IFRS Transition Resource Group for IFRS 17 *Insurance Contracts* (TRG)

Presentation of groups of insurance contracts in the statement of financial position (S03 in Agenda paper 7 of the February 2018 TRG meeting)

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Introduction

At its first meeting in February 2018, the Transition Resource Group (TRG) for IFRS 17 *Insurance Contracts* raised concerns over implementation challenges identified by insurers in practically applying the requirements of IFRS 17. The IASB staff followed up with specific questions to TRG members designed to understand the issues in more detail. These questions are included in this document.

Topic 1

Presentation of groups of insurance contracts in the statements of financial position (S03 in Agenda paper 7 of the February TRG meeting).

Issue

In applying IFRS 17, an entity must aggregate insurance contracts into "groups of insurance contracts" based on whether or not they are onerous and in cohorts that must not include contracts that are issued more than one year apart. The carrying amount of all "groups of insurance contracts" in an asset position are presented separately in the Balance Sheet from those in a liability position within insurance assets (Dr) or insurance liabilities (Cr) respectively.

The IASB introduced the "group of insurance contracts" as a unit of account for presentation purposes in the financial statements late in the development of IFRS 17 and after the last Exposure Draft in 2013. It is a significant change from current general insurance accounting requirements which adopt the legal entity as the unit of account for financial statement presentation in all major general insurance markets globally.

The "group of insurance contracts" as a unit of measurement was originally developed for identification and measurement of onerous contracts. Whilst we consider this a valid approach for the identification and measurement of onerous contracts, we do not believe this approach

needs to be extended to the balance sheet disclosures. For general insurers the individual components of the balance sheet (summarised in table 1 below) are the critical measures for both internal and external users and the "group of insurance contracts" as a unit of measurement is not considered relevant.

There is a great deal of commonality in the current global practices for reporting of general insurance and our view is the IASB should be building on these and not replacing these with an approach which is both less transparent and which moves us away from the US reporting of general insurance. Furthermore, the cohort required by identification of "groups of insurance contracts" is, at best, underwriting year cohorts which is contradictory to the broad global practice of analysing general insurance business based on accident year, generally regarded as a simpler and more efficient approach.

This issue has particular impact for those applying the PAA and we consider it likely that increasing concerns surrounding this issue will continue to filter out of the general insurance industry as these insurers progress through their impact assessments and develop their financial statements noting that many industry participants are just starting this journey.

Q1. Please describe any specific implementation challenges that you have identified as a result of applying the presentation requirement in paragraph 78 of IFRS 17.

Set out below are the key areas we have identified as significant challenges in practically implementing the requirement to aggregate "groups of insurance contracts" in an asset or liability position for disclosure purposes.

a) The cost vs benefit equation.

The underlying business of insurance requires the pooling of risk and therefore contracts. The exercise to determine the asset or liability for each "group of insurance contracts" involves a massive disaggregation of insurance components (see table 1) and re-aggregation by "group of insurance contracts" for balance sheet presentation purposes only (noting that most disclosures are performed at the level of the entity). We have identified this as an area of significant cost in our implementation assessment. Key difficulties in performing this disaggregation and re-aggregation are set out below and have been identified from experience of our own business across 36 countries and from discussions with others in the general insurance industry.

Having considered whether there are benefits to be gained from including balance sheet presentation at the level of a "group of insurance contracts", we are of the view that there is no identifiable benefit as the underlying components (see table 1 below) which are dis-aggregated and then re-aggregated to create the net insurance asset or liability for a "group of insurance contracts" have different risk profiles and require different processes to manage, monitor and report them. The aggregation of components (i.e. by type of asset or liability) for balance sheet disclosure therefore makes more intuitive sense and provides users with more transparent information.

This makes the balance of costs vs benefit elusive for this element of IFRS 17 with the changes required to systems becoming a compliance only cost.

b) The need for a centralised data store to bring all component parts of the asset or liability together.

A major implementation challenge is bringing all the components of the liability for remaining coverage and liability for incurred claims together into one data store so that the carrying value of the "group of insurance contracts" can be measured.

As shown in the financial systems diagram in Appendix 1, policy administration, reinsurance, claims, cash management and credit control systems and actuarial models are common features of a general insurance company. All such systems will need re-configured to provide information into the measurement of a "group of insurance contracts" as follows:

Table 1: Components of an insurance balance sheet

Type of asset/liability	**Source system**
Reported outstanding claims	Claims system
Incurred but not reported (IBNR) claims	Actuarial models
Discounting	Actuarial models
Risk adjustment	Actuarial models
Onerous contracts/unexpired risk reserve	Actuarial models
Unearned premium	Policy administration system and/or earnings engine
Deferred acquisition costs	Policy administration system and/or earnings engine (for contract based commission) and expense allocation and deferral model (for general allocated acquisition costs).
Trade receivables	Credit control system (needed to deduct from unearned premium) to derive premiums received.

