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25 September 2019

Dear Members of the Board,

COMMENTS ON EXPOSURE DRAFT ED/2019/4 *AMENDMENTS TO IFRS 17*

Aon acknowledges and welcomes the efforts of the International Accounting Standards Board (IASB) in addressing concerns raised by the industry as IFRS 17 implementation continues. We wish to thank the Board for their invitation to comment on the proposed amendments in the Exposure Draft ED/2019/4 *Amendments to IFRS 17*.

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. We have significant experience in advising on and placing tailor-made reinsurance arrangements to improve risk and capital positions for our clients across the globe. Our work requires us to have a deep understanding of the financial reporting requirements and impacts on financial statements.

Consequently, what follows in this submission shall be a focus on issues relevant to the measurement of reinsurance contracts held under IFRS 17.

In preparing this submission, we have also reached out to several insurance companies globally on the issue of the ineligibility of valuing reinsurance contracts using the variable fee approach – we include our findings for this purpose.

This letter summarises our responses whilst Appendix 1 includes detailed comments to the specific questions posed in the ED.

Summary of Aon's responses

1 **Expected recovery of insurance acquisition cash flows**
  a) This proposal increases consistency between requirements within IFRS 17 and of IFRS 17 and other IFRS with respect to:
    i. contract boundaries
    ii. impairment testing of the acquisition cost asset
    iii. amortisation pattern of acquisition costs
  b) This proposal is a step toward:
    i. faithful representation of the economics of the transactions
    ii. operational simplification for preparers of the financial statements

2 **Reinsurance contracts held – recovery of losses on underlying insurance contracts**
  a) The definition of 'proportionate' is too narrow; consider using 'proportional' instead of 'proportionate'
  b) Non-proportionate reinsurance contracts held should not be excluded from relief
  c) There is ambiguity in the required method of amortising the loss-recovery component
  d) Considering if there are alternative methods of calculating the loss-recovery component

e) We are concerned about potential for abuse
f) Clarification of 65(b) in conjunction with B5

3 Ineligibility of measuring reinsurance contracts held under the variable fee approach

a) Potential for accounting mismatches to remain
b) Scale of the problem and feedback received from other companies

We thank you again for the opportunity to provide our comments on the proposed amendments. If you have any questions on our response, please feel free to get in touch with my colleague Wijdan Yousuf (wijdan.yousuf@aon.com), or with myself directly.

Yours sincerely,

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Appendix 1

Responses to IASB questions ED/2019/4

Question 1 Scope exclusions: credit card contracts and loan contracts that meet the definition of an insurance contract (paragraphs 7(h), 8A, Appendix D and BC9–BC30) (a) Paragraph 7(h) proposes that an entity would be required to exclude from the scope of IFRS 17 credit card contracts that meet the definition of an insurance contract if, and only if, the entity does not reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer. Do you agree with the proposed amendment? Why or why not? (b) If not excluded from the scope of IFRS 17 by paragraphs 7(a)–(h), paragraph 8A proposes that an entity would choose to apply IFRS 17 or IFRS 9 to contracts that meet the definition of an insurance contract but limit the compensation for insured events to the amount required to settle the policyholder's obligation created by the contract (for example, loans with death waivers). The entity would be required to make that choice for each portfolio of insurance contracts, and the choice for each portfolio would be irrevocable. Do you agree with the proposed amendment? Why or why not?

1. Aon does not have any comments on this question.

Question 2 Expected recovery of insurance acquisition cash flows (paragraphs 28A–28D, 105A–105C, B35A–B35C and BC31–BC49)

Paragraphs 28A–28D and B35A–B35C propose that an entity:

(a) allocate, on a systematic and rational basis, insurance acquisition cash flows that are directly attributable to a group of insurance contracts to that group and to any groups that include contracts that are expected to arise from renewals of the contracts in that group;

(b) recognise as an asset insurance acquisition cash flows paid before the group of insurance contracts to which they are allocated is recognised; and

(c) assess the recoverability of an asset for insurance acquisition cash flows if facts and circumstances indicate the asset may be impaired.

Paragraphs 105A–105C propose disclosures about such assets.

Do you agree with the proposed amendments? Why or why not?

