STAFF PAPER

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Project	Insurance Contracts		
Paper topic	Discount rates, risk adjustment and OCI option		
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Purpose and structure of the paper

1. This paper discusses the following topics:
   (a) the use of locked-in discount rates to adjust the contractual service margin;
   (b) the risk adjustment in a group of entities;
   (c) the subjectivity in the determination of discount rates and risk adjustment; and
   (d) the OCI option for insurance finance income or expenses.
2. For each topic, this paper provides:
   (a) an overview of the requirements in IFRS 17 *Insurance Contracts*;
   (b) a summary of the International Accounting Standards Board's (Board) rationale for setting those requirements, including an overview of the Board's previous discussions;
   (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued; and
   (d) the staff analysis, recommendation and a question for Board members.
3. Appendix A to this paper includes an example illustrating the effect of using locked-in, rather than current, rates for measuring adjustments to the contractual service margin.

Summary of staff recommendations

4. The staff recommend that the Board should not amend the requirements in IFRS 17 for the following topics:

    (a) the use of locked-in discount rates to adjust the contractual service margin;

    (b) the risk adjustment in a group of entities;

    (c) the subjectivity in the determination of discount rates and risk adjustment; and

    (d) the OCI option for insurance finance income or expenses.

Use of locked-in discount rates to adjust the contractual service margin

IFRS 17 requirements

5. IFRS 17 requires an entity to measure insurance contracts as the sum of the fulfilment cash flows and the contractual service margin. The fulfilment cash flows are a current measure of the estimates of the cash flows expected to arise under the contracts and the contractual service margin at initial recognition is the unearned profit in the contracts. The contractual service margin is not an estimate of a future cash flow, it is the difference between the estimates of discounted risk-adjusted inflows and discounted risk-adjusted outflows.

6. IFRS 17 requires an entity to adjust (ie unlock) the contractual service margin for changes in estimates of cash flows that relate to future service. When measuring the fulfilment cash flows, these changes in estimates are measured consistently with all other aspects of the fulfilment cash flows using a current discount rate. For insurance contracts without direct participation features the adjustment to the contractual service margin is determined using the discount rate that applies on initial recognition (ie the locked-in discount rate).[1]

[1] For insurance contracts with direct participation features the contractual service margin at initial recognition is updated to reflect changes in the amount of the variable fee, including those related to changes in discount rates and other financial variables.

7. This leads to a difference between the change in the fulfilment cash flows and the adjustment to the contractual service margin—the difference between the change in the cash flows measured at a current rate and the change in the cash flows measured at the locked-in discount rate. That difference:

   (a) represents the cumulative effect of changes in financial variables on the underlying change in estimates between the date the insurance contracts were initially recognised and the date of the change in estimates; and

   (b) gives rise to a gain or loss that is included in profit or loss or other comprehensive income (OCI), depending on the accounting policy choice an entity makes for the presentation of insurance finance income or expenses in the statement(s) of financial performance.

Board's rationale

8. The Board introduced the requirement to adjust the contractual service margin when there are changes in estimates of cash flows in response to comments received on the 2010 Exposure Draft *Insurance Contracts*. The rationale for adjusting the contractual service margin when there are changes in estimates of cash flows is to increase consistency between estimates made at initial recognition and estimates made after initial recognition, as illustrated in the example in Appendix A to this paper. Accordingly, the Board decided that the adjustments to the contractual service margin for changes in estimates of cash flows should be measured at the rate that applied to the initial determination of the contractual service margin.

9. A change in estimates may be the consequence of either:

   (a) the inclusion of a cash flow that was not included in previous estimates—in this case no cumulative effect of changes in discount rates has been recognised before (because the cash flow was not included in previous estimates) and IFRS 17 requires an entity to perform a catch up and recognise the cumulative adjustment as insurance finance income or expenses; or

   (b) the removal of an expected cash flow that was included in previous estimates—in this case the cumulative effect of changes in discount rates has already been recognised as insurance finance income or expenses and IFRS 17 requires an entity to reverse it through insurance finance income or expenses for consistency.

10. The Board noted that making an adjustment to the contractual service margin measured at the current rate would mean that the contractual service margin would have no internal consistency and that changes in discount rates would affect the insurance service result (through the contractual service margin) rather than the insurance finance income or expenses. This is because the contractual service margin would reflect the difference between amounts determined using discount rates that applied when the contractual service margin was initially recognised, adjusted by amounts determined using current discount rates. The remaining balance of the contractual service margin would therefore reflect a mix of discount rates that applied at different times.

