from the external testing that the staff recommend the Board considers further.

Results

4. The following sections discuss the findings for each of the external testing topics:

   (a) aggregation of contracts (see paragraphs 10 to 39);

   (b) scope of variable fee approach (see paragraphs 40 to 48);

   (c) derivatives used to mitigate financial market risk (see paragraphs 49 to 65);

(d) determining the amount of insurance finance income or expenses in Other Comprehensive Income (OCI) (see paragraphs 66 to 70);

(e) recognition of changes in estimates (see paragraphs 71 to 83); and

(f) transition (see paragraphs 84 to 105).

5. General and process related findings are discussed in paragraph 106 to 108.

6. We also received feedback on topics not included in the questionnaire. These topics are discussed in Agenda paper 2G.

7. All findings represent input from all the respondents as described in Agenda paper 2A of this meeting.

Summary

Main findings

8. The input from respondents participating in external testing was generally consistent. Consistent with Agenda Paper 2A, ‘respondents’ as used in this paper refer to one or more of the following groups: the original twelve test participants, additional test participants and external reviewers. The key concerns raised are summarised as follows:

(a) **Aggregation of contracts**: Of the areas tested this gave the greatest concern. In general, the results of external testing found the number of groups of contracts that test participants believed they would have to establish to be very high, and test participants questioned if the costs that would arise would be justified by the usefulness of the information provided.

(b) **Transition**: Most test participants had strong reservations about how difficult it would be to transition to the forthcoming *Insurance Contracts* Standard based on draft IFRS 17 requirements. In particular, questions were raised about whether the simplified transition approach provides sufficient relief.

(c) **Scope of the variable fee approach**: Test participants asked for more guidance on how to interpret the scope of the variable fee approach. In particular, test participants noted that the interpretation of the first criterion, which requires that the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items, would have a significant effect on the contracts that would qualify.

9. These key concerns are addressed in the following papers:

   (a) Agenda paper 2C*: Level of aggregation*.

   (b) Agenda paper 2E: *Transition issues*

   (c) Agenda paper 2G: *Other sweep issues*

Aggregation of contracts (questions 3 to 7 of the testing questionnaire)[1]

10. We asked the test participants to assess the minimum number of groups they would need to meet the requirements for measuring the contractual service margin.

General findings

11. All test participants indicated that they thought that the level of aggregation that would result from applying draft IFRS 17 would result in a very high number of groups that would require excessively granular calculations. They stated more granular information may not necessarily equate to better quality information. They believed that the depiction of financial position and performance of an entity may lose its relevance if the entity reports information that is much more granular than the level used for business steering and decision-making.

12. A few test participants stated that a too granular level at which contracts are to be grouped will result in voluminous disclosures in the financial statements, notwithstanding disclosure is generally provided at a more aggregated level than the level at which measurement should be performed (as discussed in paragraph 18). A few test participants stated that entities should be allowed to disclose insurance contracts that are in an asset position and insurance contracts that are in

[1] Relevant extracts from draft IFRS 17 for answering the questions are included in the testing questionnaire. The testing questionnaire is included in Appendix C of Agenda paper 2A.

a liability position at a *portfolio* level. These test participants stated that the draft IFRS 17 requirement to disclose that information at an *insurance contract group* level will create operational difficulties. These test participants also stated that it would be difficult to explain to users of financial statements why certain groups of insurance contracts are in an asset position and why other groups of insurance contracts are in a liability position if the primary reason for such a difference in classification, for instance, is whether or not acquisition costs were paid up front. It is believed that on a portfolio level, due to the higher aggregation of contracts, the operational issues would be significantly smaller.

13. Most test participants mentioned that the application of draft IFRS 17 would generally, but not always be different from the way that they currently manage their business to assess profitability or track contracts' performance. The staff noted that profitability is currently assessed at different levels by different entities, from a segment level to a much more granular level (for instance, at the level where line management would start investigating contracts that are loss making). The management approach varied between test participants. For example, the staff noted that most test participants currently disaggregate contracts on the basis of risks. Similarly, some test participants are applying *average* assumptions about risk to contracts with known differences, for example setting a premium to target an overall return on a mix of riskier and less risky contracts.

14. Most, but not all, test participants thought that the number of groups required to comply with draft IFRS 17 would be much higher compared to the groups insurers currently have for:

    (a) management reporting;

    (b) existing financial reporting; and

    (c) regulatory reporting.

15. Most test participants thought the notion of "similar profitability" (as discussed later in this paper) in the requirements for the level of aggregation was the source of the granularity.

16. Most test participants stated that a level of aggregation that is too granular would be computationally burdensome and could result in significant cost and

complexity due to data storage requirements and granularity of analysis. In addition, test participants:

(a) are concerned draft IFRS 17 would result in entities reporting losses in the statement of profit or loss earlier than is currently the case where onerous contracts are part of a wider group of profitable contracts,

(b) believed that even if a high level of granularity were feasible, it would be at a significant cost, relative to the usefulness of the information that would be provided. They did not think that this cost would be justified. Some questioned whether the level of granularity they believed would result from applying draft IFRS 17 would be operationally feasible,

(c) held the view tracking at a granular level would have an inherent element of arbitrariness,

(d) are concerned about the effect of excessively granular calculations on reporting timeframes.

17. Almost all respondents agreed with the principle that onerous contracts should not be hidden and that losses on onerous contracts should be accounted for in the statement of profit or loss. However, most respondents stated that the objective of the grouping of contracts was not clearly articulated in draft IFRS 17, as they believe the objective is only that contracts written at a loss (ie onerous on day one) and contracts that could become onerous, should not be comingled with contracts that will remain profitable. Some noted that this objective could be achieved more simply.