Some of these source systems may be consolidated into a centralised data store (data warehouse); however, even the most comprehensive data warehouse is unlikely to have a sufficiently complete data set to support this new reporting requirement. In addition, it is not market practice to recognise cash based accounting for premiums. The alternative approach is to deduct trade receivables from unearned premium; however, it is not general practice to combine credit control system information in a data warehouse with other data required for statutory, regulatory or other reporting due to the different basis of management for collecting cash (e.g. by distribution channel). It is therefore unlikely that many, if any, insurers currently have an integrated storage solution that brings all these disparate sources together.

The general ledger and consolidation systems are traditionally a centralised source of accounting data; however, the granularity of balance sheet data in these systems would not currently be sufficient to measure the carrying amount at the level of a "group of insurance contracts".

c) Inconsistency over time of "groups of insurance contracts"

In most circumstances a "group of insurance contracts" will be an insurance liability expect for situations where premiums are due in arrears or premiums are due but not received (see appendix 2 for an example of this) which may cause the "group of insurance contracts" to be an insurance asset.

Therefore, at any given reporting period the carrying amount of a specific "group of insurance contracts" could be in either an asset position or a liability position; then at a future reporting period the carrying amount may have changed (e.g. from an asset position to a liability position) based simply on timing of premium receipts. This results in inconsistency in the financial statements from one period to the next and distorts the balance sheet based solely on when the premium is received.

The nature of the "group of insurance contracts" as a unit of measurement (being driven by a determination of whether a set of contracts is onerous or not) means that these "groups" will be necessarily inconsistent over time and therefore will aggregate in different combinations from reporting period to reporting period. This is true within a single entity over time but also introduces varying units of account across entities, reducing comparability. In order to determine the total of the varying "groups", data will need to be at a very granular level initially to allow aggregation. This largely removes the benefits provided by the simplified approach whereby contracts are considered onerous if "facts and circumstances" indicate this.

This inconsistency over periods also creates difficulties when developing an automated solution as the mapping rules will require rework at the end of each period end to change the mapping of any "groups of insurance contracts" that were in a liability position that are now in an asset position.

d) Data gaps in the information required

i. ***Annual cohorts*** - As a "group of insurance contracts" cannot include contracts that are issued more than one year apart, it is necessary for all the components of the asset/liability (see table 1 above) to be at a level of granularity that includes inception year. This level of granularity, where applied to 12 month cohorts, is commonly known as "underwriting year reporting" and is not common outside the Lloyd's of London market where it is required for Lloyd's specific reporting. Splitting all of the data points identified in table 1 above by underwriting year will entail a massive implementation cost in all other jurisdictions outside Lloyd's reporting companies. In particular, actuarial reserving outside of the Lloyd's of London market has historically been done on an accident year basis and this will need to be changed to an underwriting year basis or the future claim cash flows on an accident year basis will need to be converted to underwriting year. We see this requirement as being a challenge to most general insurance companies both in terms of costs and efficiency in the close process.

   Given the continuing demand for information about general insurers' performance based on incidents that occurred during the period both for internal management purposes and from users of financial statements (e.g. investors and analysts), there will be a continuing need to also prepare accident year information.

ii. ***Premiums received*** are usually maintained in a separate cash management system from the policy administration system. The policy administration systems generally export data to specific cash management systems which then focus on the collection of premiums receivable and the management of credit risk. These cash or credit control systems largely focus on aggregating contracts by distribution network and managing credit risk and do not generally have the connectivity back to policy administration systems to differentiate between what is received vs receivable or to relate current balances back to groups of contracts (please refer to our paper on Topic 2 for further details).

iii. ***Cash management systems*** frequently do not apply cash at an insurance contract level (e.g. contracts may be aggregated by broker or agent and the cash applied at this level). This

means that the premium received amounts are generally not at the level of granularity required to measure the "group of insurance contracts".

iv. ***Third party agreements*** are common practice whereby the insurer will enter into an agreement under which a third party writes insurance contracts on behalf of the insurer, subject to agreed limits (e.g. binding authorities or managing general agent/agency business). In these circumstances the data is often booked in total and the detailed contract information required to measure a "group of insurance contracts" is not generally available.

