Equity release mortgages (ERMs)

Purpose and scope

The purpose of this paper is to:

- Set out the ICAEW's perspectives on how ERMs will be accounted for under IFRS 17.
- Set out our reservations for accounting for ERMs under IFRS 17.
- Outline a rationale for scoping ERMs out of IFRS 17.

We acknowledge there are other instruments where the main risk is credit that have insurance features (for example, certain credit cards and student loans as issued in the UK). While the subject of this paper is ERMs, it may be that the IASB considers a more broadly-defined scope exception that would encompass ERMs as well as other instruments.

Background

The question of how to account for ERMs under IFRS 17 is primarily an issue for UK financial institutions that report under IFRS (although we are aware of similar mortgages that are sold in the United States). Entities that report under UK GAAP are not currently affected but could become so in the future if UK GAAP were to incorporate all, or aspects of, IFRS 17.

ERMs operate as follows:

- Interest is charged, but not settled, until the end of the mortgage, which arises either when the borrower dies or moves into long term care. The borrower may have the option to repay the mortgage balance early (i.e. before their death or movement into long term care) but that option could trigger a significant financial penalty.
- The property is then sold and the proceeds used to repay the mortgage balance (including the accrued interest).
    - If the property is sold for more than the mortgage balance, the excess is paid to the borrower.
    - If there is a shortfall, the loss is borne by the lender because these contracts include a no negative equity guarantee (NNEG) clause. See further consideration of this below.

In the UK, insurers often use ERMs to back annuity contract cash flows. They are generally managed on a fair value through profit or loss (FVTPL) basis and measured on a fair value basis for Solvency II (SII) purposes. Banks incorporate ERMs into their general mortgage lending activities and as such they are treated as an alternative product to a regular retail mortgage.

Accounting considerations

Current accounting treatment

There is currently mixed practice for accounting for ERMs, largely dependent on whether the issuer is a bank or an insurer. There are broadly two models currently used:

- To measure the whole contract at FVTPL. This is typically used by insurers and is consistent with the valuation required by Solvency II. It is also becoming general practice by banks as they adopt IFRS 9.
- To measure the loan at amortised cost, with the NNEG separated and accounted for at FVTPL, similar to the treatment of an embedded derivative. Prior to adoption of IFRS 9, this was the basis typically used by banks and other lending institutions.

Applying IFRS 9 for 2018 year ends, we understand the majority of banks are planning to account for ERMs at FVTPL

IFRS requirements

Scope

The first step is to determine which standard to apply to ERMs. A key factor in determining whether a contract is a financial instrument or an insurance contract is whether it contains significant insurance risk.

Under IFRS 17 (as under IFRS 4), 'insurance risk' is a risk, other than financial risk, that is transferred from a borrower to the issuer of a contract[1]. It is assessed at a contract level and exists if there is a scenario where the insurance risk is significant. The insurance risk is significant only if there is a scenario that has commercial substance in which, on a present value basis, there is a possibility that an issuer could:

- Suffer a loss caused by the insured event; and
- Pay significant additional amounts beyond what would be paid if the insured event had not occurred[2].

To have commercial substance it has to have a discernible effect on the economics of the transaction[3].

The implementation guidance to IFRS 4 included an example[4] relating to loan contracts that waive repayment of the entire loan balance if the borrower dies. It concludes that the contract contains a deposit component and an insurance component. While this example is not included in IFRS 17, the definition of insurance contracts has not changed substantially so we would expect the analysis to continue to be valid.

Some entities may consider the insurance component in some or all of their ERMs to be significant and thus would be required to account for them under IFRS 17 rather than IFRS 9.

If the entity determined the insurance risk was not significant then the mortgage would be accounted for under IFRS 9.