18. There are three aspects that are relevant to the level of aggregation for measuring the contractual service margin, and most test participants considered the effect of these three aspects on determining the level of aggregation separately:

(a) The groups used to determine the size of the contractual service margin, which affects which gains and losses are offset (for example, paragraphs 24[2] and 36 of draft IFRS 17 applies). This aspect received the most focus and is discussed in paragraphs 19 to 34.

(b) The allocation of the contractual service margin to the statement of profit or loss (ie the release of the contractual service margin). The findings are:

(i) a few test participants are concerned that the requirement for the allocation of the contractual service margin to reflect expected durations and size of the contracts in the group, expressed in terms of "coverage units", would result in requiring separation of contracts with different duration and sizes, and thus result in significantly more groups than allowing approximation techniques to achieve the same broad objective.

(ii) some test participants are unclear how to apply the notion of "coverage units" for releasing the contractual service margin (paragraph B107 of draft IFRS 17 applies).

(c) Accretion of interest using locked in discount rates. A few test participants observed that the requirement to use locked-in discount rates for accreting interest on the contractual service margin in the general model would limit their ability to use open portfolios (because paragraph 41(b) of draft IFRS 17 applies).

Groups used to determine size of contractual service margin

19. Most of the test participants focussed on the groups to be used to determine the size of the contractual service margin, and in particular, how they would apply paragraphs 24 and 36 of draft IFRS 17. Those paragraphs state the following:

> 24. The purpose of measuring individual contracts on initial recognition is to assess their profitability and how their expected future cash flows respond in terms of amount and timing to changes in key assumptions. These characteristics of an individual contract determine how an entity will aggregate contracts (see paragraph 36). If an entity can determine these characteristics without measuring the individual contract, for example based on the information used to establish pricing, an entity may measure a group that meets the conditions in paragraph 36 rather than the individual contracts.
>
> **36. Having determined the measurement of individual contracts on initial recognition, an entity shall aggregate contracts into groups to determine whether to recognise a loss for a group of**

[2] In this paper, IFRS 17 paragraph numbers refer the paragraphs as included in *draft* IFRS 17. The paragraph numbering may change in a later version of IFRS 17.

onerous contracts and to measure the contractual service margin after initial recognition. Those groups comprise contracts that on initial recognition have:

a. **future cash flows the entity expects will respond similarly in terms of amount and timing to changes in key assumptions; and**

b. **similar expected profitability. Unless paragraphs 50–54 apply, similar profitability means similar contractual service margin as a percentage of the total expected revenue. As a practical expedient, an entity may instead assess whether the contracts have a similar expected return on premiums, ie the contractual service margin as a percentage of expected premiums.**

20. Paragraph 36 of draft IFRS 17 consists of two elements, namely "respond similarly in terms of amount and timing to changes in key assumptions" (paragraph 36(a)); and "similar expected profitability" (paragraph 36(b)).

Overview of comments received

21. A few test participants explicitly stated that they thought that it is appropriate for a principles-based Standard to allow judgement in determining responsiveness to assumption changes and setting different bands of profitability for different products to determine what is 'similar'. However, most test participants thought that the notion of 'similar' was unclear. In addition, test participants stated that the notion of 'similar' could result in a very subjective exercise. Some were concerned that an aggressively narrow interpretation of 'similar' could be taken by auditors, resulting in greater granularity than intended.

22. Most test participants found the interaction between paragraph 24 of draft IFRS 17 and paragraph 36 of draft IFRS 17 unclear. A few test participants interpreted paragraphs 24 and 36 as offering different approaches to determining an appropriate level of aggregation, with paragraph 24 offering a more "top down" disaggregation approach, in contrast to paragraph 36 which they interpreted as a "bottom up" aggregation approach.

23. Most thought that the reference to "pricing" in paragraph 24 would result in fewer groups than applying the requirements in paragraph 36, which refer to 'similar profitability'. It appears that most test participants interpreted pricing estimations as often less precise than profitability estimations because, for example, not all variables that cause changes in fulfilment cash flows are reflected in the price charged for the contract.

24. Related to this point was the interaction of regulatory pricing and profitability. Some noted that regulatory restrictions on pricing, for example in the case of

gender neutral pricing, would not affect the number of groups identified by the test participants for pricing purposes, although it would affect profitability.

25. Nonetheless, the focus of test participants was the interpretation of the two elements of paragraph 36 of draft IFRS 17. There were differences in views on which criteria had the greatest effect:

(a) The highest number of groups identified by a test participant was a million groups (10,000 product types, with five contractual service margin groups per product type, across 20 issue years). It is evident that the granularity in this case was driven by the number of currently identified product types (ie the test participants had a broader range of products with different risk drivers included in the external testing than other test participants).

(b) However, most test participants thought that the profitability criterion (ie that profitability be ‘similar’) was the biggest factor in determining the size of the groups.

26. Since all the contractual features are not known to the staff, it is not possible to comment on the “appropriateness” of the number of identified groups and/or the distinctions drawn between groups. In some cases, test participants identified groups of contracts with less than a thousand contracts per group. Factors that could contribute to the relative low number of contracts in a group are the size of existing portfolios and/or profitability distributions.

27. The staff noted that a small number of test participants conducted an iterative process to the grouping of contracts, testing initial conclusions against outcomes and regrouping contracts if those outcomes indicated that further grouping would meet the requirements for the level of aggregation. These test participants concluded that each round produced a smaller number of groups, relative to previous rounds. A test participant noted their belief that further work may have led to an even smaller number of groups.