2. Aon welcomes this proposal because it increases conceptual consistency within the Standard and other IFRS with respect to:
    i. contract boundaries
    ii. impairment testing of the acquisition cost asset
    iii. amortisation pattern of acquisition costs

   We acknowledge that this amendment is consistent with other parts of IFRS 17, i.e. the principle of including in a contract's measurement only the cash flows that pertain to that contract and with the onerous contract test principle for contracts measured under the premium allocation approach. We agree with the rationale presented in paragraph BC39 that this change in methodology will also result in greater consistency with application of IFRS 15.

   In our opinion this amendment is a step toward:
    i. faithful representation of the economics of the transactions
    ii. operational simplification for preparers of the financial statements

   We recognise that acquisition costs are material cash outflows for the majority of our clients. Many of our clients have confirmed that their renewal rates can run as high as 90% on some portfolios and acquisition costs incurred on day-one indeed relate to expected renewals of those books. Applying the Standard in original wording would result in recognising onerous cohorts followed by very profitable cohorts in the future which would distort the view of the business and comparability across periods.

   Furthermore, given other requirements of the Standard, many insurers would have to recognize losses for a group of policies at initial recognition that would be solely driven by acquisition costs. This could preclude many of our clients from the non-life sector from applying the premium allocation approach to contracts with short durations.

Question 3 Contractual service margin attributable to investment-return service and investment-related service (paragraphs 44–45, 109 and 117(c)(v), Appendix A, paragraphs B119–B119B and BC50–BC66)

(a) Paragraphs 44, B119–B119A and the definitions in Appendix A propose that an entity identify coverage units for insurance contracts without direct participation features considering the quantity of benefits and expected period of investment-return service, if any, in addition to insurance coverage. Paragraph B119B specifies criteria for when contracts may provide an investment-return service.

Do you agree with the proposed amendment? Why or why not?

(b) Paragraphs 45, B119–B119A and the definitions in Appendix A clarify that an entity is required to identify coverage units for insurance contracts with direct participation features considering the quantity of benefits and expected period of both insurance coverage and investment-related service.

Do you agree with the proposed amendment? Why or why not?

(c) Paragraph 109 proposes that an entity disclose quantitative information about when the entity expects to recognise in profit or loss the contractual service margin remaining at the end of a reporting period. Paragraph 117(c)(v) proposes an entity disclose the approach used to determine the relative weighting of the benefits provided by insurance coverage and investment-return service or investment-related service.

Do you agree with the proposed disclosure requirements? Why or why not?

3. Aon does not have any comments on this question.

Question 4 Reinsurance contracts held—recovery of losses on underlying insurance contracts (paragraphs 62, 66A–66B, B119C–B119F and BC67–BC90)

Paragraph 66A proposes that an entity adjust the contractual service margin of a group of reinsurance contracts held that provides proportionate coverage, and as a result recognise income, when the entity recognises a loss on initial recognition of an onerous group of underlying insurance contracts, or on addition of onerous contracts to that group. The amount of the adjustment and resulting income is determined by multiplying:

(a) the loss recognised on the group of underlying insurance contracts; and

(b) the fixed percentage of claims on the group of underlying contracts the entity has a right to recover from the group of reinsurance contracts held.

Do you agree with the proposed amendment? Why or why not?

4. Aon sees this as a step in the right direction.

We agree with the IASB in that:

- An accounting mismatch could arise from the different treatment of losses on groups of insurance contracts and the recognition of the net cost or net gain of reinsurance contracts held.
- One of the sources of the accounting mismatch is the timing mismatch that arises when claims on the underlying onerous business are recognised early but reinsurance recoveries are recognised only when the underlying claims are incurred.

However, we have concerns about:

- the narrow definition proposed for a 'reinsurance contract held that provides proportionate coverage'
- non-proportionate reinsurance contacts held not being permitted to offset losses arising from underlying groups of insurance contracts written

  – specifically, with respect to the reasons supplied in BC80 and BC81.
- ambiguity in wording used to describe the amortisation of loss-recovery components after establishment

  – specifically, it is not clear what method has been prescribed under B119F for amortising the loss-recovery component. In addition, certain readings of B119F and BC74 can show them to be contradictory rather than complementary.
- lack of sufficient evidence of alternative methods considered for calculating loss-recovery components more accurately

  – specifically, we would find it helpful to see an exposition of other alternatives considered by the IASB and arguments for why they were deemed inappropriate and consequently rejected.

