Willis Towers Watson's Response to Exposure Draft ED/2019/4 –

Amendments to IFRS 17 Insurance Contracts

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WILLIS TOWERS WATSON'S RESPONSE TO EXPOSURE DRAFT ED/2019/4 – AMENDMENTS TO IFRS 17 INSURANCE CONTRACTS

Willis Towers Watson appreciates the opportunity to comment on the International Accounting Standards Board (IASB)'s recent Exposure Draft ED/2019/4 (referred to as the "ED") setting out targeted amendments to IFRS 17 Insurance Contracts as issued by the IASB in May 2017 (referred to as the "Standard" or as "IFRS 17").

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Since the publication of IFRS 17 in May 2017, we have analyzed and dedicated a significant amount of time helping our clients interpret, understand, and develop policies to address and implement the business implications of the Standard. We have also been active contributors to the development of the Standard going back to the project's inception.

We commend the IASB for reopening and updating the Standard to address key concerns brought forward by those impacted by the Standard.

The IASB posed 10 questions in its request for feedback on the ED. We have responded to the 10 questions which the IASB has asked for particular feedback on and our responses to those questions are in Appendix A to this letter.

We have also provided comments on some of the practical implementation issues associated with the Modified Retrospective Approach. Our comments are in Appendix B to this letter.

Yours sincerely,

Serhat Guven
Managing Director, Global Lead – IFRS 17

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APPENDIX A

Willis Towers Watson's response to questions

Question 1

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

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

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

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

Willis Towers Watson response:

a) We agree with the proposed amendment.

b) We agree with the proposed amendment.

Question 2

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

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

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

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

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

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

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

Willis Towers Watson response:

We agree with the proposed amendment. We feel this amendment represents an improvement in the Standard, and reflects more faithfully how business is transacted, including an upfront investment in anticipation of future renewals. Requiring an asset to be set up for expenses incurred today which will be charged against the profits of business that is not yet written better matches expenses incurred today against expected future profits that are outside the contract boundaries as defined by the Standard. However we have some reservations as discussed later.

Under the Standard, there is a potential timing difference in the accounting of the acquisition cash flows and the cash flows relating to the renewal of contracts due to contract boundaries. For example, an entity may incur certain acquisition costs with the expectation that these acquisition costs will be recovered through renewals of existing business that are outside the current contract boundaries. Limiting the recovery of acquisition costs only through existing contract boundaries will result in contracts that are otherwise profitable becoming onerous or have a profit recognition timing delay due to front loaded recognition of acquisition expenses.

The proposed amendment in the ED requires the entity to set up an asset for acquisition expenses incurred in anticipation of renewals of existing business, or renewals of existing business that is deemed outside the existing contract boundary.

Since acquisition costs can cover several products, each of which could be either onerous or non-onerous at initial recognition, we feel that additional clarification would be helpful in assessing the level of granularity at which recoverability testing is performed.

We note also that the recoverability testing may create significant additional work for entities in areas such as assessing future profitability which involves greater judgment compared to the more systematic approaches used for CSM or loss component runoff. Areas of judgment include future renewal levels and the level of profits from future contracts. We wish to point out that this may become an issue with respect to the standardization of practice.

Question 3

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

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

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

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

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

Willis Towers Watson response:

We agree with the proposed amendments and disclosure requirements.

IFRS 17 requires an entity to recognize the contractual service margin in profit or loss over time based on coverage units. Under the Standard, the number of coverage units in a group is based on insurance services provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage duration.

Under the proposed amendment, the coverage units would include some investment services that are a fundamental component of the insurance contract in addition to the insurance services. This helps clarify the scope of those contracts that provide insurance coverage that ends before the investment-related services which may otherwise have a front-end revenue recognition, as well as deferred annuity contracts with an account balance accumulating in the period before the annuity payments start which may otherwise have a back-end revenue recognition.

Question 4

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

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

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

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

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

Willis Towers Watson response:

IFRS 17 requires an entity to measure and report reinsurance contracts separately from the underlying insurance contracts. In practice, insurance entities make use of proportional (e.g. quota share) reinsurance to manage their insurance risk exposure, to offer lower premiums to the consumer reflecting the competitive pricing of reinsurers, and to reduce earnings strain associated with new business written as well as the associated acquisition cash flows. The original Standard required the underlying contract and the reinsurance contract to be viewed independently, with the reinsurance contract neither allowing initial gains nor losses to be reflected at initial recognition. This has the potential to create significant earnings mismatches between the underlying contracts and the reinsurance contract because the treatment of reinsurance for accounting purposes is inconsistent with the risk management philosophy. In other words, the linkage between the underlying contract and the reinsurance contract should be recognized.

