IFRS 17: Transition – Modified Retrospective Approach

[This article is one in a series of articles published on behalf of the IFRS 17 CSM Working Party. Members are Antoon Pelsser, Asim Ghosh, Clarence Er, Huina Zhang, James Thorpe, Joanna Stansfield, Kruti Malde, Natalia Mirin (Deputy Chair), Richard Dyble, Rob Walton, Timothy Berry, Weihe Qin and Wijdan Yousuf (Chair).]

1 Introduction

Under IFRS 17, the Contractual Service Margin (CSM) at the transition date must be calculated by applying the standard retrospectively, unless this is impracticable (as defined by IAS 8).

If a full retrospective calculation is impracticable, then companies face a free choice between the modified retrospective approach (MRA) and the fair value approach, for each group of insurance contracts (i.e. different approaches can be taken for different groups, including annual cohorts). If the MRA is impracticable, companies must use the fair value approach by default.

The intention of the MRA is to offer a method that maintains comparability of results, while recognising that companies will often lack data for a full retrospective calculation. In this article we give an overview of the MRA and highlight some advantages and disadvantages of the approach that companies are finding during their implementation efforts.

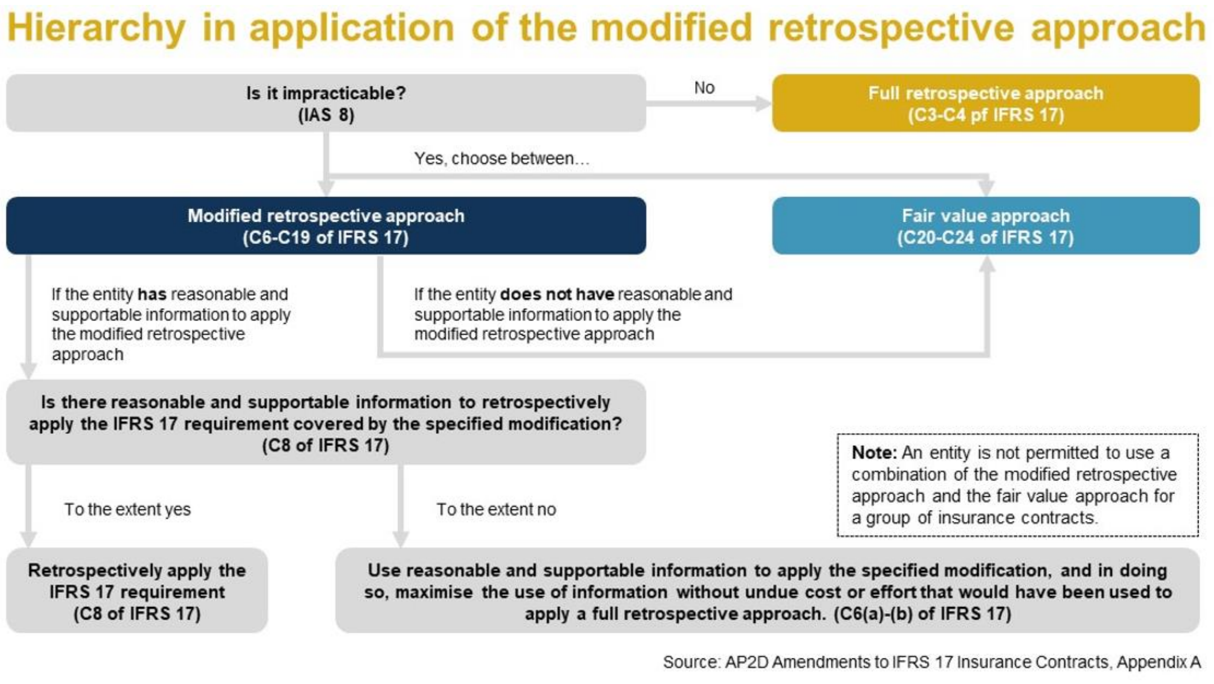
2 Modifications available

The objective of the modified retrospective approach is to achieve the closest outcome to retrospective application as possible using reasonable and supportable information available without undue cost or effort. This is achieved through specific modifications to a full retrospective calculation, as set out in the standard.

For contracts following the General Measurement Model, specific modifications are available in a number of areas, including estimates of future cash flows, calculation of the risk adjustment, setting of the discount rate, amortisation of the CSM and other areas. The MRA also allows for grouping of annual cohorts, where there isn't sufficient data to perform a retrospective calculation at this level. The permitted modifications under the General Measurement Model are summarised in the table below.

