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2 February 2022

UK Endorsement Board

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Call for comments on Draft Endorsement Criteria Assessment: IFRS 17 Insurance Contracts

We write to comment on the UK endorsement and adoption of IFRS 17 Insurance Contracts issued by the International Accounting Standards Board (IASB) in May 2017.[1]

We have your reply form but it was difficult to fill in the boxes, so we write this as a separate letter with cross references to your form throughout.

<u>Section 1: Legislative framework and UKEB's approach to the assessment</u>

In my letter of 18 February 2021 to the UKEB Chair, I raised concerns as a director of UKSA about the process adopted by UKEB for the Technical Advisory Group (TAG). I wrote:

> The TAG process is not designed to produce an independent and objective outcome. It is stage managed and scripted, consisting of papers either written by the Secretariat, or heavily edited by them. At meetings, members are simply asked if they agree or disagree, with no detailed discussion or analysis possible.
>
> .. the TAG is dominated by preparers and their auditors, who have no interest in challenging insurance firms' practice on discount rates, having tacitly endorsed the practice either in preparing the accounts, or signing off on them.

[1] Subsequently amended in June 2020 and December 2021

> I do not think there is a conscious conflict of interest, but there is an unconscious bias when most members come from a culture where such practice is widely accepted.

That view, i.e. of the weakness of the UKEB's approach to assessing the Standard, remains.

Section 2 description of IFRS 17

We have no comment on this section.

Section 3 technical accounting issues

"Do you agree that the assessment in Section 3, together with Appendix B, captures all the priority and significant technical accounting issues?"

We agree with the assessment of priority issues as set out in 3.14.

Profit Recognition

"*CSM allocation for annuities*: do you agree with the [tentative] assessment against the endorsement criteria (paragraphs 3.40 – 3.53)?"

We do not agree with the broad conclusion set out in 3.53, namely that the standard's objective and principles are clear on the question of profit recognition, and that the current difficulties in finding a consensus in the case of annuities do not necessarily indicate that the technical accounting criteria as a whole are not met.

Our reason is the visible disagreement between UK insurers and accounting firms about the precise method for recognising profits under the Contractual Service Margin (CSM). We refer to the letter sent by Philippa Kelly (Director of Financial Services, Institute of Chartered Accountants, England and Wales) to the Chair of the International Accounting Standards Board on November 18 2021.[2] The paper attached to her letter sets out two different methods of profit recognition, one of which (Approach 'B') is markedly less prudent than the other ('A'). We understand that the matter is to go to the IASB interpretations committee.[3]

We agree with the stakeholders who "are concerned that, depending on the interpretation of IFRS 17's requirements, the accounting will not fairly reflect the economic substance of the transactions, will not provide useful or understandable financial information and will therefore not meet the technical accounting criteria."

B: Discount rates

"6. Discount rates: do you agree with the [tentative] assessment against the endorsement criteria (paragraphs 3.72 – 3.90)?"

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[2] https://www.icaew.com/-/media/corporate/files/technical/financial-services/ifrs17-and-iasb/ifrs-17-letter-to-the-iasb.ashx?la=en

[3] *Per litt.* Philippa Kelly 20 Jan 2022.

We wholly disagree with the analysis and conclusions presented in those paragraphs, for the following reasons.

“3.73 The requirement to use updated (current) discount rates promotes a faithful representation of an insurer’s economic position”

This would be true only if there were a way of decomposing the asset spread in a way that faithfully reflected the decomposition of the spread into illiquidity and credit risk. But financial economists recognise that there is no such way. Therefore the use of discount rates which purport to take account of illiquidity does not promote a faithful representation of an insurer’s economic position.

3.74 “IFRS 17 requires the discount rates applied to be based on the characteristics of the cash flows being discounted. This means that discount rates – and insurance finance expenses - reflect the nature of the insurance contract liabilities and thereby provide relevant information.”

This would be true only if the illiquidity spread on the insurance contracts were relevant to the observable spread on the bonds supporting the contracts. But as we observe above, there is no way of decomposing the bond spread in a way that is relevant. The imputed discount rates therefore do not provide relevant information.

3.75 For the same reason as above, the imputation of discount rates based on an immeasurable quantity (namely illiquidity spread which can only be calculated by making assumptions which cannot be objectively supported) cannot enhance reliability and relevance.

3.76 is a *non sequitur*. It first states that assets (such as corporate bonds) are usually highly liquid, implying a low or zero illiquidity spread. This is correct. Then it states that insurance contracts are highly illiquid, which is also correct. However, owning a highly liquid but risky bond to offset the liability represented by an illiquid insurance contract does not justify discounting the liability by the (risky) yield on the bond. Accordingly it does not follow that such discounting “leads to a more faithful representation of liabilities and insurance finance expense, enhancing reliability, and to more relevant information”. Rather, the opposite.

3.80 “The requirements that discount rates applied are consistent with observable current market prices, reflecting current market conditions from the perspective of a market participant, and maximise the use of observable inputs means that the rates determined are less subjective, as they do not reflect purely an entity view. This supports the provision of information that is reliable and comparable.” But, as noted above, there is no observable market data that determines the decomposition of asset spreads into an illiquid component and a credit risky component. No such ‘information’ exists, therefore no reliable and comparable information exists.

3.85 begins by correctly noting the inherent limitations in estimating adjustments to observable rates. We have noted the same limitation several times above. It then states (3.85a) that “the requirement for consistency with observable current market prices and for maximum use of observable inputs should help make the determination of discount rates less subjective”. This contradicts the previous statement about the inherent limitations of determining the illiquidity spread. It continues “the application of judgement in this area should not present major difficulties for insurers, as such judgements and estimates are integral to insurance business and insurers have extensive relevant experience”. But the guiding principle of IFRS generally is to avoid the use of firm-specific judgments. Moreover the history of such firm-specific judgments (e.g. Equitable Life, AIG) is not promising.

3.86 “IFRS 17’s overall objective and principles in this area are clear and the standard’s requirements and application guidance mitigate the challenge to reliability.” As noted above, the overall objective of IFRS is to avoid the use of firm-specific judgments, so it is wholly unclear how allowing firm-specific judgments will mitigate the challenge to reliability.

3.87 “Absolute precision is not possible but is also not necessary.” We agree, but the consensus among financial economists is that measuring the illiquidity spread is next to impossible.

Other priority issues

We have no view on (7) (“Grouping insurance contracts – profitability buckets and annual cohorts: do you agree with the [tentative] assessment against the endorsement criteria (paragraphs 3.101 – 3.116)”).

On with-profits estates, we note that accounting for and reporting these is a complex issue, which has not been resolved by the proposed Standard.

Overall assessment

In summary, for the reasons set out above, we do not agree with your overall tentative conclusion that IFRS 17 meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

Yours,

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