We agree with the intent of the proposed amendment to the Standard which now allows for the CSM in respect of those proportionate reinsurance contracts to be adjusted to reflect losses on the associated underlying contracts. However we feel that the proposed amendment as worded does not fully meet that goal.

We have several comments on the proposed ED:

- We believe the term "proportionate" needs to be expanded. The proposed wording in Appendix A – Defined terms, defines proportionate reinsurance as "A reinsurance contract held that provides an entity with the right to recover from the issuer a percentage of all claims incurred on groups of underlying insurance contracts. The percentage the entity has a right to recover is fixed for all contracts in a single group of underlying insurance contracts".

  This definition would exclude a number of commonly-used proportional reinsurance constructions, such as surplus reinsurance. We do not believe that it was the IASB's intention to limit the definition of proportionate reinsurance to "plain vanilla" quota share contracts, and thereby significantly reduce the potential applicability of IFRS 17.66A and 66B (and by extension IFRS 17.70A).

  We therefore recommend that the definition of proportionate be modified from "is fixed for all contracts in a single group" to "is fixed for each contract in a single group". While we recognize this adds additional complexity, we strongly believe that this is consistent with the intent of the ED and reflects the underlying commercial substance of these reinsurance transactions.

  We also note that a significant number of proportional reinsurance contracts held will include features that introduce an element of non-proportionality in the extreme tail. As the ED stands, no credit could be taken for these contracts even if they are operating in the proportionate range in respect of the loss on onerous contracts at initial recognition. To better reflect the intent of allowing gains at initial recognition on proportionate policies, we recommend that the IASB consider introducing wording that permits allowance for these contracts.
- The adjustment to the reinsurance CSM is calculated as the loss recognized on groups of insurance contacts multiplied by the fixed percentage at which claims are recovered from the reinsurer. Policyholders' premiums are intended to cover insurance claims and expenses, and for life insurance, also nonforfeiture benefits, all of which contribute to the onerousness of the underlying contracts. We do not believe that the assumption made in BC79 is valid in all cases. Indeed, the IASB staff commented that this approach was "arbitrary"

in staff paper 2B, paragraph 59, as presented to the IASB Board in January 2019. In our experience, the level of expenses may be a significant contributing factor to the overall profitability of a group of contracts, and there is not necessarily a strong link between the insurer's projected/actual expenses and any compensation received from the reinsurer in the form of a ceding commission. This is particularly the case in new businesses or business lines but can also be the case in more mature portfolios and entities.

By recognizing income from reinsurance contracts held where, in fact, no gain will arise to the cedant the proposals under the ED may not, in our view, represent a true reflection of the economics of the reinsurance transaction in such cases.

The wording of IFRS 17.66A and 66B appears to be confusing, since in combination they require both an adjustment to CSM and the establishment of a loss-recovery component of the asset for remaining coverage. We understand the intention of the ED is to make clear that both a CSM and a loss-recovery component may exist in parallel for a single group of contracts, unlike the treatment of a group of underlying contracts, and that the release of each component to income/expense will differ. To provide additional explanation and clarification of the IASB's intentions, we suggest that Illustrative Example 19 be extended to capture the presentation in both the statement of financial position and statement of financial performance.

- Although the wording of IFRS 17.66(c)(ii) is unchanged from the original IFRS 17, the wording of this paragraph in relation to changes in the level of recognized loss at subsequent measurement are highlighted by the amendments proposed in the ED in respect of initial recognition. We note that IFRS 17.66(c)(ii) appears only to relate to contracts measured using the general model since IFRS 17.66 refers to the measurement of the contractual service margin. IFRS 17.70A extends the treatment of reinsurance contracts held that provide coverage for underlying groups of insurance contracts which are onerous to those groups measured using the premium allocation approach; however, no such relief is provided for changes at subsequent measurement. We do not believe that it was the IASB's intention to introduce a deliberate difference between contracts measured under the general measurement model/variable fee approach and the PAA and therefore recommend the wording be amended.