Separating the NNEG from the host contract

IFRS 17 requires an entity to separate specified embedded derivatives (by applying IFRS 9[5]) as well as performance obligations and components of insurance contracts if, and only if, those components

[1] IFRS 17, Appendix A
[2] IFRS 17, paragraph B18: *Insurance risk is significant if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (ie no discernible effect on the economics of the transaction). If an insured event could mean significant additional amounts would be payable in any scenario that has commercial substance, the condition in the previous sentence can be met even if the insured event is extremely unlikely, or even if the expected (ie probability-weighted) present value of the contingent cash flows is a small proportion of the expected present value of the remaining cash flows from the insurance contract.*
[3] IFRS 17, paragraphs B18 – B21
[4] IFRS 4 IG Example 1.24
[5] IFRS 17, paragraph 11 (a)

and/or performance obligations are ‘distinct’[6]. The components are distinct if:

- The investment and insurance component are not highly interrelated; and
- A contract with equivalent terms is sold, or could be sold, separately in the same market or the same jurisdiction[7].

An investment component is defined in IFRS 17 as ‘the amounts that an insurance contract requires the entity to repay to the policyholder [or borrower] even if an insured event does not occur’[8]. Although this definition refers to amounts owed by the entity rather than by the borrower, we consider it to apply analogously to the loan asset component of ERMs.

Applying the separation requirement to ERMs, in accordance with IFRS 17 investment and insurance components are highly interrelated if and only if:

- An entity is unable to measure one component without considering the other; and
- The borrower is unable to benefit from one component unless the other is also present[9].

We consider that the NNEG and loan are highly interrelated as:

- The value of the NNEG depends on the value of the loan component; and
- The borrower (or the beneficiaries of their estate) benefits from the NNEG by virtue of provision of the loan throughout their life.

Further, it is not generally possible to sell the NNEG separately from the loan (although we acknowledge that it is possible to sell the mortgage without a NNEG).

For these reasons, we do not believe that the host and NNEG features in ERMs would meet the separation criteria in IFRS 17.

IFRS 9

IFRS 9 is effective for annual periods beginning on or after 1 January 2018 for all banks and other financial institutions that report under IFRS that are not eligible for the deferral option provided to insurers under IFRS 4[10].

IFRS 9 introduces both the ‘business model approach’ and SPPI criteria to accounting for financial assets[11]. The SPPI criteria requires consideration of whether an asset’s contractual cash flows include solely payments of principal and interest while the business model approach considers whether assets are held to collect contractual cash flows.

For banks that have adopted IFRS 9, we understand that ERMs may in some cases fail the ‘SPPI’ criteria as a result of the NNEG feature and are thus accounted for at FVTPL.

IFRS 13

Under IFRS 13, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants[12]. A fair value measurement is made up of one or more ‘inputs’, which are the assumptions that market participants would make in valuing an asset or liability. The most reliable evidence of fair value is a quoted price in an active market. However, when

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[6] IFRS 17, paragraphs 11 (b) and IN6 (b)
[7] IFRS 17, paragraph B31
[8] IFRS 17, Appendix A
[9] IFRS 17, paragraph B32
[10] IFRS 4, paragraph 20A
[11] IFRS 9, paragraph 4.1.1
[12] IFRS 13, paragraph 9

that information is not available, entities may use other valuation techniques to estimate fair value. These are arranged into a three-level hierarchy based on the inputs to valuation techniques used to measure fair value[13].

In certain instances, the fair value of an asset or liability may differ from the transaction price (e.g. the consideration paid or received). Under IFRS 9, if an entity's fair value measurement uses only data from observable markets, then the entity immediately recognises a gain or loss (equal to the difference between the fair value on initial recognition and the transaction price). In all other cases, the carrying amount of the financial instrument at initial recognition is adjusted to defer the difference between the fair value at initial recognition and the transaction price. This deferred difference is subsequently recognised as a gain or loss only to the extent that it arises from a change in a factor (such as time) that market participants would consider in setting a price[14].

Valuation differences between IFRS 9 and IFRS 17

It is appropriate to consider the impact that moving from an IFRS 9 to an IFRS 17 valuation model might have on financial institutions. Whilst initial valuations may not be different, the timing of recognition of profit and the classification of profit between the insurance service result and finance result could be different for the following reasons:

- The CSM under IFRS 17 has an absorbing capacity for non-financial changes (house prices, longevity), the effect of which would be recognised over the remaining period of the contract in a pattern prescribed by coverage units; and
- CSM amortisation using coverage units is likely to change the timing of profit recognition. Under the GMM CSM is recognised only based on the insurance service, and not the investment service[15].