- potential for abuse

  – specifically, the conclusion in BC79 'that a reasonable practical assumption would be that the loss on underlying insurance contracts issued is caused by claims cash flows, rather than by any other fulfilment cash flows'.

We now explain each of these concerns in greater detail:

a. Narrow definition of 'proportionate'

The proposed definition of 'proportionate' is too narrow and will prevent gaining relief from several types of quota share reinsurance contracts held. This will limit the effectiveness of the proposed amendment.

Insurance companies buy not only typical quota share covers with fixed percentage of claims, but also quota share covers with upper limits (to amounts ceded) or quota shares treaties covering the net of catastrophe risk exposure. Cedants purchase these types of quota share covers after taking into consideration their risk appetites and the costs of purchasing reinsurance. Excluding such covers from the day one relief could penalise sound business management decisions and is thus a counterintuitive result of the narrow definition.

Many of our non-life clients around the world also enter into types of proportional surplus treaties whereby there is a fixed percentage share of premiums and losses ceded to reinsurers in excess of the insurers retention level. Formulaically this means:

- There is a known sum insured: (SI)
- The retention level is fixed across all policies in treaty: (R) (in non-life jargon this will be referred to as a line retention)
- Percentage share of premium and losses ceded will be: (SI – R)/SI

e.g.1: Policy 1 has SI of 2m; line retention of 1m. Percentage share ceded is consequently 50%. A loss of 100k would be shared 50k/50k between the reinsurer/insurer respectively.

e.g.2: Policy 2 has SI of 10m; line retention of 1m. Percentage share ceded is consequently 90%. A loss of 100k would be shared 90k/10k between the reinsurer/insurer respectively.

We also would like to take this opportunity to highlight a minor point that the reinsurance industry has been referring to these types of reinsurance covers as "proportional" rather than proportionate and perhaps adhering to the commonly used terms would avoid or reduce confusion in transition to IFRS 17.

We've identified the following examples that would not currently satisfy the "proportionate" definition:

a. proportional surplus share
b. facultative obligatory treaty reinsurance
c. variable quota share – by limit bands and variable quota share – by geographic region
d. net quota share – where other treaties inure to the benefit of this quota share, including straight quota share – where the cedant has facultative reinsurance

purchase on the underlying contracts and quota share is applied on gross book net of facultative reinsurance

We share examples of some of those reinsurance programs in Appendix 2.

b. Non-proportionate reinsurance contracts held not being permitted to offset losses arising from underlying groups of insurance contracts written

For the avoidance of doubt, by non-proportionate reinsurance contracts we only refer to excess of loss arrangements (and not any reinsurance contracts that do not meet the proposed definition of 'proportionate').

Paragraphs BC80-81 and BC86 illustrate IASB's conclusion that it is not possible to know which expected reinsurance recoveries relate to the expected underlying claims in the case of non-proportionate reinsurance contracts. Based on our experience, we see insurers having access to data that would enable them to estimate the expected proportion of claims that will be recovered for excess of loss arrangements. For this reason, we believe that the IASB's conclusion would not reflect the reality and create a somewhat irrelevant obstruction to implementation.

We appreciate the need, at establishment of a loss-recovery component, for an estimate about the proportion of future reinsurance recoveries. At the same time, we believe this assessment does not have to take an 'all-or-nothing' approach. Reasonable, practical approximations about the proportion of claims that could be recovered should be allowed to be taken into consideration after which the same mechanism would apply as that for proportionate reinsurance contracts held.

Cases that have potentially been overlooked: The scenario described here is intended to illustrate why in some cases, looking at non-proportionate reinsurance contracts held on a standalone basis is not appropriate from an economic point of view.

Consider an insurance company that enters into two separate reinsurance treaties at the same time: (1) a proportionate reinsurance contract with reinsurer A whereby 30% of all claims can be recovered up to a maximum of £300k per each claim recovery and (2) an aggregate excess of loss arrangement with reinsurer B whereby 50% of all claims in excess of £1m can be recovered.