28. More specific findings on the two criteria are described in paragraphs 29-34.

“Respond similarly to changes in key assumptions”

29. Test participants generally considered different product types (ie key risks being insured) to react differently to different risks. Such an approach can be regarded as a qualitative test. A few test participants grouped together contracts that had similar sensitivities to changes in key assumptions based on a percentage band width. Such an approach can be regarded as a quantitative test. These test participants determined percentages attributable to the band widths of between 20%-30% depending on their interpretation of the term ‘similar’.

30. In some jurisdictions entities issue a host contract which present the policyholder with a choice of multiple different contract riders. The combination of different riders means that there are many different permutations of risks possible. Contracts with different rider combinations would have different response to changes in key assumptions if the contract was assessed as a whole. A few test participants noted that such contracts could result in a large number of groups, because the existence of options for policyholders to select different coverage in the form of different contract riders could result in exposure to different risks.

“Similar expected profitability”

31. Most test participants thought that the “similar expected profitability” criterion would have the most significant effect on the number of groups. Most test participants interpreted this requirement as being primarily quantitative in nature. Again, test participants generally divided the contracts into different bands, based on how they interpreted similar profitability. For instance, some test participants grouped contracts into 2%-profitability bands, other test participants grouped contracts in 5%-profitability bands. One test participant indicated that a change from a 2% band to a 5% band would cause a change in groups from over a thousand to around fifty for a particular product type. The staff noted that the profitability distribution is another factor that could drive granularity (for instance, a wider distribution of profitability could results in more units of account compared to a situation where the distribution of profitability is narrow).

32. A few test participants questioned whether the definition of profitability in draft IFRS 17[3] was appropriate. These test participants noted that profitability can be defined in several ways, and limiting the approach to that defined in draft IFRS 17 was not consistent with the way their businesses are managed.

33. The following areas were identified by test participants to affect profitability, and as a result would affect how an entity would group the contracts:

    (a) Mutualisation: To the extent that mutualisation reduces the differences in profitability between contracts, it can reduce the number of groups. It was clear that many test participants did not take into account the effect of mutualisation in determining the cash flows of contracts, and hence the effect of mutualisation on the level of aggregation (paragraph B68(k)[4] of draft IFRS 17 applies). However, a few test participants did and it significantly reduced the number of groups identified. Test participants:

        (i) asked for further guidance on the link between mutualisation and the level of aggregation;

        (ii) requested that mutualisation be defined in IFRS 17; and

        (iii) stated they found the current wording as included in paragraph B68(k) unclear.

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[3] Draft IFRS 17 states that similar profitability means similar contractual service margin as a percentage of total expected revenue.

[4] Paragraph B68k states the following:

> B68 Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract and include:
>
> …
>
> k. for contracts that include an implicit or explicit requirement to share returns on underlying items with, or to transfer cash flows to or from, policyholders of other contracts:
>
> i. payments arising from the terms of existing contracts to policyholders of other contracts, regardless of whether those payments are made to current or future policyholders; and
>
> ii. cash inflows arising from the terms of existing contracts of other policyholders.

This means that when mutualisation applies, the insurer suffers losses only to the extent those losses exist after risk absorption by other policyholders.

(b) Interest rate changes: Test participants were concerned that an entity may be forced to segregate similar contracts within the same issue year simply due to changes in market conditions from, for instance, one day to the next. This is a particular concern for test participants from developing countries, where interest rate changes can be more extreme. In addition, test participants stated that interest rate movements will make it very difficult to combine previous-period contracts with current-period contracts (ie combining contracts in an 'open portfolio'), which would also increase the number of groups.

(c) Cost allocations: The manner in which costs are allocated affects profitability and as a result affects the number of groups identified. In addition, test participants noted that draft IFRS 17 did not specify a method for the allocation of expenses, and that the methodology used for the allocation of expenses may differ dependent on internal objectives. These test participants also noted that they generally do not allocate expenses at the granular level required under draft IFRS 17. Consequently, these test participants noted that if they do not change their cost allocation methods, their existing methodology may result in groups of contracts being inappropriately classified as onerous when IFRS 17 is implemented.

(d) Distribution channels: Test participants noted differences in distribution channels could affect profitability and result in further granularity. A few test participants did not think that differences in distributions channels reflected differences in the underlying contracts.

(e) Discounts given: When an entity charges a discounted premium because of the existence of other contracts, the allocation of the discount could affect the profitability of both contracts and as a result would affect how an entity would group the contracts.

34. The level of profitability described by some test participants varied significantly for some product types. For example, variances between a profitability of very close to 0% to a profitability of 60% were reported for contracts that are currently grouped together applying existing accounting principles.

Allocation of actuarial outputs

35. Some test participants discussed the interaction between the level at which assumptions are set and actuarial calculations are performed and the level of aggregation for measuring the contractual service margin.

36. Most test participants assumed that all actuarial calculations would need to be performed and assumptions would be set at the contractual service margin group level (ie at the level at which contracts are to be grouped in accordance with paragraphs 24 and 36 of draft IFRS 17). The testing participants were primarily concerned about the fact that:

    (a) performing actuarial calculations at the contractual service margin group level could increase system run-time; and

    (b) assumptions derived from small data sets are not statistically credible and statistical variability in such assumptions can lead to artificial volatility.

37. However, some test participants agreed that it is in principle possible to perform actuarial calculations independently from the contractual service margin calculations: the fulfilment cash flows could be calculated using a more aggregated level than needed for measuring the contractual service margin, and the output from the actuarial systems about changes in fulfilment cash flows could be allocated to the contractual service margin groups. The staff note that if entities had assumed that actuarial calculations are to performed at the same level as at which the contractual service margin is to be measured, this could have contributed to the test participants' concerns about the operational complexities that draft IFRS 17 might introduce.