<table>
<tr><th>Area</th><th>Full Retrospective</th><th>Permitted Modification</th><th>Reference</th></tr>
<tr><td>Identification of IFRS 17 groups</td><td rowspan="3">Determine at initial recognition date</td><td rowspan="3">Determine at transition date</td><td rowspan="3">C9</td></tr>
<tr><td>VFA assessment</td></tr>
<tr><td>How to identify DCF</td></tr>
<tr><td>Cohort size</td><td>No more than 1 year</td><td>More than 1 year</td><td>C10</td></tr>
<tr><td>Estimates of cash flows at the date of initial recognition</td><td rowspan="4">Calculate retrospectively</td><td>Use actual occurred cash flows instead of projections prior to transition date</td><td>C12</td></tr>
<tr><td>Estimates of the risk adjustment at the date of initial recognition</td><td>Adjust risk adjustment at transition date for expected release prior to transition date</td><td>C14</td></tr>
<tr><td>Determining discount rates at the date of initial recognition</td><td>Approximate using observable yield curve</td><td>C13</td></tr>
<tr><td>Determining the contractual service margin recognised in profit or loss prior to transition</td><td>By comparing the remaining coverage units at transition with the coverage units provided before the transition date</td><td>C15</td></tr>
</table>

There is a requirement to use as few modifications as necessary, which means companies will need to demonstrate for each modification used that a full retrospective approach is impracticable. A hierarchy of the application of the MRA is shown below.



These modifications provide relief from the requirements of the full retrospective approach where required, and act as a proxy for that approach. They generally reduce the need for historic estimates (that may involve hindsight), replacing this with estimates as at the transition date, and actual historic data.

The method to be used under the MRA for contracts measured using the variable fee approach is more prescribed, but again makes use of historic actual data to estimate the CSM at inception, before rolling this forward to the transition date.

3 Advantages and disadvantages of the MRA

Given the free choice available where a full retrospective calculation is impracticable, companies can assess the advantages and disadvantages of MRA and a fair value approach, both from an operational perspective as well as the impact on their financial results.

For contracts under the variable fee approach, such as UK-style with-profits business, the proxy method under MRA could be significantly less onerous than a full retrospective calculation. The fact that retrospective calculations of liabilities for with-profits business have been required for a number of years under the UK regulatory regime means that availability of historic actual cash flow data may be less of an issue here than for some other products. This is also an area where the nature of the business means that defining fair value can be particularly challenging - again making a modified retrospective approach potentially more appealing.

Some companies may find that the issues they face with a full retrospective calculation are limited to specific areas - such as the calculation of the risk adjustment or discount rate. If a historic calculation of the Risk Adjustment is found to require hindsight, then the modification available under the MRA provides a route for a calculation that is largely in line with a full retrospective approach, while avoiding this issue.

However, a view expressed by many in the industry (as recognised in IASB discussions) is that the MRA is too restrictive, making it costly and burdensome to apply.

The approach is deliberately limited to specific modifications. This may be seen as overly restrictive in cases where data is available to support an estimate of the CSM that companies deem to be more in line with a full retrospective approach than the calculation under the fair value approach, but the method doesn't meet the specific requirements of the MRA.

A specific restriction noted in the MRA concerns the treatment of financial assumptions. The MRA allows for historic estimates of future cash flows to be based on estimates at the transition date, adjusted for actual historic cash flows. However, a result of this is that it reflects the financial assumptions as at the transition date, with no allowance to adjust these to the assumptions that would have been used at initial recognition, where these are known. This may particularly be an issue for companies writing long-term index-linked business (such as annuities), where inflation assumptions may vary significantly between initial recognition and transition.

Some companies may find that a full retrospective calculation is impracticable, due to a lack of available historic data on actual cash flows, at the required level of granularity. Although there is some relief available from the permitted modification to group annual cohorts of business, this is an issue that will remain for some.

4 IASB discussions

In February 2019, the concerns expressed by many in the industry over MRA were discussed by the IASB when considering amendments to the standard. Although a number of topics were discussed, the only area of amendment related to the classification of liabilities for settling claims incurred before an insurance contract was acquired.

However, the staff paper clarified the point that when applying a requirement retrospectively, it may be necessary to make estimates. The existence of prescribed modifications does not prevent companies from making estimates in either a full retrospective calculation or in applying the modifications in the MRA.

5 Conclusion

In offering a modified approach to retrospective application of the standard, the IASB recognised that it would often be impracticable to carry out a full retrospective calculation. There are clearly areas that may offer some relief to companies, and some may find that the financial result of adopting the MRA is preferable to the use of the fair value approach.

However, the MRA does not give companies free reign to approximate the CSM at transition with the best information they have available - though the use of estimates will be necessary in any retrospective calculation (full or modified), and discussion of this with auditors will be important. Given the limited changes proposed by the IASB, it is likely that the MRA will continue to be an approach that may be acceptable for some, but not others.

[END]