11. During the development of IFRS 17, and in particular in redeliberating the proposals in the 2013 Exposure Draft *Insurance Contracts*, the Board considered:[2]

    (a) the concerns raised by some stakeholders who thought that tracking locked-in discount rates would be too burdensome, because doing so would require systems and processes to track discount rates from contract inception to completion which, for some insurance contracts, could be up to 60 years;

    (b) the view expressed by those stakeholders that the operational burden could be reduced if an entity were to use current, rather than the locked-in, discount rates for measuring the adjustments to the contractual service margin;

    (c) the view expressed by some stakeholders that a current discount rate should be used for measuring the adjustments to the contractual service margin, to be consistent with the current discount rate used to measure the fulfilment cash flows, and that such an approach would be conceptually correct; and

[2] See Agenda Paper 2B for the July 2014 Board meeting.

(d) the support of some stakeholders for the Board’s view that it would be conceptually correct to use the locked-in discount rate for measuring the adjustments to the contractual service margin because it would:

(i) separate changes in estimates of cash flows that relate to future service between the insurance service result and the insurance finance income or expenses in a clear way (see the discussion in paragraphs 9–10 of this paper).

(ii) provide a faithful representation of the revenue earned as an entity provides service that would reflect the price charged for that service. If the contractual service margin were to be fully remeasured to reflect current discount rates, the revenue recognised would reflect the effect of current interest rates on the price that the entity would charge for the service at the reporting date. To the extent that the contractual service margin reflected current discount rates because of adjustments measured using current rates, the revenue recognised would reflect the effect of current interest rates on the prices that the entity would charge for the service at the date of the adjustments.

12. The Board noted that measuring the adjustments to the contractual service margin at a current rate would only be appropriate if the contractual service margin as a whole were to be remeasured to reflect current rates. This would mean that:

(a) the rate implicit in the contractual service margin would be updated and the interest accreted on the contractual service margin would be at the current rate, as well as the adjustments to the contractual service margin being determined at the current rate; and

(b) the changes to the contractual service margin arising from interest, including the unwinding of and changes in discount rates, would be captured in the insurance finance income or expenses.

13. The Board considered such an approach and concluded that it would be appropriate only for insurance contracts with direct participation features (for which the variable fee approach applies). The Board also concluded it would not be appropriate to reflect

current discount rates only in the adjustment to the contractual service margin as it would create inconsistencies, as described in paragraph 10 of this paper, and make the depiction of the contractual service margin and the resulting revenue arbitrary and difficult to explain.

14. Therefore, the Board confirmed the proposals in the 2013 Exposure Draft that, for insurance contracts without direct participation features, an entity should use the locked-in discount rate for measuring the adjustments to the contractual service margin. The Board observed that:

   (a) both locked-in rates and current rates for measuring the adjustments to the contractual service margin have complexities.

   (b) remeasuring the contractual service margin as a whole to reflect changes in discount rates would not be appropriate for insurance contracts accounted for applying the general model and would add substantial complexity.

   (c) the use of locked-in discount rates does not introduce additional complexities for entities that track locked-in discount rates for the presentation of insurance finance income or expenses (ie entities that decide to use the OCI option for the presentation of insurance finance income or expenses in the statement(s) of financial performance). However, it imposes an additional burden on entities that decide to present changes in discount rates entirely in profit or loss.

15. In the editorial review of a draft of IFRS 17 that was conducted before the issuance of IFRS 17, some reviewers also disagreed with requiring the use of a locked-in discount rate for measuring adjustments to the contractual service margin, citing the concerns and views mentioned in paragraphs 11(a)–11(c) of this paper. The Board considered those concerns and views again and decided not to reconsider the alternative of applying a current discount rate for measuring adjustments to the contractual service margin, noting again its view that:

   (a) the balance of the contractual service margin is not a future cash flow; and

(b) the adjustments represent a change to amounts previously determined in the contractual service margin at initial recognition and those amounts are not updated for changes in discount rates.[3]

Concerns and implementation challenges expressed since IFRS 17 was issued

16. Consistent with the feedback during the development of IFRS 17, some stakeholders would prefer to use current discount rates for measuring adjustments to the contractual service margin.

17. Some stakeholders state that the gain or loss arising from the difference between the change in the fulfilment cash flows and the adjustments to the contractual service margin described in paragraph 7 of this paper would significantly distort the performance results. This is because they think that it is difficult to explain the gain or loss in the statement(s) of financial performance if the entity chooses not to use the OCI option for the presentation of insurance finance income or expenses in the statement(s) of financial performance.