In this scenario, the Exposure Draft would not enable losses arising from a group of onerous underlying contracts to be offset by gains under either reinsurance treaty however the combined effect of the reinsurance programme structured by the insurance company is such that economically the company is no different to another company that has a quota share without limits. In this case, it is irrelevant how the insurer ascertains what the size of the claims is and it would be inappropriate to look at the non-proportionate element in isolation.

We propose that if, in the IASB's opinion, relief may not be extended to non-proportionate reinsurance contracts held, relief should at the least be extended to take account of these types of structures to ensure that the economic view and accounting view coincide. To achieve this desired effect, it may be necessary to include such reinsurance contracts held in a single group.

b. Ambiguity in wording used to describe the amortisation of loss-recovery components after establishment

We would appreciate greater clarity on how to interpret the wording of the requirements with respect to amortising the loss-recovery component.

B119F seems to say that the loss recovery component needs to be amortised using the same *amounts* as the underlying loss components (i.e. a simple sum). However, BC74 seems to say the loss recovery component needs to be amortised using the same *method* as the loss components (i.e. not a simple sum).

We explain this with the help of an example.

Consider two onerous groups of contracts recognized more than one year apart but covered by the same reinsurance contract.

One interpretation of B119F could be that the amount by which the loss-recovery component is amortised is just a simple sum of the amounts by which the two underlying loss components are being (independently) amortised. For example, if one loss component is amortised by 10, and a second loss component is amortised by 20, the loss-recovery component shall be amortised by 30.

This route will be practically simpler and relatively easier to follow in the financial statements. However, this is *too* simple and not a technically precise method. For example, the amortisation of an underlying loss component will allow for amounts relating to expected claims, attributable renewal expenses and releases of the risk adjustment. A full allowance of each of these three items when amortising the loss-recovery component is not consistent with assumptions underlying the establishment of the loss-recovery component (as per BC79).

On the other hand, one reading of BC74, and in particular the sentence:

> *"(...) applying the proposed amendment, the recovery of a loss on a reinsurance contract held would be treated similarly to the loss component on insurance contracts issued"*

suggests a possibly contradictory approach. Rather than amortising the loss-recovery component based on the sum of amounts by which the underlying loss components are amortised (as B119F could be suggesting as noted above), BC74 could be read as requiring the systematic amortisation of the loss-recovery component to be treated similarly to loss components *by way of similar methodologies being applied* in both instances.

In this case, the amortisation of the loss-recovery component would be an entirely separate calculation altogether but one that applies similar methodology principles used for amortising the underlying loss-components. This is operationally more complex but one that is technically a more superior method than that described above.

c. Alternative methods considered for calculating loss-recovery components more accurately

We would appreciate evidence of IASB consideration of the following, particularly why allowing for these are deemed unnecessary or inappropriate:

- **An allowance for the risk of non-performance of the reinsurer in the calculation of the loss-recovery component.**

  Lack of such an allowance seems inconsistent with the principles of the treatment of reinsurance contracts held elsewhere in the Standard. Further, allowing 100% of future reinsurance recoveries is not 'best estimate' and is independent of the early recognition of reinsurance recoveries (to coincide with the early recognition of underlying claims).

- **Revaluing the loss component at the discount rates used at initial recognition of the reinsurance contract held.**

  Consider a reinsurance contract held that is recognized in year 20X1 and locks-in to yield curve A, and consider an onerous direct contract that is written in year 20X2 and locks-in to yield curve B. The loss component is calculated using yield curve B and the reinsurance CSM will be calculated using yield curve A.

  When adjusting the reinsurance CSM as per paragraph B119D, entities will have to do this based on loss components that have been calculated based on different yield curves. This has the consequence of distorting the amounts presented in insurance service expenses and the insurance finance expenses lines.

- **Calculating the loss-recovery component based on an adjusted underlying loss component**

  We note that the proposed calculation of the loss-recovery component fundamentally depends on the conclusion of BC79 whereby the loss component originates because of claims.

