



HM Treasury

Financial Reporting Advisory Board

IFRS 17 Update

Issue:	An update on the implementation of IFRS 17- Insurance Contracts in the public sector.
Impact on guidance:	HM Treasury is developing IFRS 17 application guidance. Any interpretations and/or adaptations will be brought into the Government Financial Reporting Manual (FRM).
IAS/IFRS adaptation?	Some interpretations and adaptations are likely to be necessary to fit IFRS 17 effectively to public sector conditions.
Impact on WGA?	IFRS 17 will impact on WGA when implemented; the potential impact is being considered with each issue raised.
IPSAS compliant?	There is no equivalent insurance accounting standard in IPSAS.
Interpretation for the public sector context?	Some interpretations and adaptations are likely to be necessary to fit IFRS 17 effectively to public sector conditions.
Impact on budgetary and Estimates regimes?	The budgetary regime will need to recognise insurance contracts and related cashflows.
Alignment with National Accounts	ESA10 does not have an equivalent recognition of government insurance contracts so there will be misalignment; HMT staff will engage on this issue with the ONS.
Recommendation:	FRAB members are invited to provide comments on this paper and provide feedback on the questions asked throughout the paper.
Timing:	IFRS 17 is effective in the private sector from 2023-24. The timing for adopting the Standard in the public sector is discussed in this paper.

Background

1. The International Accounting Standards Board (IASB) has issued IFRS 17 Insurance Contracts (the Standard), which replaces IFRS 4 Insurance Contracts.
2. At the November 2021 FRAB meeting HM Treasury presented an update on the IFRS 17 project, with a focus on the scope of the Standard, risk adjustment measurement and disclosure, transition arrangements and the timeline for implementing the Standard. Since the last FRAB meeting HM Treasury has held a further Technical Working Group (TWG) meeting, where the following areas were discussed in detail:
 - The risk adjustment for non-financial risk (refer to paper in [Appendix 1](#))
 - i. Question for FRAB: **Do you agree with the proposed adaptation to remove the IFRS 17 para 119 disclosure requirement?**
 - Discount rates (refer to paper in [Appendix 2](#))
 - i. Question for FRAB: **Do you agree with HM Treasury's proposal to issue a central discount rate based on Treasury Gilt yields and, to support consistency across IFRS 9 and IFRS 17 liabilities, for this to be the same as the financial instrument rate?**
 - Timeline for implementing the Standard (refer to paper in [Appendix 3](#))
 - i. Question for FRAB: **Does FRAB agree to the revised planned mandatory adoption date for the Standard (2025-26 financial year), with early adoption permitted on a case-by-case basis by HM Treasury.**
3. Note, there is a table of contents on the next page to aid navigation of this paper.

HM Treasury

31 March 2022

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Appendix 1: IFRS 17 Risk Adjustment

Purpose

1. The purpose of this paper is to set out HM Treasury's rationale for removing the disclosure requirement in IFRS 17 para 119 to disclose the confidence interval at which the risk adjustment for non-financial risk has been measured. This was also discussed at the November 2021 FRAB meeting.

Risk adjustment for non-financial risk

2. IFRS 17 para 37 states the following:

"An entity shall adjust the estimate of the present value of the future cash flows to reflect the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk."

3. The risk adjustment for non-financial risk is defined as the compensation an insurer requires for bearing uncertainty over the amount and timing of future cash flows as it fulfils the contract.
4. In addition to measuring the risk adjustment for non-financial risk, IFRS 17 para 119 requires entities to disclose the confidence level at which the risk adjustment is measured. In the private sector it is expected that many entities will use a 75% level of confidence¹.
5. There are three common methods discussed within the profession regarding how to calculate the risk adjustment. These are:
 - Value at risk (VaR)
 - Tail VAR
 - Cost of Capital
6. In addition to these three methods entities may also use explicit loading for prudence on the assumptions (e.g., use 5% for the risk adjustment based on management's judgement rather than undertaking specific statistical calculations).
7. It should be noted that IFRS 17 does not prescribe a specific way of calculating the risk adjustment, i.e. the Standard does not say entities have to use a specific confidence level technique or even any technique. Indeed, the IASB considered limiting the number of techniques used to calculate the risk adjustment in the 2010 Exposure Draft but rejected this approach. Rather, the IASB decided to provide a number of core principles that entities must follow when calculating the risk adjustment as set out in IFRS 17 paras B86 – B92, meaning specifying a single approach to calculating the risk adjustment would go against the aims of IFRS 17.
8. Similarly, para 119 of IFRS 17 notes that if an entity uses a technique other than the confidence level technique, the technique used shall be disclosed and the confidence