18. Other stakeholders would prefer the contractual service margin to be remeasured as a whole as discussed in paragraph 12 of this paper. Those stakeholders note that in some situations, an insurance contract would comprise fulfilment cash flows in a debit position and a contractual service margin in a credit position. Those stakeholders regard the application of different rates to the adjustments to the fulfilment cash flows and the contractual service margin as particularly anomalous in these situations because they regard the fulfilment cash flows as in an asset position and the contractual service as being a related liability. For example, those stakeholders stated that:

    (a) the measurement of a regular premium contract with initial fulfilment cash flows in a debit position combined with a contractual service margin in a credit position typically results in a small overall balance; and

[3] See Agenda Paper 2C for the February 2017 Board meeting.

(b) the effect of the subsequent measurement of the fulfilment cash flows using current discount rates would not be offset by the effect of the subsequent measurement of the contractual service margin using locked-in discount rates—there would be an unexpectedly large effect in profit or loss or OCI from the subsequent measurement of a contract with a small overall balance.

Staff analysis and recommendation

19. The staff note that the arguments for the IFRS 17 requirements that use a locked-in discount rate for measuring adjustments to the contractual service margin when there is a change in estimates are still valid. Those arguments are described in paragraphs 8–15 of this paper. In summary, the use of a locked-in discount rate:

(a) is consistent with the rationale for unlocking the contractual service margin—ie to ensure there is consistency between the unearned profit that is determined on initial recognition of a group and the effect of changes in estimates on that profit. Thus, the contractual service margin does not reflect locked-in rates for cash flows expected at initial recognition and different rates for each change in estimates of cash flows.

(b) ensures that the effects of changes in discount rates on the difference in estimated cash flows are not included in the contractual service margin and therefore do not affect the insurance service result. This is consistent with the principle in IFRS 17 that the insurance service result is shown separately from the insurance finance income or expenses.

(c) ensures that the revenue recognised as an entity provides service reflects the price charged for that service, rather than being affected by an arbitrary amount arising from changes in discount rates at different dates.

20. The staff note that the Board has considered feedback consistent with the concerns and implementation challenges described in paragraphs 16–18 of this paper a number of times during the development of IFRS 17. Each time the Board has concluded that the use of a locked-in discount rate for measuring adjustments to the contractual service margin is consistent with what the Board intended the contractual service

margin to represent. The Board has also concluded that there are balancing considerations relating to the operational burden described by stakeholders.

21. The staff note in particular the stakeholder concerns that using a locked-in discount rate results in a gain or loss arising from the difference between a change in fulfilment cash flows and a change in the adjustment to the contractual service margin which some stakeholders regard as difficult to explain. The magnitude of this gain or loss has become clearer in recent discussions with stakeholders and this is consistent with the fact that small changes in discount rates can have a significant effect on the measurement of insurance contracts. However, the staff note that:

(a) if the adjustments to the contractual service margin were determined using current rates, that effect of changes in discount rates on the change in cash flows would still exist, but it would be incorporated into the adjustments to the contractual service margin.

(b) an adjustment to the contractual service margin is substantially a catch-up adjustment. It is an over or under accretion of interest on the contractual service margin in previous periods which is shown as an adjustment in profit or loss or OCI in the current period. The adjustment ensures that the correct amount of accretion (at the locked-in rate) is applied to the current contractual service margin balance after adjustment.

(c) contrary to the view expressed by some stakeholders, the gain or loss included in either profit or loss or OCI provides useful information. That gain or loss reflects either the cumulative amount of insurance finance income or expenses that was previously recorded and should be reversed or the amount that should have been previously recorded and has not been caught up (see discussion in paragraph 9 of this paper).

(d) under the existing approach in IFRS 17:

(i) an entity can choose to present the effects of changes in discount rates disaggregated between profit or loss and OCI, leaving the information some stakeholders regard as relevant to the profit or loss unaffected by these requirements; and

(ii) there are sufficient disclosure requirements about changes in estimates and the effects on the contractual service margin and the statement(s) of financial performance to enable preparers to explain to the users of their financial statements the implications of applying IFRS 17 requirements.

22. In addition, the staff observe that:

(a) requiring the use of current discount rates for determining adjustments to the contractual service margin for changes in estimates of cash flows, rather than locked-in discount rates, would damage the consistency in separating the insurance service result from the financial result, which is one of the improvements introduced by IFRS 17. Thus, amending IFRS 17 in this way would reduce the usefulness of information that would arise from applying IFRS 17.

(b) the analysis in paragraph 18 of this paper of an insurance contract comprising an asset component for the fulfilment cash flows and a liability component for the contractual service margin is not consistent with the approach required in IFRS 17 to depicting insurance contracts. As discussed in Agenda Paper 2A *Presentation of insurance contracts on the statement of financial position*, IFRS 17 treats the combination of rights and obligations arising from a group of insurance contracts as a single asset or liability. A debit balance for fulfilment cash flows and a credit balance for the contractual service margin does not affect the analysis in paragraph 22(a) of this paper.