e) Data requires allocation down to a level below that in which it is managed

Certain insurance balances are not calculated at the level of a "group of insurance contracts" as follows:

i. IBNR claims which are part of the liability for incurred claims are generally determined at a reserve class which is the level at which there is sufficient meaningful data to determine the appropriate IBNR through actuarial modelling. To enable the measurement of a "group of insurance contracts" these amounts need to be allocated to a lower level of granularity.

ii. The risk adjustment for non-financial risk is currently calculated at the entity level and under IFRS 17 the risk adjustment will also be calculated at this level. To enable measurement of "groups of insurance contracts" the risk adjustment needs to be allocated.

iii. Acquisition expenses attributable to a portfolio of insurance contracts are typically booked by functional cost centre. To enable measurement of "groups of insurance contracts" any acquisition expenses (and those deferred) need to be allocated.

Such allocations will add more complexity to the reporting process and reduce efficiency of the close process. In addition, allocations will be based on judgement rather than fact and are therefore likely to differ between insurance companies, driving inconsistency in reporting and therefore reduced comparability between entities.

Q2. Do these challenges apply to the presentation aspect alone (paragraph 78 of IFRS 17).

The challenges described above would equally apply to the identification and measurement of an onerous "group of insurance contracts" (paragraph 47 – 52 of IFRS 17) but will have less of an impact where contracts are measured by applying the PAA. Insurance contracts measured by applying the PAA are assumed to be not onerous unless facts and circumstances indicate otherwise, therefore only those onerous groups identified would need to be measured as a group rather than all the remaining contracts that make up the insurance contract asset and liability balances.

The IFRS 17 requirement to identify onerous contracts is similar to the current requirements in most insurance markets to identify deficiency in unearned premium. In Australia this is the "Liability Adequacy Test" and is carried out at each reporting date, albeit that IFRS 17 requires the test to be performed at a more granular level. Performing an "onerous contracts test" would enable the insurer to identify onerous groups and measure and recognise the loss component, without the need to aggregate all data into groups. It appears that the need to identify "onerous groups" has been extrapolated to form the measurement basis in the balance sheet. However, provided the loss component is recognised for "groups" this extrapolation seems an unnecessarily granular unit of account for the balance sheet.

Q3. Are these challenges relevant equally for life and non-life contracts issued?

We understand from discussions with life insurance companies in our local market and overseas that this is a broad issue but mostly relevant where the PAA approach is applied to both general and life companies.

Potential solutions

We believe that using entity as the unit of account for presentation of the balance sheet would be most appropriate and is consistent with current global reporting of general insurance. This would involve recognising the components of assets or liabilities (as shown in table 1) and grouping at entity level into either assets or liabilities to produce the short form balance sheet required by IFRS 17.

By using entity as the unit of account, insurance companies will have fewer operational challenges and reduce the currently significant costs of implementation whilst not losing any of the information that users might require to understand the financial position of the entity.

Presentation at an entity level would make the balance sheet more comparable between entities as it will not be dependent on the aggregation of groups which will necessarily, be different by entity. In addition, there will be improved comparability with other local accounting standards e.g. US GAAP, which are based on entity as the unit of measurement.