Alternative approaches suggested for grouping contracts

38. Alternative approaches for the grouping of contracts were suggested, namely:

    (a) Reduce the number of groups due to differences in profitability. Respondents suggested:

(i) Requiring an entity to group only on the basis of "similar risk features and are managed in the same way". In other words, removing the profitability criterion.

(ii) Requiring an entity to group separately only contracts that are onerous at inception and those that are profitable at inception (with no subsequent reassessment).

(iii) Requiring an entity to group contracts in three categories, namely contracts that are clearly profit making, contracts that are onerous, and contracts that are more likely to become onerous. Detailed tracking of contracts that are clearly profit making is not required, whereas detailed tracking of the remaining two categories are required (onerous contracts may become profitable; and contracts that are likely to become onerous may become onerous).

(b) To introduce a 'top-down' approach for the grouping of contracts in which:

(i) The entity would group profitable and onerous groups of contracts separately on initial recognition;

(ii) The entity would assess at the end of each reporting period whether there is any indication that there has been a significant change in the expected pattern of profit recognition for contracts profitable at inception. If such an indication exists, the entity should consider the causes of such a change and whether it would be necessary to separate a sub-group of contracts into a distinct group to better meet the objective that profit is recognised in line with the transfer of services;

(iii) The entity would disclose an explanation of the methodology used to assess whether there are any indications that there has been a significant change in the expected pattern of profit recognition.

39. Agenda paper 2C discusses a possible response to the feedback received on the level of aggregation for measuring the contractual service margin. Agenda paper 2G discusses a possible response to mutualisation; and 'coverage units'.

Scope of the variable fee approach (questions 8 to 10 of the testing questionnaire)

40. We asked the test participants to analyse whether selected contracts meet each of the scope criteria for the variable fee approach. The variable fee approach would apply to insurance contracts with direct participation features, defined as follows:

> B97. Insurance contracts with direct participation features are defined as insurance contracts for which:
>
> a. the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items (see paragraphs B98–B100);
>
> b. the entity expects to pay to the policyholder an amount equal to a substantial share of the returns from the underlying items (see paragraph B100); and
>
> c. a substantial proportion of the cash flows that the entity expects to pay to the policyholder should be expected to vary with the cash flows from the underlying items (see paragraph B100).

Findings

41. A few test participants explicitly stated that contracts that are economically similar should be treated similarly to avoid cliff effects. They further stated that they believe that contracts with legally enforceable obligations are economically similar to contracts with discretionary payments, if the insurer intends the same outcome.

42. However, in assessing the test participants' conclusions about the application of the scope criteria, the staff believe that the test participants were generally able to interpret the criteria as intended. Furthermore, although a few test participants did not agree with the proposed scope, the staff concluded that the outcome of the criteria appropriately distinguished economic differences between contracts.

43. Nonetheless, in reaching those conclusions most respondents needed additional clarification from the staff at their initial kick-off calls, as follows:

    (a) The first criterion requires that the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items. Most test participants sought clarification of that condition as follows:

        (i) Do terms implied in the contract due to the effect of law or regulation form part of the contractual terms?

(ii) Do contractual terms include terms created by constructive obligations?

(b) The second and third criteria refer to "a substantial share" and "a substantial proportion". Some test participants questioned what "substantial" meant in these contexts, and there were differences in interpretation. For instance, a test participant interpreted "substantial" to mean a percentage of 50%, whereas another test participant interpreted it to mean a percentage of 80%.

44. Some test participants sought other clarification on criteria two and three including:

(a) the difference between criterion two and criterion three.

(b) whether the variability in the expected cash flows should be considered over the entire contract term or for only the reporting period.

(c) whether the cash flows should be assessed on an expected basis or on a worst outcome basis.

45. A few test participants asked at what level of aggregation the assessment of the eligibility for the variable fee approach should be performed. A test participant stated that the expected cash flows of an individual contract may differ from the average expected cash flows of the group the contract is allocated to. These differences in expected cash flows could affect the eligibility for the variable fee approach.

46. One respondent was concerned about the operational challenge that would arise in valuing the underlying item at fair value, if the underlying item is not typically measured at fair value, for instance, because the underlying item is a share in the entity itself, or a share in a deferred tax asset, etc.

47. A few respondents questioned whether an entity applying IFRS 17 for the first time should assess eligibility for the variable fee approach based on the conditions that existed at the date of initial application of IFRS 17, or at the inception of the contract. For example, they highlighted that in some cases there could have been changes in the regulatory environment between the date of inception and the date of initial application that might affect how the criteria are to be assessed. Similarly

it could be difficult to know what the entity had expected for the cash flows of the contract by the time IFRS 17 is applied for the first time.

48. Agenda paper 2G describes a proposed response to these findings on:

(a) how to interpret and apply the scope criteria of the variable fee approach; and

(b) operational challenges of valuing underlying items at fair value.

Agenda paper 2E describes a proposed response to the issue of when eligibility for the variable fee approach needs to be determined.

Agenda paper 2C describes a proposed response to the findings on the level of aggregation for assessing the eligibility for the variable fee approach.

Derivatives used to mitigate financial market risk (questions 11 to 15 of the testing questionnaire)

49. We asked test participants to describe and quantify the fair value[5] of the derivative instruments that they entered into to mitigate financial market risk of insurance **contracts with direct participation features**.

50. Paragraph B104 of draft IFRS 17, is relevant only to entities that use derivatives to mitigate risk arising from contracts qualifying for the variable fee approach. It was relevant to only six of the test participants. Accordingly, we supplemented the testing of this question by seeking input from another entity, as discussed in paragraph 15 of Agenda paper 2A.