(c) the systems requirements for determining the contractual service margin are one of the most significant changes to existing insurance accounting practices. The difference between the systems required to store and manage locked-in discount rates for the measurement of the contractual service margin and other types of systems could be significant. Accordingly, amending IFRS 17 in this way could unduly disrupt implementation already under way because entities would need to revisit the work they have already done to develop systems and processes to store and manage locked-in discount rates. Such disruption could be minimised if the Board were to allow an optional approach for determining the rate used to measure adjustments to the contractual service margin. However, such optionality would impair the comparability which is a key benefit arising from IFRS 17.

23. Accordingly, the staff think it would not be possible to amend the requirements in IFRS 17 relating to the discount rates used to determine the adjustments to the contractual service margin in a way that would meet the criteria set by the Board at its October 2018 meeting and summarised in paragraph 5 of Agenda Paper 2.

24. The staff therefore recommend that the Board should not amend the requirements in IFRS 17 relating to the discount rates used to determine the adjustments to the contractual service margin.

Question 1 for Board members
Do you agree that the Board should not amend the requirements in IFRS 17 relating to the discount rates used to determine the adjustments to the contractual service margin?

Risk adjustment in a group of entities

IFRS 17 requirements

25. The measurement of a group of insurance contracts includes a risk adjustment for non-financial risk. IFRS 17 defines the risk adjustment for non-financial risk as 'the compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts'.

26. The risk adjustment for non-financial risk reflects the degree of diversification benefit an entity includes when determining the compensation it requires for bearing that risk.

27. An entity is required to:

    (a) remeasure the risk adjustment for non-financial risk at each reporting date; and

    (b) recognise the reduction in the liability for remaining coverage related to the risk adjustment for non-financial risk as revenue over the coverage period.[4]

Board's rationale

28. The Board noted that the measurement of the risk adjustment for non-financial risk depends on the probability distribution of the underlying cash flows and that the shape of that distribution depends on the level at which an entity determines the risk adjustment for non-financial risk.

29. The 2010 Exposure Draft proposed to specify the level of aggregation to be used in determining the risk adjustment for non-financial risk: the risk adjustment for non-financial risk would be determined at the level of a portfolio of insurance contracts.

30. In redeliberating the proposals in the 2010 Exposure Draft, the Board:

    (a) considered the feedback on those proposals—many stakeholders indicated that the risk adjustment for non-financial risk should reflect the effect of diversification between portfolios and therefore that it should be determined at a higher level, rather than at a portfolio level.

    (b) concluded that the objective of the risk adjustment for non-financial risk is to reflect the *entity*'s perception of the economic burden of its non-financial risks and that it would be consistent with that objective to allow an entity to determine the risk adjustment for non-financial risk based on the extent to which it considered diversification benefits in its perception of the economic burden of its non-financial risks. Thus, specifying the level of aggregation at which to determine the risk adjustment for non-financial risk could contradict that objective.

[4] The release of risk adjustment within the liability for incurred claims reduces expenses recognised for incurred claims rather than creating revenue.

Concerns and implementation challenges expressed since IFRS 17 was issued

31. Some existing insurance accounting practices already require an entity to reflect in the measurement of insurance contracts an explicit adjustment for risk, which may be different from the risk adjustment for non-financial risk in IFRS 17. Some stakeholders are concerned that, when determining the risk adjustment for non-financial risk for contracts issued by an entity in a group structure, the requirements in IFRS 17 could be read in different ways and, depending on the reading, might introduce significant changes to those existing insurance accounting practices.

32. Some stakeholders read IFRS 17 as requiring the risk adjustment for non-financial risk to be determined from the perspective of the entity issuing the contract, which does not change depending on whether the reporting entity is the issuing entity or a consolidated group that includes the issuing entity. Therefore, if a subsidiary issues an insurance contract, the risk adjustment for non-financial risk is determined by considering what compensation the subsidiary requires for the risk. The subsidiary might require compensation that reflects the diversification benefits available to it from the group and, therefore, the risk adjustment for non-financial risk might be different compared to if the subsidiary had been a standalone entity with no diversification benefits available to it from the group. On the other hand, some subsidiaries might set the compensation required for bearing non-financial risk without considering any diversification benefits available to it because it is part of a group. In both cases, the risk adjustment for non-financial risk is not different in the issuing entity's individual financial statements and in the parent's consolidated financial statements, even if the parent might require different compensation for risk for the contracts if it had issued them directly.

33. Other stakeholders read IFRS 17 as requiring or allowing different measurement of the risk adjustment for non-financial risk for a group of insurance contracts at different reporting levels if the issuing entity and the consolidated group would require different compensation for bearing non-financial risk.