Question 5

Presentation in the statement of financial position (paragraphs 78–79, 99, 132 and BC91–BC100)

The proposed amendment to paragraph 78 would require an entity to present separately in the statement of financial position the carrying amount of portfolios of insurance contracts issued that are assets and those that are liabilities. Applying the existing requirements, an entity would present the carrying amount of groups of insurance contracts issued that are assets and those that are liabilities. The amendment would also apply to portfolios of reinsurance contracts held that are assets and those that are liabilities.

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

Willis Towers Watson response:

The IASB proposes an amendment to paragraph 78 to simplify the balance sheet presentation of insurance contracts by presenting insurance contracts at a portfolio level. This amendment would also apply to portfolios of reinsurance contracts held. There are no proposed changes to the measurement requirements of IFRS 17 as a result of this proposed amendment. Consequential amendments are made to paragraph 79 and to the disclosure requirements in paragraph 99 and 132 to reflect a portfolio rather than a group level of presentation.

We support this proposed amendment because through the higher level of aggregation, it will allow the netting of positive and negative groups at the portfolio level instead of the group level without detracting from the information provided to the stakeholders.

Question 6

Applicability of the risk mitigation option (paragraphs B116 and BC101–BC109)

The proposed amendment to paragraph B116 would extend the risk mitigation option available when an entity uses derivatives to mitigate financial risk arising from insurance contracts with direct participation features. That option would apply in circumstances when an entity uses reinsurance contracts held to mitigate financial risk arising from insurance contracts with direct participation features.

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

Willis Towers Watson response:

We agree with the proposals, but we feel the risk mitigation option could be further expanded beyond derivatives and reinsurance, as discussed later.

The Standard includes a risk mitigation option for contracts with direct participation features, to which the Variable Fee Approach (VFA) applies, available when derivatives are used to mitigate financial risk of the insurance contracts. The primary concerns with the mitigation option is that it was not permitted for reinsurance or other arrangements which could offer substantially similar risk mitigation and that it can only be used prospectively from the date of initial application, even though mitigations would have been in place before the initial application of IFRS 17.

The proposed amendments include extending the mitigation option to reinsurance contracts held, allowing prospective application from the transition date, rather than the date of initial application, and permitting use of the fair value approach to transition when the risk mitigation option is elected to be applied and the entity has used derivatives or reinsurance for mitigation purposes prior to the transition date.

While the expanded scope is still limited to derivatives and reinsurance contracts held, the changes broaden the potential application of the risk mitigation option, giving insurers more flexibility for the reduction of accounting mismatches, which better reflect from an economic perspective the tools available to insurance entities to manage certain financial risks.

Therefore we support the proposed amendment but would also recommend the wording in the Standard be expanded to also include situations where assets are used as tools for hedging financial risks, and not limit the risk mitigation to derivatives, provided the assets form part of a documented risk management strategy. This is important as insurers will often use a combination of “vanilla” assets (such as government or corporate bonds, which can be used to protect against interest rate risk), as well as derivatives, to mitigate financial risk.

Question 7

Effective date of IFRS 17 and the IFRS 9 temporary exemption in IFRS 4 (paragraphs C1, [Draft] Amendments to IFRS 4 and BC110–BC118)

IFRS 17 is effective for annual reporting periods beginning on or after 1 January 2021. The amendments proposed in this Exposure Draft are such that they should not unduly disrupt implementation already under way or risk undue delays in the effective date.

(a) The proposed amendment to paragraph C1 would defer the effective date of IFRS 17 by one year from annual reporting periods beginning on or after 1 January 2021 to annual reporting periods beginning on or after 1 January 2022.

(b) The proposed amendment to paragraph 20A of IFRS 4 would extend the temporary exemption from IFRS 9 by one year so that an entity applying the exemption would be required to apply IFRS 9 for annual reporting periods beginning on or after 1 January 2022.

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

Willis Towers Watson response:

a) We welcome the extension of the effective date from 1 January 2021 to the proposed new effective date of 1 January 2022. We recognize the difficulty in implementing such an all-encompassing Standard; it is complex and requires significant systems modifications. There are areas of the Standard which are still being debated, and there is significant judgment involved to determine the appropriate interpretation (and accounting policy).