Appropriate accounting model

We consider that IFRS 9 provides a more appropriate basis for accounting for ERMs than IFRS 17. The main considerations are as follows:

1) A fair value measure is consistent with how the assets are measured and monitored by insurers in the UK. This is primarily because this is consistent with the fair value basis insurers use for all other investment assets under IFRS and is the basis for measurement under Solvency II. The impact of moving to an IFRS 17 model for ERMs could significantly impact how issuers manage their asset portfolios;
2) As insurance entities may hold ERMs as 'underlying items' for contracts valued under the variable fee approach (VFA), a fair value measurement model will be more appropriate for 'matching' the insurance liabilities. Application of IFRS 17 would create an accounting mismatch which could be significant for insurers;
3) The NNEG is typically a small or insignificant component of the total valuation. Including the NNEG in the fair value of the instrument is established practice, well-controlled and auditable;
4) The application of IFRS 17 to ERMs may lead to significantly different carrying values and revenue recognition between ERMs and other mortgages. This is due largely to the subsequent measurement of the CSM, which will serve to dampen changes in non-financial assumptions (such as house prices and longevity); and
5) For banks, measuring ERMs under IFRS 17 could also require significant operational effort to conform them to the general measurement model, including grouping, risk adjustment and CSM production. In addition, a new valuation would be required for the fulfilment cash flows and CSM on transition. Changes to operational and reporting processes that may be needed are:

[13] IFRS 13, paragraph 72
[14] IFRS 9, paragraph 5.1.1A and B5.1.2A
[15] AP05 (paragraph 30 (g) (i)) to the IASB's May 2018 TRG

a) Valuation processes would need to follow the general measurement model (GMM) requirements including an explicit risk adjustment and CSM.
b) CSM methodology and calculation engine would be required for CSM calculation at initial recognition and its subsequent release.
c) Reporting processes would need to change to reflect these products as insurance products and not financial instruments.

Banks would then need to educate their investor community on the financial impact of reporting under IFRS 17 for ERMs (which could be an onerous process if those investors have not had experience of interpreting the results of insurers in the past).

Proposed solution - specifically scoping ERMs out of IFRS 17

As is outlined above, although we believe that ERMs may qualify as 'insurance contracts' under IFRS 17, we consider that they and contracts with similar characteristics to them should be treated as financial assets within the scope of IFRS 9. A similar issue regarding treatment of loans that may waive some or all of the payments due under the contract on death was highlighted at submission 33 to AP11 presented at the IASB's September transition resource group (TRG).

As a result, we propose the inclusion of the following sub paragraph (new paragraph 8A) of IFRS 17 to scope ERMs (and contracts with similar characteristics) out of IFRS 17 and into IFRS 9

"8A Some contracts meet the definition of an insurance contract but have credit risk as their main risk to the issuer. An entity applies IFRS 9 instead of IFRS 17 to such contracts that it issues if, and only if, specified conditions are met. The conditions are:

a. The contract compensates the holder by reducing the holder's outstanding debt to the issuer, rather than requiring cash payments to the holder; and
b. The insurance risk transferred by the contract arises only from terms that limit the amount repayable if specified uncertain future events occur to the value of assets on which the contract is secured."

We understand that this proposal may introduce complications for insurers that plan to utilise the 'OCI option' (to disaggregate insurance finance income and expense between profit or loss and OCI) under IFRS 17. For those insurers, the solution proposed by the CFO forum[16] (to provide an option to account for ERMs under IFRS 9 or IFRS 17) may be more acceptable. However, this is not expected to be an issue for UK insurers who, for the most part, value assets backing insurance liabilities at FVTPL.