  However, in some cases it is impossible to rule out other factors, such as drivers of a loss component (e.g. acquisition cash flows, maintenance expenses or the risk adjustment). We think it would be more consistent to determine the loss-recovery component based only on the present value of future cost of claims. This approach would also minimize the potential for abuse of the proposed amendment as outlined in below.

d. Potential for abuse

Paragraph BC79 concludes 'that a reasonable practical assumption would be that the loss on underlying insurance contracts issued is caused by claims cash flows, rather than by any other fulfilment cash flows'. This indicates that the method prescribed by the IASB for determining the loss-recovery component was swayed in favour of practical expediency rather than technical accuracy.

We are concerned about the potential for abuse that may arise from this conclusion.

We recognise that many insurance contracts will have claims as the primary cash outflow, but this does mean that most will. We think it is too arbitrary to categorically attribute the cause of onerousness to claims when in reality a number of factors may be at play. Groups of contracts may be onerous because of high acquisition or maintenance expenses or simply because of the risk adjustment.

For this reason, we are concerned about the unintended negative consequences of making this practical assumption. If entities were permitted to use reinsurance to offset underlying onerous contracts where the loss component is not solely driven by expected future claims, they could now have a tactical incentive to use unsustainably low premiums or unjustifiably high commissions to gain competitive advantage in a market. This could have a domino effect of downward pressure on pricing in the markets. It is not clear how auditors and regulators might respond to this in different jurisdictions and we expect that any variation in practice would be undesirable.

e. Clarification of 65(b) in conjunction with B5

Paragraph 65(b) states that on initial recognition "the net cost of purchasing reinsurance coverage related to events that occurred before the purchase of the group of reinsurance contracts, in which case, notwithstanding the requirements of paragraph B5, the entity shall recognize such cost immediately in the P&L as an expense."

We think that the phrase "notwithstanding the requirements of paragraph B5" could lead to unintended interpretation, where one could interpret it as B5 would be an exception to paragraph 65(b), and the cost of an adverse development cover does not have to be recognized immediately in the P&L as an expense.

Question 5 Presentation in the statement of financial position (paragraphs 78–79, 99, 132 and BC91–BC100)

The proposed amendment to paragraph 78 would require an entity to present separately in the statement of financial position the carrying number of portfolios of insurance contracts issued that are assets and those that are liabilities. Applying the existing requirements, an entity would present the carrying number of groups of insurance contracts issued that are assets and those that are liabilities. The amendment would also apply to portfolios of reinsurance contracts held that are assets and those that are liabilities.

Do you agree with the proposed amendment? Why or why not?

5. Aon does not have any comments on this question.

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Question 6 Applicability of the risk mitigation option (paragraphs B116 and BC101–BC109)

The proposed amendment to paragraph B116 would extend the risk mitigation option available when an entity uses derivatives to mitigate financial risk arising from insurance contracts with direct participation features. That option would apply in circumstances when an entity uses reinsurance contracts held to mitigate financial risk arising from insurance contracts with direct participation features.

Do you agree with the proposed amendment? Why or why not?

6. Aon sees this as a step in the right direction.

We agree that this proposal will reduce accounting mismatches from arising when changes in financial risk arise however there is still potential for large mismatches to arise simply because different models, and consequently different requirements, will apply in the measurement of direct participating contracts and the corresponding reinsurance contracts held.

To resolve this, we propose that reinsurance contracts held and issued should be permitted to be valued under the variable fee approach (VFA).

a. Potential for accounting mismatches remaining

We note the following as an important accounting mismatch that remains despite the extension of the risk mitigation option as per B116:

- When the underlying company updates assumptions relating to future service, the CSM for the gross business (VFA) will be adjusted based on a current view of interest rates whilst the CSM for the reinsured business (general model) will be adjusted based on the 'locked-in' view of interest rates (i.e. based on interest rates at initial recognition of the reinsurance contract). To take an extreme example, where such business has been 100% reinsured, this will result in an unequal impact on the IFRS shareholder equity despite a full economic hedge being in place.

b. Objections to BC213

We note that one of the reasons supplied in BC213 for excluding reinsurance contracts from being valued under the VFA is that, in the IASB's view, these contracts do not provide investment service. However, this is not true in Aon's view.

Aon has worked with clients to provide funded reinsurance solutions for participating business (both with and without guarantees). For funded reinsurance structures with collateral account structures, liabilities are reinsured and assets are physically transferred to a collateral account managed by the reinsurer. In doing so, the reinsurance contract is responsible for providing investment services to the cedant.