The original Standard has been studied and debated, and companies have already incurred significant cost and effort to begin to adapt their systems and processes to adopt it. The IASB has made changes to the Standard to reflect the industry's most significant concerns, while being pragmatic and practical about which changes to not consider. We feel the proposed changes will require additional work, but that work is only a small amount of the effort expended to date. While a further delay of the implementation of the Standard past January 1, 2022 may alleviate some of the practical issues companies are facing, this will further push out a Standard that has been years in the making. Our own view (subject to the comments in the next paragraph) is that while the Standard is not perfect, we believe that on balance the proposed changes along with some additional adjustments reflecting the ED responses, will be appropriate to report insurance contract liabilities and insurance earnings and that companies will be able to meet the implementation date.

In our view, the industry's ability to meet this timetable is dependent on the IASB being able to issue a final standard by June 2020, i.e. in line with its timetable in force at the date of this letter. If the results of the consultation on the ED indicate that a further round of changes would be necessary that substantially affect implementation, potentially involving further EDs, we have significant concerns about the time available for insurers to adjust their projects to meet a 1 January 2022 effective date, and in that scenario would therefore recommend a further deferral of the effective date.

b) We agree with the proposed amendment to extend the temporary exemption from IFRS 9 to align the effective dates of both IFRS 17 and IFRS 9. We believe this alignment is important.

Question 8

Transition modifications and reliefs (paragraphs C3 (b), C5A, C9A, C22A and BC119–BC146)

(a) Paragraph C9A proposes an additional modification in the modified retrospective approach. The modification would require an entity, to the extent permitted by paragraph C8, to classify as a liability for incurred claims a liability for settlement of claims incurred before an insurance contract was acquired. Paragraph C22A proposes that an entity applying the fair value approach could choose to classify such a liability as a liability for incurred claims.

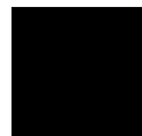
(b) The proposed amendment to paragraph C3 (b) would permit an entity to apply the option in paragraph B115 prospectively from the transition date, rather than the date of initial application. The amendment proposes that to apply the option in paragraph B115 prospectively on or after the transition date, an entity would be required to designate risk mitigation relationships at or before the date it applies the option.

(c) Paragraph C5A proposes that an entity that can apply IFRS 17 retrospectively to a group of insurance contracts be permitted to instead apply the fair value approach to that group if it meets specified criteria relating to risk mitigation.

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

Willis Towers Watson response:

We have no comments in relation to this question.



Question 9

Minor amendments (BC147–BC163)

This Exposure Draft also proposes minor amendments (see paragraphs BC147–BC163 of the Basis for Conclusions).

Do you agree with the Board's proposals for each of the minor amendments described in this Exposure Draft? Why or why not?

Willis Towers Watson response:

We have no comments in relation to this question.

Question 10

Terminology

This Exposure Draft proposes to add to Appendix A of IFRS 17 the definition 'insurance contract services' to be consistent with other proposed amendments in this Exposure Draft.

In the light of the proposed amendments in this Exposure Draft, the Board is considering whether to make a consequential change in terminology by amending the terms in IFRS 17 to replace 'coverage' with 'service' in the terms 'coverage units', 'coverage period' and 'liability for remaining coverage'. If that change is made, those terms would become 'service units', 'service period' and 'liability for remaining service', respectively, throughout IFRS 17.

Would you find this change in terminology helpful? Why or why not?

Willis Towers Watson response:

We believe that the terminology change would be helpful, especially in light of the proposed changes in the ED to the contractual service margin respecting investment-return service and investment-related service (Question 3 above).

APPENDIX B
The modified retrospective approach

From our practical work with insurers, we believe that the permitted modifications to the Full Retrospective Approach (“FRA”) in order to implement the MRA at transition are too restrictive, and will therefore result in a very limited application of the MRA. The result of this will be a significant amount of business being transitioned using the Fair Value Approach (“FVA”). The FVA is not equivalent to the FRA or MRA. We encourage the IASB to introduce additional modifications or provide extra flexibility to facilitate a broader adoption of the MRA where the FRA is deemed to be impracticable.

We believe some minor amendments could include:

- Relaxing the requirements of IFRS17.C10 to include contracts issued more than one year apart.
- Relaxing the requirements of IRS17.C13 to allow the use of a discount rate that exists at time of transition rather than estimating the yield curve in effect at initial recognition. While this will impact the level of CSM, it nonetheless reflects the remaining profitability of the portfolios.
- A relaxation of the requirements to use detailed historical cash flow information.

We believe those suggestions will not adversely impact work done to date and would result in a broader adoption of the MRA.

In summary, we feel the MRA would benefit from more of a principles-based approach in order to minimize the amount of business that we believe would be otherwise be reported using the FVA.

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