51. Paragraph B104 of draft IFRS 17 states that, for contracts qualifying for the variable fee approach (VFA):

> B104. An entity may choose not to recognise a change in the contractual service margin to reflect the changes in some or all of the fulfilment cash flows set out in B102.b.iii, if, in accordance with a previously documented risk management objective and strategy for using derivatives to mitigate financial market risk arising from those fulfilment cash flows:
> a. the entity uses a derivative to mitigate the financial market risk arising from those fulfilment cash flows;
> b. an economic offset exists between the specified fulfilment cash flows and the derivative, ie the fulfilment cash flows and the derivative generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated. An entity shall not consider accounting measurement differences in assessing the economic offset; and
> c. credit risk does not dominate the economic offset.

Findings

52. Most test participants welcomed the option to account for the effect of derivatives for the variable fee approach, specified in paragraph B104 of draft IFRS 17. Test participants primarily focussed on the scope of paragraph B104 of draft IFRS 17, as described below.

Risk in contracts in the variable fee approach

53. Some test participants thought that the requirements in paragraph B104 of draft IFRS 17 should apply not only to the effect of financial risks included in fulfilment cash flows being mitigated (for instance financial risks associated with

[5] Test participants were asked to quantify the fair value of the derivative relative to the total value of insurance contract liabilities reported on the statement of financial position.

the issue of financial options and guarantees), but should also apply to other risks, including those arising from:

(a) the entity's share of underlying items; and

(b) insurance risk (for instance mortality bonds or hedging against longevity).

54. The test participants believed that without extending the scope of paragraph B104 of draft IFRS 17 include those other risks, accounting mismatches would result because changes in the effect of the financial risk would be adjusted in the contractual service margin whilst the change in the value of the derivative that mitigates that risk would be recognised in the statement of profit or loss.

55. A few test participants questioned whether paragraph B104 of draft IFRS 17 applies only to the risk mitigation of financial options and guarantees and not also to the mitigation of other financial risks, for instance equity movements. Since equity risk is a financial market risk, the staff thinks that equity movements would also be eligible for the accounting treatment as described in paragraph B104.

Risk in contracts in the general model

56. Most test participants that responded to this question thought that an equivalent option to paragraph B104 of draft IFRS 17 should also be allowed for contracts that are accounted for using the general model. Test participants were particularly concerned that without that an equivalent option, an entity that uses OCI for presenting part of the insurance finance income or expense would experience accounting mismatches because changes of the value of financial options and guarantees are presented in OCI whilst changes in the value of derivatives used to economically hedge those options and guarantees would be presented in the statement of profit or loss. Those mismatches would result in volatility in the statement of profit or loss.

57. Test participants noted that presenting all the insurance finance income or expense in the statement of profit or loss would reduce the accounting mismatch to the extent that the financial risk is mitigated. However, presenting insurance financial income or expense in the statement of profit or loss would result in additional

volatility in the statement of profit or loss from the effect of changes in other financial assumptions or to the extent that the particular risk is not mitigated.

58. A similar point was also made by a few test participants, who suggested that the Board retain the effect of the option in IFRS 4 that permits an entity to separate from a host contract an embedded derivative that itself meets the definition of an insurance contract. The change in the fair value of the embedded derivative would offset the fair value changes of standalone financial derivatives in the statement of profit of loss while the host contract (either a deposit contract or an insurance contract) would be measured at cost. In contrast, IFRS 17 will require the entire contract to be measured on a 'fulfilment cash flow' basis.

59. Some test participants believe that, as is the case for contracts qualifying for the variable fee approach, the scope of paragraph B104 of draft IFRS 17 should be extended to include non-financial risks arising in the general model as well, as discussed in paragraph 53 above.

Differences in measurement basis

60. Paragraph B104 of draft IFRS 17 requires an entity to measure the effect of the financial risk reflected in the changes in fulfilment cash flows on a different basis from the derivatives used to mitigate that risk that are measured at fair value (ie the hedged cash flows are measured on a 'fulfilment cash flow' basis whereas the hedging derivatives would be measured at fair value). The majority of the test participants that responded to this topic had not considered this accounting mismatch or did not think it would be problematic. However, one test participant stated that there would be a significant accounting mismatch due to differences in the discount rate used to value the insurance contract cash flows compared that used in the valuation of the derivatives (ie due to the liquidity premium). As a result, an entity that applied paragraph B104 because it economically hedged financial options and guarantees could report greater volatility in the statement of profit or loss than an entity that is also applying the variable fee approach but did not use derivatives to mitigate the risks from the contracts.

61. It was suggested that this accounting mismatch could be eliminated by valuing the changes in fulfilment cash flows that are not adjusted in the contractual service

margin at an amount equal to the change in the fair value of the derivative (ie accounting as if this were a perfect hedge, without regard as to whether this was in fact the case).

Prospective application of paragraph B104

62. Some respondents stated that requiring paragraph B104 of draft IFRS 17 to be applied prospectively at transition could lead to significant accounting mismatches and, as a result, misstate shareholders' equity at the date of transition and future profits after transition. This is because a prospective application results in a different net income in the comparative years, as well as a different value of the contractual service margin at the date of initial application compared to if paragraph B104 had always been applied.

63. Test participants had the following suggestions for when an entity could be permitted to retrospectively apply paragraph B104:

    (a) if the entity can demonstrate that their risk mitigation strategy has been well defined with the financial impact audited.

    (b) if their existing hedge programs already meet the requirements of paragraph B104.

    (c) from the beginning of the earliest period presented when adopting IFRS 17.

Macroeconomic management of economic risks

64. A few test participants stated that there is a lack of a comprehensive solution in draft IFRS 17 to reflect all hedging strategies applied by entities that needs to be addressed to take account of how the risk management is undertaken across different types of economic risk and product.