An alternative solution may be to revise IFRS 17 to provide for an option to separate contracts of this kind (as we do not believe that the separation requirements, as currently worded, allow for this option). We consider that an amendment might be in the form of a limited scope change at paragraph B27. The ultimate aim of the amendment would be to permit entities to separate the insurance and loan features of these contracts and account for each as follows:

- Insurance (e.g. NNEG) component – account for under IFRS 17; and
- Loan component – account for under IFRS 9 at FVTPL, FVOCI or amortised cost depending on the outcome of the business model test.

[16] CFO Forum letter sent to EFRAG and IASB on proposed solutions to IFRS 17 (page 7), 17 October 2018

Appendix – references

IFRS 17

11 An entity shall:

a) apply IFRS 9 to determine whether there is an embedded derivative to be separated and, if there is, how to account for that derivative.
b) separate from a host insurance contract an investment component if, and only if, that investment component is distinct (see paragraphs B31–B32). The entity shall apply IFRS 9 to account for the separated investment component.

B17 A contract is an insurance contract only if it transfers significant insurance risk. Paragraphs B7-16 discuss insurance risk. Paragraphs B18–B23 discuss the assessment of whether the insurance risk is significant.

B18 Insurance risk is significant if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (ie no discernible effect on the economics of the transaction). If an insured event could mean significant additional amounts would be payable in any scenario that has commercial substance, the condition in the previous sentence can be met even if the insured event is extremely unlikely, or even if the expected (ie probability-weighted) present value of the contingent cash flows is a small proportion of the expected present value of the remaining cash flows from the insurance contract.

B19 In addition, a contract transfers significant insurance risk only if there is a scenario that has commercial substance in which the issuer has a possibility of a loss on a present value basis. However, even if a reinsurance contract does not expose the issuer to the possibility of a significant loss, that contract is deemed to transfer significant insurance risk if it transfers to the reinsurer substantially all the insurance risk relating to the reinsured portions of the underlying insurance contracts.

B20 The additional amounts described in paragraph B18 are determined on a present-value basis. If an insurance contract requires payment when an event with uncertain timing occurs and if the payment is not adjusted for the time value of money, there may be scenarios in which the present value of the payment increases, even if its nominal value is fixed. An example is insurance that provides a fixed death benefit when the policyholder dies, with no expiry date for the cover (often referred to as whole-life insurance for a fixed amount). It is certain that the policyholder will die, but the date of death is uncertain. Payments may be made when an individual policyholder dies earlier than expected. Because those payments are not adjusted for the time value of money, significant insurance risk could exist even if there is no overall loss on the portfolio of contracts. Similarly, contractual terms that delay timely reimbursement to the policyholder can eliminate significant insurance risk. An entity shall use the discount rates required in paragraph 36 to determine the present value of the additional amounts.

B21 The additional amounts described in paragraph B18 refer to the present value of amounts that exceed those that would be payable if no insured event had occurred (excluding scenarios that lack commercial substance). Those additional amounts include claims handling and assessment costs, but exclude:

a) the loss of the ability to charge the policyholder for future service. For example, in an investment-linked life insurance contract, the death of the policyholder means that the

entity can no longer perform investment management services and collect a fee for doing so. However, this economic loss for the entity does not result from insurance risk, just as a mutual fund manager does not take on insurance risk in relation to the possible death of a client. Consequently, the potential loss of future investment management fees is not relevant when assessing how much insurance risk is transferred by a contract.

b) a waiver, on death, of charges that would be made on cancellation or surrender. Because the contract brought those charges into existence, their waiver does not compensate the policyholder for a pre-existing risk. Consequently, they are not relevant when assessing how much insurance risk is transferred by a contract.
c) a payment conditional on an event that does not cause a significant loss to the holder of the contract. For example, consider a contract that requires the issuer to pay CU1 million1 if an asset suffers physical damage that causes an insignificant economic loss of CU1 to the holder. In this contract, the holder transfers the insignificant risk of losing CU1 to the issuer. At the same time, the contract creates a non-insurance risk that the issuer will need to pay CU999,999 if the specified event occurs. Because there is no scenario in which an insured event causes a significant loss to the holder of the contract, the issuer does not accept significant insurance risk from the holder and this contract is not an insurance contract.
d) possible reinsurance recoveries. The entity accounts for these separately.