34. At its May 2018 meeting, the Transition Resource Group for IFRS 17 (TRG) discussed the determination of the risk adjustment for non-financial risk in a group of entities. Some TRG members agreed with the reading in paragraph 32 of this paper,

whereas other TRG members agreed with the reading in paragraph 33 of this paper. TRG members observed that a group of entities must apply the requirements consistently across all groups of insurance contracts.

Staff analysis and recommendation

35. The staff note that the TRG discussions indicate that:

    (a) some entities already have systems in place to manage different risk adjustments for different reporting levels. For some of those entities, the reading in paragraph 32 of this paper would introduce more changes to the insurance accounting practices they currently apply than the reading in paragraph 33 of this paper would. This is because the reading in paragraph 32 would not permit an entity to continue to use different risk adjustments for different reporting levels for the same group of insurance contracts.

    (b) the reading in paragraph 33 of this paper is nonetheless expected to be limited to insurance contracts accounted for applying the premium allocation approach. This is because:

        (i) for insurance contracts accounted for applying the general model, the reading in paragraph 33 of this paper would potentially result in two different measurements of the risk adjustment for non-financial risk for each group of contracts issued by a subsidiary. This in turn would require the management of two different measurements of the contractual service margin, which would significantly increase the practical complexity of the general model in IFRS 17 and hence the reading in paragraph 33 of this paper is unlikely to be applied for general model contracts.

        (ii) for insurance contracts accounted for applying the premium allocation approach the risk adjustment for non-financial risk is identified only for the liability for incurred claims. Therefore, applying the requirements in IFRS 17 as analysed in paragraph 32 of this paper would result in fewer practical complexities.

(c) a group of entities must apply the requirements in IFRS 17 consistently across all group of insurance contracts it issues (based on the reading in either paragraph 32 or paragraph 33 of this paper), thus reducing the likelihood of diversity among contracts.

(d) applying the requirements in IFRS 17 as analysed in paragraph 32 of this paper would be more practical to implement, thus further reducing the likelihood of diversity in practice.

36. In summary, the TRG discussions indicate that the requirements in IFRS 17 might result in diversity in practice, but only in limited circumstances—most entities are expected to apply IFRS 17 as analysed in paragraph 32 of this paper.

37. The staff think that determining the risk adjustment for non-financial risk in IFRS 17 is a single decision that is made by the entity that is party to the contract (ie the issuer of the insurance contract) and would not change depending on whether the reporting entity is the issuing entity or the consolidated group (ie the staff think that the stakeholders' reading discussed in paragraph 32 of this paper is what IFRS 17 requires). An amendment to clarify that only the issuing entity that is party to the contract determines the compensation the entity would require for bearing non-financial risk would:

(a) further clarify the Board's objective when setting the IFRS 17 requirements for the risk adjustment for non-financial risk; and

(b) help some entities to apply IFRS 17 in a slightly more consistent way and might, therefore, reduce possible diversity in practice.

38. However, as discussed in paragraphs 25–26 of this paper, the risk adjustment for non-financial risk reflects the compensation an entity requires to fulfil an insurance contract and is expected to vary entity by entity. Therefore, the staff think that such a clarification to the requirements in IFRS 17 would not help to address all the possible differences in the determination of the risk adjustment for non-financial risk among entities. Consistency of the risk adjustment for non-financial risk considering all aspects of its determination is something the Board can consider in a future post-implementation review of IFRS 17, once practice has developed.

39. The staff also note that, in the meantime, any potential lack of comparability will be alleviated by the required disclosures about the risk adjustment for non-financial risk—IFRS 17 requires an entity to disclose the approach used to determine the risk adjustment for non-financial risk (see the discussion about the subjectivity in the determination of the risk adjustment for non-financial risk in paragraphs 45–49 of this paper).

40. Accordingly, the staff think that there is no need to amend IFRS 17 at this time to clarify how to determine the risk adjustment for non-financial risk in a group of entities and recommend that the Board should not amend the requirements in IFRS 17 for the risk adjustment for non-financial risk.

Question 2 for Board members
Do you agree that the Board should not amend the requirements in IFRS 17 for the risk adjustment for non-financial risk?

Subjectivity in the determination of discount rates and risk adjustment

IFRS 17 requirements

41. As with other IFRS Standards, IFRS 17 is principle-based. IFRS 17 requires an entity to measure insurance contracts by:

    (a) discounting cash flows using current, market-consistent discount rates that reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts; and

    (b) reflecting the risk adjustment for non-financial risk, as discussed in paragraphs 25–27 of this paper.