Similarly, we also have other clients who have reinsured their VFA business on an 'original-terms' basis whereby the reinsurance follows the gross business in all aspects. In doing so, the reinsurance contract will also be providing investment services to the cedant.

c. Scale of the problem and feedback from other companies

We have conducted a brief study to establish the scale of the problem and reached out to companies globally. Based on this, we understand that the problem is of large concern for insurers in the UK and Ireland with moderate concern indicated from companies in continental Europe.

Most feedback from the UK, Ireland and continental Europe has indicated that permitting reinsurance contracts held to be valued under the VFA would aid rather than disrupt implementation efforts.

Feedback we have received from our survey includes head offices for groups based in the UK and Europe as well as subsidiaries based in Ireland and Singapore.

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Question 7 Effective date of IFRS 17 and the IFRS 9 temporary exemption in IFRS 4 (paragraphs C1, [Draft] Amendments to IFRS 4 and BC110–BC118)

IFRS 17 is effective for annual reporting periods beginning on or after 1 January 2021. The amendments proposed in this Exposure Draft are such that they should not unduly disrupt implementation already under way or risk undue delays in the effective date.

(a) The proposed amendment to paragraph C1 would defer the effective date of IFRS 17 by one year from annual reporting periods beginning on or after 1 January 2021 to annual reporting periods beginning on or after 1 January 2022.

Do you agree with the proposed amendment? Why or why not?

(b) The proposed amendment to paragraph 20A of IFRS 4 would extend the temporary exemption from IFRS 9 by one year so that an entity applying the exemption would be required to apply IFRS 9 for annual reporting periods beginning on or after 1 January 2022.

Do you agree with the proposed amendment? Why or why not?

7. Aon does not have any comments on this question.

Question 8 Transition modifications and reliefs (paragraphs C3 (b), C5A, C9A, C22A and BC119–BC146)

(a) Paragraph C9A proposes an additional modification in the modified retrospective approach. The modification would require an entity, to the extent permitted by paragraph C8, to classify as a liability for incurred claims a liability for settlement of claims incurred before an insurance contract was acquired. Paragraph C22A proposes that an entity applying the fair value approach could

choose to classify such a liability as a liability for incurred claims.

Do you agree with the proposed amendments? Why or why not?

(b) The proposed amendment to paragraph C3 (b) would permit an entity to apply the option in paragraph B115 prospectively from the transition date, rather than the date of initial application. The amendment proposes that to apply the option in paragraph B115 prospectively on or after the transition date, an entity would be required to designate risk mitigation relationships at or before the date it applies the option.

Do you agree with the proposed amendment? Why or why not?

(c) Paragraph C5A proposes that an entity that can apply IFRS 17 retrospectively to a group of insurance contracts be permitted to instead apply the fair value approach to that group if it meets specified criteria relating to risk mitigation.

Do you agree with the proposed amendment? Why or why not?

8. Aon does not have any comments on this question.

Question 9 Minor amendments (BC147–BC163) This Exposure Draft also proposes minor amendments (see paragraphs BC147–BC163 of the Basis for Conclusions). Do you agree with the Board's proposals for each of the minor amendments described in this Exposure Draft? Why or why not?

9. Aon does not have any comments on this question.

Question 10 Terminology
This Exposure Draft proposes to add to Appendix A of IFRS 17 the definition 'insurance contract services' to be consistent with other proposed amendments in this Exposure Draft. In the light of the proposed amendments in this Exposure Draft, the Board is considering whether to make a consequential change in terminology by amending the terms in IFRS 17 to replace 'coverage' with 'service' in the terms 'coverage units', 'coverage period' and 'liability for remaining coverage'. If that change is made, those terms would become 'service units', 'service period' and 'liability for remaining service', respectively, throughout IFRS 17. Would you find this change in terminology helpful? Why or why not?

10. Aon does not have any comments on this question. Please see our comment included in the discussion on the definition of "proportionate" reinsurance covers in Question 4.

Appendix 2

Anonymized, sample reinsurance contract templates forming Appendix 2 have been submitted to the IASB but are not part of the official submission due to their commercially sensitive nature.