B31 Paragraph 11(b) requires an entity to separate a distinct investment component from the host insurance contract. An investment component is distinct if, and only if, both the following conditions are met:

a) the investment component and the insurance component are not highly interrelated.
b) a contract with equivalent terms is sold, or could be sold, separately in the same market or the same jurisdiction, either by entities that issue insurance contracts or by other parties. The entity shall take into account all information reasonably available in making this determination. The entity is not required to undertake an exhaustive search to identify whether an investment component is sold separately.

B32 An investment component and an insurance component are highly interrelated if, and only if:

a) the entity is unable to measure one component without considering the other. Thus, if the value of one component varies according to the value of the other, an entity shall apply IFRS 17 to account for the combined investment and insurance component; or
b) the policyholder is unable to benefit from one component unless the other is also present. Thus, if the lapse or maturity of one component in a contract causes the lapse or maturity of the other, the entity shall apply IFRS 17 to account for the combined investment component and insurance component.

IN6 The key principles in IFRS 17 are that an entity:

(b) separates specified embedded derivatives, distinct investment components and distinct performance obligations from the insurance contracts.

Appendix A:

Insurance contract - A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

Investment component - The amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.

Insurance risk - Risk, other than financial risk, transferred from the holder of a contract to the issuer.

IFRS 9

4.1.1 Unless paragraph 4.1.5 applies, an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:

a) the entity's business model for managing the financial assets and
b) the contractual cash flow characteristics of the financial asset.

5.1.1A However, if the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, an entity shall apply paragraph B5.1.2A.

B5.1.2A The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also IFRS 13). If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 5.1.1A, the entity shall account for that instrument at that date as follows:

a) at the measurement required by paragraph 5.1.1 if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) or based on a valuation technique that uses only data from observable markets. An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.
b) in all other cases, at the measurement required by paragraph 5.1.1, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability.

IFRS 4

20A IFRS 9 addresses the accounting for financial instruments and is effective for annual periods beginning on or after 1 January 2018. However, for an insurer that meets the criteria in paragraph 20B, this IFRS provides a temporary exemption that permits, but does not require, the insurer to apply IAS 39 Financial Instruments: Recognition and Measurement rather than IFRS 9 for annual periods beginning before 1 January 2021. An insurer that applies the temporary exemption from IFRS 9 shall:

a) use the requirements in IFRS 9 that are necessary to provide the disclosures required in paragraphs 39B–39J of this IFRS; and
b) apply all other applicable IFRSs to its financial instruments, except as described in paragraphs 20A–20Q, 39B–39J and 46–47 of this IFRS.

IFRS 13

9 This IFRS defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

72 To increase consistency and comparability in fair value measurements and related disclosures, this IFRS establishes a fair value hierarchy that categorises into three levels (see paragraphs 76–90) the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the

highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs).

May 2018 TRG

AP05

30 (g) (i) for an insurance contract without an investment component…the quantity of benefits provided under an insurance contract without an investment component depends solely on the insurance services provided…

CFO Forum letter sent to EFRAG and IASB on proposed solutions to IFRS 17 issues, 17 October 2018, page 7

It is proposed a new scope exemption should be added to IFRS 17 for loan type contracts. It is proposed the following wording should be added to the standard as paragraph 8A:

"Some contracts meet the definition of an insurance contract but are in substance loans that expose the issuer to credit risk. An entity may choose to apply IFRS 9 instead of IFRS 17 to such contracts that it issues if, and only if, specified conditions are met. The entity may make that choice contract by contract, but the choice for each contract is irrevocable. The conditions are:

c. The contract compensates the customer by reducing the customer's outstanding debt to the entity, rather than making cash payments to the customer; and
d. The insurance risk transferred by the contract arises primarily from guarantees provided to the customer of the maximum amount of debt that is repayable if specified uncertain future events occur"