42. IFRS 17:

(a) sets an objective for the discount rates and risk adjustment for non-financial risk included in the measurement of insurance contracts;

(b) permits an entity to determine discount rates and the risk adjustment for non-financial risk using different approaches and techniques, as long as they achieve the objectives set out in the Standard; and

(c) requires the entity to disclose, among other information:

(i) information about the approach used to determine discount rates and the risk adjustment for non-financial risk, including the methods and processes used and changes to methods and processes;

(ii) the yield curve (or range of yield curves) used to discount the cash flows that do not vary based on the returns on underlying items; and

(iii) the confidence level used to determine the risk adjustment for non-financial risk or, if the entity uses a technique other than the confidence level technique for determining the risk adjustment for non-financial risk, the technique used and the confidence level corresponding to the results of that technique.

Board's rationale

43. The Board decided to require a principle-based approach for determining discount rates and for measuring the risk adjustment for non-financial risk, rather than identifying specific rates or techniques. This is because this approach:

(a) allows entities to develop the best approaches in their circumstances that meet the principles; and

(b) is consistent with the approach used by the Board in other IFRS Standards, such as the Board's approach on how to determine a similar risk adjustment in IFRS 13 *Fair Value Measurement*.

44. The principle-based approach that IFRS 17 uses for determining discount rates and the risk adjustment for non-financial risk could give rise to different amounts. Accordingly, the Board decided that an entity should disclose information to allow users of financial statements to understand how those amounts might differ from entity to entity.

Risk adjustment for non-financial risk

45. As noted in paragraph 25 of this paper, the objective of the risk adjustment for non-financial risk is to reflect the compensation an entity requires for bearing the uncertainty inherent in the cash flows that arise as the entity fulfils the insurance contract.

46. The Board noted that permitting a wide range of techniques to determine the risk adjustment for non-financial risk could lead to diversity in practice, which might reduce the relevance of the resulting measurement and might make it difficult for users of financial statements to compare risk adjustments for non-financial risk determined by different entities. Accordingly, the 2010 Exposure Draft proposed to limit the number of permitted techniques for determining the risk adjustment for non-financial risk.

47. However, when commenting on the proposals in the 2010 Exposure Draft many stakeholders supported a principle-based approach rather than limiting the number of techniques. Only a few stakeholders supported limiting the number of approaches to improve comparability between insurers.

48. The Board:

    (a) was persuaded that a more principle-based approach for measuring the risk adjustment for non-financial risk would be consistent with the Board’s approach of not providing extensive guidance on how to determine a similar risk adjustment in IFRS 13; and

    (b) noted that:

        (i) it is not practicable for a Standard to specify in detail every situation in which particular techniques would be appropriate; and

(ii) specifying particular techniques might prevent the use of new techniques that are more suitable.

49. Therefore, the Board concluded that IFRS 17 should specify the objective of the risk adjustment for non-financial risk rather than prescribing the techniques for and the level of the determination of the risk adjustment for non-financial risk. The Board decided to require an entity using a technique other than the confidence-level technique for determining the risk adjustment for non-financial risk to disclose a translation of the result of that technique into a confidence level. The Board concluded that this information is important to allow users of financial statements to see how the entity's own assessment of the compensation it requires for risk compares to that of other entities.

Discount rates

50. Throughout the project, the Board has specified that the objective of the discount rate is to reflect the current value of the time value of money and that, therefore, the discount rates are current discount rates that reflect only the characteristics of the cash flows of the contracts and that do not consider an insurer's own credit risk. Some stakeholders have disagreed with this objective, but the Board did not change its view.

51. In commenting on the Board's proposals that preceded IFRS 17, some stakeholders expressed concerns about:

(a) the difficulty of directly reflecting the inherent illiquidity of insurance contracts in the discount rates; and

(b) the lack of application guidance on how to determine discount rates when observable market rates for an instrument with the same characteristics of the cash flows of the insurance contract are not available.

52. The Board addressed those concerns by providing:

(a) a simplification that can be used when an entity applies the top-down approach to determine discount rates—the entity need not make an adjustment for any remaining differences in liquidity characteristics between the reference portfolio and the insurance contracts; and

(b) a number of clarifications to the accompanying guidance to make its intentions clear and to reduce the risk of inconsistent application—for example, the application guidance in IFRS 17 specifies that when observable market rates for an instrument with the same characteristics are not available, or observable market rates for similar instruments are available but do not separately identify the factors that distinguish the instrument from the group of insurance contracts, an entity shall estimate the appropriate rates using an estimation technique.

53. However, the Board remains committed to provide principle-based guidance and notes that difficulties could arise if the guidance is too detailed.

Concerns and implementation challenges expressed since IFRS 17 was issued

54. Some investors, analysts and regulators expressed concerns that the principle-based nature of IFRS 17 could limit comparability between insurance entities. This is because the accounting for insurance contracts relies on assumptions and IFRS 17 requires entities to use judgement to determine key factors for the measurement of insurance contracts, such as the discount rates and the risk adjustment for non-financial risk.