65. Agenda paper 2F describes a proposed response to the feedback on "Derivatives used to mitigate financial market risk". Agenda paper 2G describes a proposed response to the option in IFRS 4 that permits an entity to separate an embedded derivative under specific circumstance.

Determining the amount of insurance finance income or expenses in OCI (questions 16 and 17 of the testing questionnaire)

66. We asked test participants how they would disaggregate insurance finance income and expense into an amount presented in the statement of profit or loss and an amount presented in OCI.

Findings

67. Findings from test participants were limited, and some test participants have not yet decided whether to disaggregate insurance income or expenses between the statement of profit or loss and OCI.

68. No significant interpretation issues were noted by the staff from reviewing test participants' input and from discussions with test participants. However, test participants stated that the methods specified for disaggregating insurance income or expenses between the statement of profit or loss and OCI would be complex:

    (a) there would be complexity from a systems perspective, because of the need to obtain and store additional data to perform two parallel liability calculations.

    (b) there would be complexity in determining the appropriate discount rate for the systematic allocation of the expected total finance income or expense.

    (c) there could also be complexity in applying the expected crediting rate approach.

69. Test participants noted that, other than the current period book yield approach, none of the OCI approaches would fully eliminate accounting mismatches, for example:

(a) accounting mismatches could arise under the general model if the assets backing participating and long-term non-participating insurance contracts are measured using a mixed measurement basis[6].

(b) accounting mismatches may arise if entities apply a level yield approach to disaggregating the total insurance finance income or expense into an amount in OCI and an amount in the statement of profit or loss.

(c) accounting mismatches may also arise because of differences in the timing and amount of any recycling from OCI to profit or loss, in particular:

(i) when the underlying items are measured at FVOCI and recycling occurs on realisation of the underlying items.

(ii) when the underlying items are measured at Fair Value OCI without recycling (for instance equity instruments).

70. The staff notes that the Board was aware of the complexity and the potential for accounting mismatches that arises when an entity disaggregates total insurance finance income or expense into a component that is presented in OCI and a component that is presented in the statement of profit or loss. Addressing these issues was one of the primary reasons for the Board permitting an entity an accounting policy choice for presenting the total financial income or expense in the statement of profit or loss, rather than requiring disaggregation as proposed by the 2013 ED. Accordingly, the staff does not think that the Board needs to take further action to respond to these findings.

[6] For instance when some backing assets are measured at fair value through profit or loss; and other assets at measured at fair value through OCI.

Recognition of changes in estimates (questions 18 to 20 of the testing questionnaire)

71. We asked test participants to provide information about the changes in estimates that are recognised in the statement of profit or loss, OCI or the contractual service margin. In particular, we sought to understand the way in which paragraph B93(a)(ii) of draft IFRS 17 would be interpreted and applied. That paragraph addresses the accounting for the **combined effect** of experience adjustments and the associated changes in estimates of future cash flows, as follows:

> B93. In general an entity shall regard experience adjustments other than those described in paragraph B92 as relating to current or past services and changes in estimates of future cash flows other than those described in paragraph B92 as relating to future services. However, circumstances where this does not apply are
>
> (a) the following changes in the liability for remaining coverage:
>
> (i) experience adjustments arising from premiums paid in the period that relate to future services. These experience adjustments relate to future service; and
>
> (ii) the effect of events that result in an experience adjustment that causes a change in estimate of future cash flows. The combined effect is regarded as relating to future service. Hence, for example, the contractual service margin for insurance contracts that provide death benefits is adjusted for the combined effect of experience adjustments and changes in estimates of future cash flows caused by more or fewer deaths than expected in the current period if that change in the number of deaths causes a change in the number of deaths expected in the group in future periods; and
>
> (b) changes in estimates of incurred claims, which relate to current or past services.

Findings

72. Most test participants had little difficulty in interpreting the accounting requirements when an experience adjustment clearly related to past or current services only, for instance a change in estimate of an incurred claim; or when a change in estimate clearly related only to future cash flows.

"Combined effect"

73. However, the staff noted that many test participants had difficulty in interpreting and applying paragraph B93(a)(ii) of draft IFRS 17 that deals with the combined effect. For instance some respondents:

(a) stated that the definition of 'experience adjustment' as referred to in paragraph B93(a)(ii) of draft IFRS 17 or the use of that term creates confusion as some entities understand the term differently under existing GAAP.

(b) expressed concern that it was not clear how to distinguish when a change in estimate was caused by an experience variance and when it was not.

(c) noted that for insurance contracts measured using 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 adjust the contractual service margin. Some of these respondents questioned whether this was the Board's intention.

(d) stated that it would create operational challenges to identify and combine:

   (i) experiences variances; and

   (ii) related changes in estimates of future cash flows.

   A respondent stated that at present, most existing systems do not identify the source of changes in estimates.

(e) stated that the 'unlocking' of the contractual service margin for the combined effect would impose a huge operational burden. This is because entities would be required to extract information about current or past services (for instance incurred claims) from financial systems and allocate this information to groups of contracts established for calculating the contractual service margin.

(f) stated that it would operationally be less complicated if the combined effect were accounted for in the statement of profit or loss and not in contractual service margin.

74. Some respondents disagreed with the outcome of paragraph B93(a)(ii) of draft IFRS 17. They stated that they believe the combined effect should be accounted for in the statement of profit or loss and not adjusted against the contractual service margin. They thought that this would result in more meaningful revenue and net income numbers compared to accounting for the combined effect as an

adjustment against the contractual service margin. In contrast, other test participants stated that, in line with draft IFRS 17, it would be appropriate to adjust the combined effect against the contractual service margin, otherwise accounting volatility in the statement of profit or loss could arise.