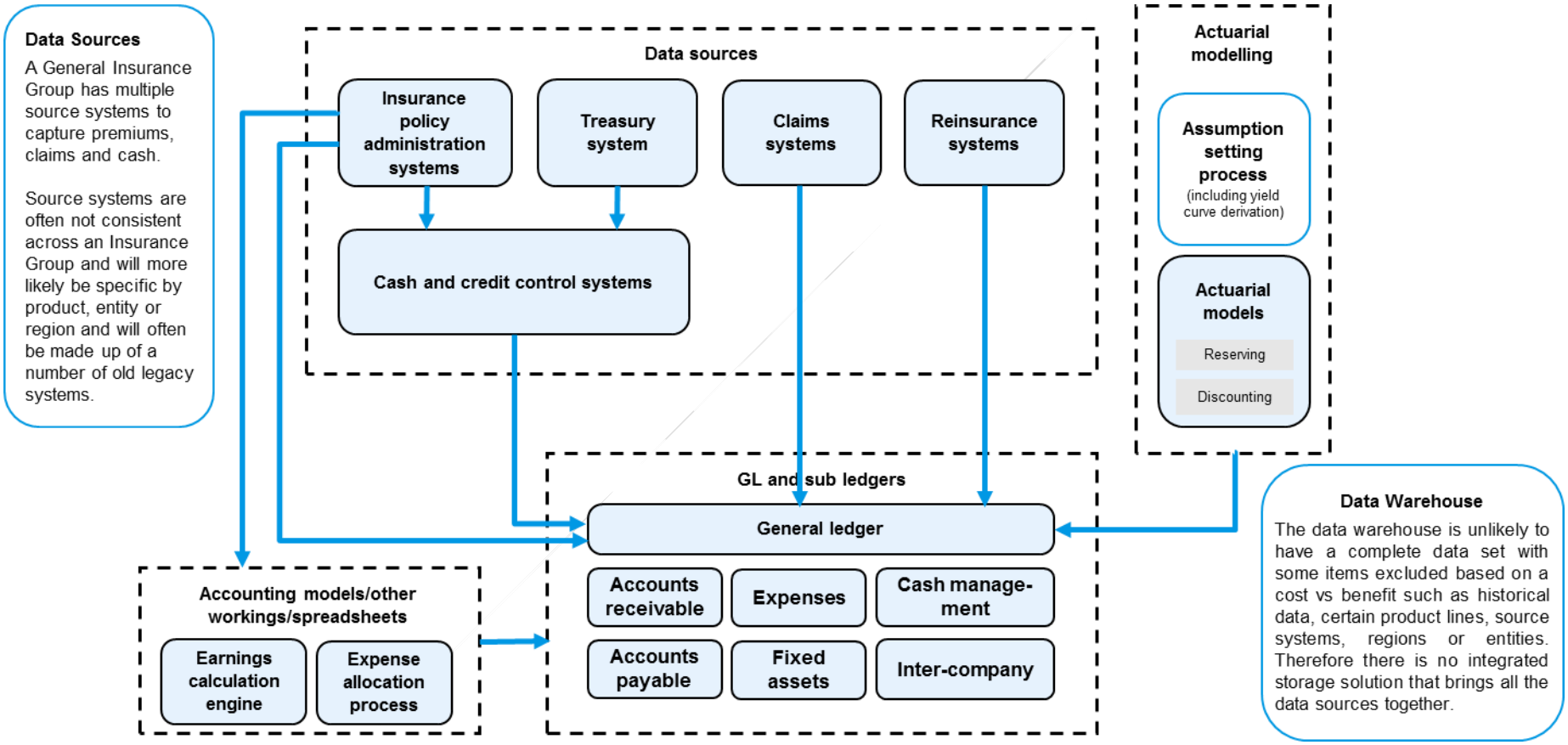
Using the entity as the unit of account for presentation of the balance sheet does not preclude using "group" as a unit of account for measurement of onerous contracts, thereby ensuring that profitable contracts do not subsidise identified loss making groups.

It should be noted that in measuring the "group of insurance contracts", identifying premiums received is a major challenge and reference should be made to the Topic 2 paper.

Disclaimer

Appendix 1

The diagram below shows a simplified architecture of the typical systems included in the financial accounting and reporting process. This is intended to show that there are multiple data sources that feed the general ledger and no single centralised source.



Appendix 2

Circumstances that will always result in the LfRC (non loss) being in an asset position

Payment in arrears

Period of insurance coverage	1 July 20X1 – 30 June 20X2
Contractually agreed premium:	CU 1,200

Example 1: Full payment in arrears

	1 July 20X1	30 Sep 20X1	31 Dec 20X1	31 Mar 20X2	30 June 20X2
Payment made					1,200
Premium receivables	1,200	1,200	1,200	1,200	0
UPR	(1,200)	(900)	(600)	(300)	0
DAC	180	135	90	45	0
Insurance contract asset/(liability)	**180**	**435**	**690**	**945**	**0**

Example:

Groups of contracts where full payment is due at the end of the coverage (eg. Business written through Delegated Underwriting Authorities)

Example 2: Payment in arrears (instalments)

	1 July 20X1	30 Sep 20X1	31 Dec 20X1	31 Mar 20X2	30 June 20X2
Payment made		300	300	300	300
Premium receivables	1,200	900	600	300	0
UPR	(1,200)	(900)	(600)	(300)	0
DAC	180	135	90	45	0
Insurance contract asset/(liability)	**180**	**135**	**90**	**45**	**0**

Example:

Groups of contracts where payment is in instalments over the life of the contract one quarter in arrears
(eg. Inwards reinsurance contracts, settling on a quarterly basis)

Note that where payment is due in arrears but paid early (ie. effectively paid in advance), this would result in the LfRC (non loss) being in an liability position due to the lower level of receivables netting against the UPR liability.