Staff analysis and recommendation

55. As discussed in paragraphs 45–53 of this paper, the Board set out the requirements in IFRS 17 for the determination of discount rates and the risk adjustment for non-financial risk considering the feedback during the development of IFRS 17, including the concerns about principle-based accounting versus rule-based accounting.

56. The staff note that insurance contracts have a variety of forms, terms and conditions. Requiring an entity to measure insurance contracts using a rule-based approach would result in outcomes that are appropriate only in some circumstances. The Board was concerned that, for example, prescribing the use of a particular observable market rate would result in appropriate measurement of the insurance contracts only if the cash flows of the insurance contracts are similar to the assumptions driving that particular

rate. In all other circumstances, requiring the use of that particular rate might reduce the relevance of the financial statements of entities issuing insurance contracts. In contrast, applying the principle-based approach in IFRS 17 entities:

(a) determine the inputs that are most relevant to the circumstance thus providing the information that is most useful to their users of financial statements; and

(b) provide information in the notes to the financial statements about the methods used and the judgements applied.

57. Importantly, entities applying IFRS 17 are all required to meet the same measurement objectives. IFRS 17 requirements provide comparability without imposing uniformity.

58. Discount rates and the risk adjustment for non-financial risk are fundamental components of the measurement model in IFRS 17. Any change to make more prescriptive the IFRS 17 requirements for determining those components would require entities that have already started implementation of IFRS 17 to revisit the work they have already done to implement IFRS 17.

59. The staff therefore recommend that the Board should not amend IFRS 17 to prescribe the discount rates used to measure insurance contracts or to limit the number of risk adjustment techniques that an entity can use.

Question 3 for Board members
Do you agree that the Board should not amend the requirements in IFRS 17 to prescribe the discount rates used to measure insurance contracts or to limit the number of risk adjustment techniques that an entity can use?

OCI option for insurance finance income or expenses

IFRS 17 requirements

60. IFRS 17 permits an entity to choose to present insurance finance income or expenses either in profit or loss or disaggregated between profit or loss and OCI. This choice is made on a portfolio-by-portfolio basis.

Board's rationale

61. The Board decided that an entity should be permitted to choose to present insurance finance income or expenses either in profit or loss or disaggregated between profit or loss and OCI because it concluded that users of financial statements may find that, for some contracts, the presentation of insurance finance income or expenses based on a systematic allocation in profit or loss would be more useful than the presentation of total insurance finance income or expenses in profit or loss. This conclusion also led the Board to decide not to require all insurance finance income or expenses to be included in profit or loss with separate presentation of some or all such income or expenses.

Concerns and implementation challenges expressed since IFRS 17 was issued

62. Most investors and analysts we spoke to expressed concerns that permitting, but not requiring, a presentation of the effect of some changes in financial assumptions in OCI could impair comparability between entities.

63. When developing IFRS 17 the Board was aware of this potential impediment to comparability and therefore sought to mitigate the effects. IFRS 17 requires:

    (a) an entity to make the amounts recognised in OCI in any period clearly identifiable; and

    (b) an entity that chooses to disaggregate insurance finance income or expenses between profit or loss and OCI to disclose an explanation of the methods used to determine the amounts recognised in profit or loss.

64. Hence IFRS 17 provides users of financial statements with a basis to adjust information reported by entities to make them more comparable. However, some investors have expressed the view that the OCI option for insurance finance income or expenses adds unnecessary complexity to their analysis of the information reported by entities applying IFRS 17.

Staff analysis and recommendation

65. The Board developed the OCI option for insurance finance income or expenses considering the feedback during the development of IFRS 17.

66. The staff think that amending IFRS 17 to require, rather than permit, entities to present insurance finance income or expenses either entirely in profit or loss or partly in OCI would increase comparability between entities. However, the staff note that:

    (a) the Board already exposed for comments those alternative accounting treatments in the proposals that preceded IFRS 17 and overall feedback on those proposals was mixed. Such feedback is not surprising given the Board's experience on the use of OCI across many projects and is likely to continue whatever the Board decides on this question.

    (b) the reasons for which the Board decided to introduce the OCI option for insurance finance income or expenses discussed in paragraph 61 of this paper are still valid.

67. The staff note that the systems requirements for determining amounts recognised in profit or loss and OCI are complex. Accordingly, such an amendment to IFRS 17 would unduly disrupt implementation already under way. Entities may also need to revisit related considerations about the classification of financial assets held, considering that the OCI option allows an entity to align the accounting treatment of each portfolio of insurance contracts with the accounting treatment of the assets that back that portfolio and, therefore, helps the entity to reduce accounting mismatches.