75. Agenda paper 2D considers a possible response to the feedback on experience adjustments.

Order of calculations

76. A few respondents questioned the order in which the elements for measuring the contractual service margin should be performed. However, draft IFRS 17 does not specify the order, only that it requires the release of the contractual service margin to be performed last.

77. A few respondents stated that their existing practice is to determine experience adjustments and changes in estimates annually. They thought that if they were to continue to determine those amounts annually, there would be a significant additional practical burden in the requirement to release the contractual service margin *after* the contractual service margin has been 'unlocked' if reporting is performed more frequently than annually (the staff note updating estimates annually is not permitted by draft IFRS 17). One test participant noted that in order to calculate the contractual service margin amount at year-end:

(a) contractual service margin amounts released during the year will have to be reversed;

(b) the contractual service margin will have to be adjusted for the effect of experience variances and assumption changes; and

(c) the contractual service margin release for the year will have to be calculated anew.

78. A few test participants also stated that this requirement would greatly reduce the informational value of the interim financial statements for stakeholders as they would become less indicative of final annual results.

79. One test participant questioned whether insurance contract revenue for the current period should be affected by changes in estimates of future cash flows that are not

caused by experience variances (for instance a change in the probability a policyholder will die).

80. Agenda paper 2G considers a possible response to the feedback on the order of the allocation and unlocking.

Discretion

81. Paragraph B94 of draft IFRS 17 requires:

> B94. The terms of some insurance contracts without direct participation features give an entity discretion over the cash flows to be paid to policyholders. A change in the discretionary cash flows is regarded as relating to future service, and accordingly adjusts the contractual service margin. To determine how to identify discretionary cash flows, an entity shall specify at the inception of the contract:
>
> a. what basis it regards as its commitment under the contract for the payments that it expects to continue with regardless if changes in assumptions that give rise to financial risk and
>
> b. what it regards as discretionary.

82. Some testing participant stated that it could be difficult for entities to define the mechanism used to determine the amounts paid to the policyholders (eg using a formula) and the amounts that are subject to discretion to contracts at the date of initial application of IFRS 17, as this information might not be available in retrospect.

83. Agenda paper 2E considers a possible response to the feedback on discretion.

Transition (questions 21 and 22 of the testing questionnaire)

84. Draft IFRS 17 specifies that for each group of contracts, an entity should determine the contractual service margin at transition using a single approach. Entities would be required to apply IFRS 17 retrospectively to contracts for which retrospective application is practicable. If retrospective application is not practicable, entities would be required to apply the simplified transition approach, unless the simplified transition approach is not practicable. If both retrospective application and the simplified transition approach are impracticable, entities would be required to apply the fair value transition approach.

85. We asked the test participants for information about the transition methods they expect would apply to the contracts they issue.

Findings

86. Most respondents noted the importance of the determination of the contractual service margin at transition and the effect on the statement of profit or loss in the future. Most test participants did not provide quantitative input on the transition questions. Some test participants stated that transition requirements require further testing.

87. In addition, some test participants were concerned about the cost involved in transitioning to IFRS 17. Respondents also stated that given the complexity of IFRS 17, adequate time needs to be allowed for implementation, with the longest **implementation period** suggested by a test participant being 5 years. For some, the long implementation period was seen as a way to promote as harmonised an adoption process as possible, to ensure that all entities preparing IFRS-results adopt IFRS 17 at the same time. The mandatory effective date of IFRS 17 is discussed in Agenda paper 2H.

88. The feedback from test participants is separately discussed below for each of the three transition approaches and is followed by a more general discussion.

Retrospective transition approach

89. Most test participants expect to apply IFRS 17 retrospectively to less than 10% of their *existing* contracts. This was due to the unavailability of data[7] and the fact that they would need to apply hindsight which would preclude retrospective application. However, some test participants stated that retrospective application would be possible for a much higher percentage (up to 80%) of their *existing* contracts, as they believe data required under draft IFRS 17 is already captured under existing reporting frameworks or if the contracts had been issued more recently. In addition, test participants thought that they would be able to apply draft IFRS 17 retrospectively to contracts that they will issue close to and after the issuance of IFRS 17.

Simplified transition approach

90. Some test participants questioned whether the simplified transition approach would be practical to apply. Concerns included:

(a) The difficulties in obtaining reliable data. Some test participants mentioned that actual cash flow data relating to historical business is very often not retained.

(b) The difficulties in obtaining reliable estimates particularly at the necessary level of granularity, for instance where historic experience variances only exist at a high level.

(c) In practice, the simplified transition approach is hardly more practicable than the retrospective transition approach given the significant amount of data required (ie it seems to provide little relief).

(d) The simplified transition approach involves a lot of judgment and provides little comparability.

[7] *Examples* of data fields missing could include the following. The list is therefore not a comprehensive list.

1. Estimated cash flows for existing contracts
2. Actual cash flows that occurred between the contract issuance date and the transition date for existing contracts
3. Risk adjustment at the issuance date for existing contracts
4. The same data (point 1 to 3) for contracts that already lapsed / were already surrendered

91. Accordingly most test participants suggested further simplification to the simplified transition approach.

92. A test participant interpreted the requirements of the simplified transition approach as being that an entity may use such simplifications as it deems appropriate subject to full disclosure. Based on this interpretation, the test participant stated that it will be possible for them to appropriately develop estimates that will reasonably replicate the retrospective transition approach.

93. Some test participants were concerned about the outcome of applying the simplified transition approach believing that the contractual service margin for such contracts would be overstated.

