

## **IFRS 17 – impact on UK with-profits business**

This article from the IFRS 17: Transversal working party introduces some key issues insurers may face when implementing IFRS 17 for with-profits business. The working party intends to explore some of these issues more deeply over the coming months and would be happy to receive feedback from members on topics of particular interest.

### **Requirements of the standard**

Under the IFRS 17 standard, UK-style with-profits business will generally be treated as business with direct participation features and therefore eligible for the Variable Fee Approach (“VFA”). This helps minimise otherwise material accounting mismatches that could be introduced if the liability values were disconnected from the underlying asset values.

IFRS 17 will mean a move away from profits under the current (IFRS 4) standard being directly related to the bonus declared, both for regular bonuses and the typically larger final bonuses. IFRS 17 profit will be run off gradually over time as the insurance benefits are provided and so is expected to emerge faster and more smoothly over the lifetime of the contract, but without any link to the actual bonuses or cash payments.

This acceleration of accounting profit, relative to the actual cash basis, could introduce a potentially confusing concept of “entity equity”, i.e. profit shown on the income statement that is restricted and unavailable to the shareholder. This entity equity will remain part of underlying items until cash transfers move it to shareholder equity. Returns on shareholder equity will fall into profit as they are earned. In all, this may increase the need for alternative profit metrics, such as operating profit, for with-profits insurers to tell their story.

With-profits business differs from other VFA business in that the cash flows of groups of contracts can affect the cash flows of other groups of contracts (referred to as “mutualisation”, noting that the standard does not use this term). In this regard in particular, the standard does not directly address the typical mechanics of a with-profits sub fund (“WPSF”). Consequently, the standard needs to be interpreted allowing for “different practical approaches” for it to be applied and the appropriate treatment will most likely vary from fund to fund.

There are a number of technical and operational considerations introduced by the standard regarding its application to with-profits business. A few of the key issues are discussed in more detail below:

### **Transition**

The standard requires, wherever possible, retrospective application from day 1 for all in force policies. This step will define how any estate in the funds is treated under IFRS 17 and determine the opening equity shown on the income statement. It is a material task to try to recreate a full history allowing for investment conditions, bonus scales, costs spread across funds and/or the estate. Policies are often managed on legacy administration systems that may not be flexible or well-supported. Material investment in data platforms and calculation systems would be necessary, and so instead many firms are expected to apply the “fair value” approach for their with-profits business, which will have its own challenges and may result in a higher equity value but a lower Contractual Service Margin at adoption, and so lower future profits.

## **VFA eligibility**

While most standard UK with-profits business is expected to be eligible for the VFA, there are defined criteria and there may be some groups of contracts, for example those with heavily-in-the-money guarantees, which do not qualify, leading to accounting mismatches and presenting operational complexities.

## **Level of aggregation**

Companies may, understandably given the risk sharing implicit within WPSFs, expect that the WPSF would form one group or “unit of account”, which is the level at which an asset or liability is measured and which can impact the pattern of profit recognition. However, different product types can be written within a WPSF and IFRS 17 considers risks at the contract level and so divisions of the WPSF may be necessary, increasing operational complexity.

## **Non-Profit business in the WP fund**

Linked to the above point, several WPSFs have significant volumes of non-profit contracts within them. Currently, under IFRS 4, profits on these contracts are not separately recognised but contribute to the cost of bonus. Extrapolating IASB-issued guidance for mutuals could mean that these contracts are not eligible for the VFA and will generate a profit directly onto the income statement despite only a portion being eligible to shareholders. This, at a minimum, raises communication concerns as the profits released by this business will be owned by the entity rather than shareholders.

## **Other considerations**

A large number of UK with-profits funds are closed (or materially closed) to new business, and so firms may have little appetite to spend significant time and effort focusing on IFRS 17 when the current management for most funds is driven by capital. However, IFRS 17 is a principles-based standard and so gives rise to several areas of uncertainty and complexity for with-profits business which is expected to drive up implementation costs whilst, it has been argued, providing an unclear benefit to the users of financial statements.

## **Summary**

In summary, UK with-profits firms have several complex methodology and design decisions to make this year to prepare for IFRS 17. These will have lasting business implications; impacts on the market's view of WP funds, the attractiveness of future WP business, as well as process and operational considerations. There is little clarity on these issues, and they may not meet the criteria to warrant IASB intervention. The UK accounting and actuarial professions are taking steps to better understand the issues with a view to providing guidelines for sensible treatment.

Further articles from the IFRS 17: Transversal Working Party will discuss these and other with-profits issues further, see <https://www.actuaries.org.uk/practice-areas/life/research-working-parties/ifrs-17-transversal> for details.