68. The staff therefore recommend that the Board should not amend IFRS 17 to require, rather than permit, entities to present insurance finance income or expenses either entirely in profit or loss or partly in OCI.

Question 4 for Board members
Do you agree that the Board should not amend the requirements in IFRS 17 about the presentation of insurance finance income or expenses?

Appendix A—Example illustrating the effect of using locked-in, rather than current, rates for measuring adjustments to the contractual service margin[5]

A1. The example in this appendix illustrates the difference in an entity's financial statements when an entity uses:

(a) the locked-in discount rate for measuring adjustments to the contractual service margin; compared to

(b) the current discount rate for measuring adjustments to the contractual service margin.

A2. The example is based on the following assumptions:

(a) the contract provides coverage for insurance risk over 5 years;

(b) the policyholder pays a premium of CU1,200 at the start of the coverage period;

(c) the entity expects to pay a claim of CU893 at the end of the coverage period;

(d) the insurance contract liability discount rate at inception equals 5%;

(e) the insurance contract liability discount rate changes to 2% at the end of Year 2; and

(f) the risk adjustment for non-financial risk equals zero for simplification.

A3. The contractual service margin equals CU500 at inception (present value of expected premiums of CU1,200 minus present value of expected claims of CU700). The contractual service margin is allocated based on coverage units on a straight-line basis.

A4. At the end of Year 3, the entity revises its expectations about the expected cash outflows so that the entity expects to pay CU1,100, rather than the CU893 that was expected at inception. The present value of the difference of CU207 adjusts the contractual service margin. That present value would be:

[5] This example is extracted from Appendix A to Agenda Paper 2B for the July 2014 Board meeting.

(a) CU188 if the change in cash flows is discounted using locked-in rate of 5%; and

(b) CU199 if the change in cash flows is discounted using current rate of 2%.

Statement of financial position

A5. The tables below illustrate the reconciliation of the contractual service margin from the opening to closing balance at the end of each period of the coverage period calculated using (i) locked-in; and (ii) current rates. The staff note that the calculation of the contractual service margin does not affect the amount of the fulfilment cash flows which are always measured using the current rate. Consequently, the difference between the contractual service margin at the end of each period would result in the equivalent difference between the insurance contract liabilities.

Locked-in rate	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Opening balance	500	420	331	44	23	500
Interest accreted	25	21	17	2	1	66
Release to P&L	(105)	(110)	(116)	(23)	(24)	(378)
Change in present value of expected cash flows	-	-	(188)	-	-	(188)
Closing balance	420	331	44	23	-	-

Current rate	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Opening balance	500	420	331	33	17	500
Interest accreted	25	21	17	2	1	66
Release to P&L	(105)	(110)	(116)	(18)	(18)	(367)
Change in present value of expected cash flows	-	-	(199)	-	-	(199)
Closing balance	420	331	33	17	-	-

Difference in closing balance	-	-	(11)	(6)	-	-

A6. As illustrated above, the rate used to calculate the present value of cash flows that unlocks the contractual service margin affects the balance of the insurance contract liability at the end of each period after the change (Year 3).

Statement(s) of financial performance

A7. The tables below illustrate the amounts recognised in the statement(s) of financial performance using locked-in and current rates for calculating present value of expected cash flows that unlock the contractual service margin.

Locked-in rate	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Insurance service result (revenue)	105	110	116	23	24	378
Insurance finance expenses	(25)	(21)	(28)	(2)	(1)	(77)
Total comprehensive income	80	89	88	21	23	301

Current rate	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Insurance service result (revenue)	105	110	116	18	18	367
Insurance finance expenses	(25)	(21)	(17)	(2)	(1)	(66)
Total comprehensive income	80	89	99	16	17	301

Comparison	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Insurance service result (revenue)	-	-	-	5	6	11
Insurance finance expenses	-	-	(11)	-	-	(11)
Total comprehensive income	-	-	(11)	5	6	-

A8. As illustrated in the tables above, the choice of locked-in or current rates does not affect the accumulated total comprehensive income. However, in addition to the effects on the measurement of the insurance contract liability (as explained in paragraph A6 of this paper), it affects:

(a) the insurance service result and the insurance finance income or expenses in each reporting period and over the life of the contract; and

(b) the total comprehensive income at the end of each period.

A9. When the entity unlocks the contractual service margin for the present value of cash flows calculated using the locked-in rate, the discount rate effect on changes in cash flows is recognised in the insurance finance income or expenses. Therefore, the insurance service result is not affected by the discount rate changes but only by the change in expected cash flows since inception. When the present value of cash flows that unlocks the contractual service margin is measured using the current rate, the discount rate effect on changes in those cash flows is reported in the insurance service result.