Fair value transition approach

94. Many respondents requested more clarity on how to fair value insurance contracts and how to determine the contractual service margin at the date of transition if the fair value transition approach is applied. Other respondents thought it would be useful to confirm that fair value for transition would be measured applying IFRS 13 *Fair Value Measurement*.

95. Test participants were concerned about the cost of determining fair value for transition. In addition, test participants were concerned about the outcome of applying the fair value transition approach. There are differences of opinion on the possible outcome of applying the fair value transition approach as:

    (a) some test participants believed that the fair value transition approach would result in a contractual service margin of close to zero.

    (b) other test participants noted that the fair value transition approach may result in a higher contractual service margin than would have resulted if the contractual service margin had been calculated applying the retrospective transition approach or the simplified transition approach, for example if the contracts had previously been considered onerous.

Combination of transition approaches

96. Some respondents noted that for some contracts, retrospective application might not be practicable, because of a deficiency in one aspect of information, even

though other information exists. Those respondents suggest that the entity should be able to use a combination of a simplified transition approach and retrospective application in those circumstances. For example, an entity could have fully retrospective information for a number of years in the past (some suggested 8-10 years) and have limited information before then. Test participants suggested that entities should be permitted to determine the contractual service margin at that date in the past and then "roll-back" the contractual service margin from that date to determine the contractual service margin at inception by using the simplified transition approach. In addition, those respondents suggested that the entity should be able to use the fair value transition approach in combination with the simplified and/or the retrospective transition approach as well.

Date for determining contractual service margin for contracts with direct participation features

97. The simplified transition approach for contracts under the VFA requires the contractual service margin at the beginning of the earliest period presented to be determined by reference to the contractual service margin at the date of initial application. Some respondents were concerned that they would not be able to prepare their opening comparative information until they start reporting in real time. Those respondents suggested that entities should apply the simplified transition approach by reference to the contractual service margin at the beginning of the earliest period presented, as in the general model.

Unit of account at transition

98. Most respondents requested more clarity on the unit of account at transition to be applied for each transition approach, particularly when there is mutualisation between contracts written before and after the date of transition.

99. Additionally, some test participants:

(a) believe that IFRS 17 should allow for contracts issued before the effective date to be grouped with contracts that were issued after the effective date. These test participants believe it should be permitted for all types of contracts, regardless of whether contract mutualisation occurs or not.

(b) stated that since data is not available at the granular level resulting from the wording in draft IFRS 17 for existing contracts at the point of transition, a higher unit of account should be set for transition.

Prospective approach to transition

100. Feedback on the prospective application of paragraph B104[8] is discussed in paragraph 62 of this paper.

Other issues

101. Test participants raised other issues relating to transition, as follows:

(a) It may not be possible for an entity applying IFRS 17 for the first time to make assessments that would normally be required to be made at contract inception. For example, draft IFRS 17 requires an entity to assess at the date of initial recognition whether contracts are within the scope of the variable fee approach (as discussed in paragraph 40) and which cash flows are discretionary in the general model (as discussed in paragraph 81).

(b) There are complexities and judgement introduced to account for acquisitions and business combinations that occurred before the date of transitioning to IFRS 17. For instance:

(i) Different contractual service margins might be required to be calculated. For example, consider a subsidiary which issues insurance contracts, and which was acquired before the transition date, but after the date on which it has written a portfolio of contracts. For preparing the subsidiary's financial statements, the contractual service margin is calculated from the date the portfolio of insurance contracts was issued. In contrast, for consolidation purposes, the contractual service margin is calculated from the date the acquisition occurred. This could result in a number of different contractual service margin calculations (potentially

[8] See paragraph 50 for discussions on paragraph B104 of draft IFRS 17 (in the context of Derivatives used to mitigate financial market risk).

one each for every level of consolidation). The different contractual service margin calculations will have to be performed for every reporting period.

(ii) A the test participant stated that significant judgment will be required to allocate considerations paid to each line of business and group of contracts.

(iii) Acquisitions could have been made a long time ago and historical data may be unavailable.

102. Some test participants were concerned about the effort and associated cost required to prove to their external auditors that it is ‘impracticable’ to apply the retrospective transition approach (if the simplified transition approach is to be applied); or the simplified transition approach (if the fair value transition approach is to be applied).

103. Some test participants requested that IFRS 17 be explicit that the Board requires only one year of comparative results, to help maintain a level-playing field between SEC and non-SEC registrants noting that the Board has provided this relief previously.

104. Some test participants also took the opportunity to highlight their concerns about paragraph C16(b) of draft IFRS 17. That paragraph states that in some situations, the cumulative difference between the insurance finance income or expenses recognised in the statement of profit or loss and the total insurance financial income or expenses equals zero. One test participant noted that an accounting mismatch would arise in future periods’ statement of profit or loss because the related assets will have cumulative unrealized gains and losses which will be held in OCI.

105. Agenda papers 2E and 2G consider a possible response to the feedback on transition.

General and process comments

Quality of input

106. The test participants in general were able to perform a thorough analysis which was very useful, although some test participants indicated time and resource constraints. In addition, in general, feedback received from all respondents was constructive.

Process

107. The following general and process related comments were received from the test participants:

(a) A few test participants noted they consider further testing necessary. Some indicated that they thought there was a need for proper and comprehensive testing of the forthcoming *Insurance Contracts* Standard in its entirety prior to its finalisation; and

(b) A few test participants suggested that the Board should form an industry group or committee tasked to provide the insurance industry with support during the implementation phase of IFRS 17.

108. Most respondents raised in addition to findings described in this paper and Agenda paper 2G matters of a drafting nature. In addition, some respondents suggested improvements to the structure of draft IFRS17, for example relating to the sections on discounting and mutualisation. The staff intend to address matters related to drafting or structure as part of the drafting process.