IFRS 17: Transition - fair value approach vs modified retrospective approach

[This article is one in a series of articles (which can be found here and here) 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

In previous articles, we introduced the various approaches for transition under IFRS 17 and subsequently discussed the fair value approach in more detail.

In this article, we build on the discussion and consider possible reasons that companies might choose to apply the fair value approach or the modified retrospective approach at transition.

Questions and comments about items discussed in this article can be left in the comments section.

2. Should a company apply the modified retrospective approach or the fair value approach?

2.1. As noted in our introductory article, if the full retrospective approach is impracticable for a company to apply, IFRS 17 does not establish a 'pecking order' in relation to the alternatives and entities have the flexibility to choose between the modified retrospective approach and the fair value approach for transition[1]. This choice means that companies could use this as an opportunity to select an approach that best reflects their desired outcome in terms of the opening CSM balance, and consequently their future earnings and balance sheet position, by understanding the relative costs and benefits of the two approaches.

2.2. Current industry thinking seems to suggest that the fair value approach will typically, but not always, result in smaller CSMs at transition than the retrospective approaches. One argument for this, as noted in papers issued by EFRAG (see in particular paragraphs 10-12 of paper 05-05 dated 18-19 December 2017), is that by seeking to use an exit price concept from IFRS 13, the CSM at transition will only reflect the margin that an average market participant expects to earn for taking over a block of business. On the other hand, the modified retrospective approach will reflect an updated view of the unamortised CSM yet to be recognised as profits.

[1] Note that each modification is also subject to the impracticability requirement hence companies cannot arbitrarily pick and choose which modifications to adopt once they are applying the modified retrospective approach.

3. In support of the fair value approach

3.1. A consequence of the considerations set out in section 2 might lead some companies to prefer the fair value approach over the modified retrospective approach for transition in certain circumstances. Examples include:

- Companies that are concerned about the potential hits to shareholder equity from certain blocks of business and would instead prefer lower retained earnings. For instance, there might be large portfolios that are closed to new business and in run-off where the CSM set up on a modified retrospective results in a disproportionately larger liability for remaining coverage than the IFRS 4 reserve it replaces. An extreme outcome could be for this to become a constraint on the dividend paying capacity of the company.
- Portfolios where a modified retrospective approach is expected to result in a loss component at transition but it seems likely that the fair value approach would still result in a CSM. Examples of these might be a deferred annuity portfolio with GAOs or annuities purchased through exercising GAOs that were in-the-money. A company might consider this to be a more desirable situation than one with a loss component[2].
- Some companies may not have the appetite or capacity to invest in the resources and time required to apply the modified retrospective approach for certain legacy lines of business. For example, a modified retrospective calculation could be a particularly onerous exercise for unit-linked products where data might need to be heavily processed and checked before it is ready to use at the appropriate level of granularity. Another reason might be that a modified retrospective approach is estimated to result in CSM balances that are not materially different to the fair value approach.
- In some instances, company strategies might be to aim to report financial impacts of transition that are as consistent as possible with impacts reported by competitors. Fair value calibrations could be used as a lever for this.

4. In support of the modified retrospective approach

4.1. Conversely, companies may prefer the modified retrospective approach for transition because they reason that:

- A higher CSM at transition acts to smoothen out the emergence future profits and minimize future earnings volatility (as much as possible) as it can absorb large basis updates and other experience variances that relate to future service. This might naturally be considered an attractive option for several companies of various risk profiles.
- The modified retrospective approach better reflects the stated aims of IFRS 17 and more accurately depicts the financial performance of the business compared to the fair value approach. Under this view, the fair value approach is only considered appropriate to apply as an option of last resort.
- There could be a push towards consistency of approach between business being issued pre- and post-transition. For example, this could be due to a desire to report similar levels of profitability under IFRS 17 for similar lines of business where underlying margins and demographic assumptions have been relatively stable.

---

[2] There is a trade-off here. A loss component will not have an impact on the shareholder equity upon transition like a CSM will yet at the same time, a loss component does not have the ability to smoothen the impact of potential basis updates to the extent a CSM does (both favourable or unfavourable changes). Similarly, a loss component means no future profit recognition (in the theoretical but unlikely scenario where all experience is in line with expected) and that might not be acceptable to a profit-hungry firm.

- Companies might be aiming to be as consistent as possible in their transition approaches with competitors. In some jurisdictions, the modified retrospective approach is expected to be favoured over the fair value approach, particularly in continental European countries.
- A higher CSM at transition will translate into higher future earnings which closely matches the existing profits reported under IFRS 4. This might be considered an attractive message from an investor relations point of view and avoids the need to explain and justify calibrations[3] required for the fair value approach.

5. Conclusion

Where a choice is to be made between applying the modified retrospective approach and the fair value approach for groups of contracts, an appropriate response would be for companies to take its own circumstances into account and seek to apply the choice they have available in a manner that enables them to achieve the desired impacts on shareholder equity upon transition and future profit profiles thereafter. Each of the two possible approaches have their own challenges but bring with them their own opportunities.

[END]

[3] By calibrations we mean the need to explain and justify the CSM under FV using information available internally (other reporting metrics, information from M&A teams etc.) and then also about what other firms might be doing for similar lines of business.