¹ Online [Moody's](#) (p.7) and [Milliman's](#) (p.8) for evidence many entities will be using a confidence interval of 70% - 75%.

level corresponding to the results of that technique shall also be disclosed. IFRS 17 is not any more prescriptive on this point- it would appear a level of reverse engineering is required to calculate the VaR equivalent confidence level if a non-confidence level technique is used, but the Standard does not provide any further specific guidance on techniques to be used. [e.g., if an entity decides to add a risk adjustment of 5% based on their professional judgement, that entity would still need to calculate the confidence level equivalent using the VaR technique to comply with IFRS 17 para 119]

9. This paper seeks to explain why removing the requirement to disclose the confidence level at which the risk adjustment is calculated (IFRS 17 para 119) is appropriate for central government annual reports and accounts.
10. For the avoidance of doubt, this proposed adaptation is not impacting the IFRS 17 asset and liability measurement requirements in the Standard.

Purpose of the confidence level disclosure (IFRS 17 para 119) and comparability

11. IFRS 17 Basis for Conclusions para BC215 notes the following rationale for including the requirement to disclose the confidence level at which the risk adjustment is calculated: *'An important difference between IFRS 17 and IFRS 13 is that the risk adjustment for non-financial risk in IFRS 17 relies on an entity's own perception of its degree of risk aversion, rather than on a market participant's perception. This could result in entities determining different risk adjustments for non-financial risk for similar groups of insurance contracts. Accordingly, to allow users of financial statements to understand how the entity-specific assessment of risk aversion might differ from entity to entity, IFRS 17 requires entities to disclose the confidence level to which the risk adjustment for non-financial risk corresponds.'*
12. Applying the rationale for including the confidence level disclosure in annual reports and accounts for public sector bodies can result in different results compared to the private sector. In the proceeding paragraphs I have explained how the yellow-highlighted sections of BC215 above apply in the public sector.
13. *'...relies on an entity's own perception of its degree of risk aversion'*. Applying this to the private sector makes sense as private sector entities will issue insurance contracts depending on their risk appetite. In the public sector, many insurance contracts are issued for policy reasons. For example, an entity may issue an indemnity to a contractor for an infrastructure project. This doesn't reflect the entity's attitude to risk- it reflects the fact there is a wider policy objective from government to achieve and the indemnity must be provided to attract suppliers to work on the project, and the Exchequer is willing to take on this risk should it crystallise. In the private sector this wouldn't happen as there would be no market for providing such an indemnity.
14. *'...entities determining different risk adjustments for non-financial risk for similar groups of insurance contracts.'* In the private sector, entities operate in the same market. For example, insurer A and insurer B may both issue car insurance policies. However, public sector entities rarely (if ever) operate within the same market as each other. They don't typically look to compete in the market and often the reason public sector entities are issuing these contracts is because the open market is unwilling or unable to do so. Therefore, in the public sector there isn't the issue of entities determining different risk

adjustments for similar groups of insurance contracts. This is because public sector entities do not issue similar contracts- they issue contracts which are specific to their public sector remit, e.g., DfT will issue transport-related indemnities, Defra environment related insurance contracts etc. There is unlikely to be a situation where DfT and Defra will issue the same types of contracts. Therefore, the comparability issue IFRS 17 BC215 notes is considerably less relevant to public sector entities. Additionally, public sector entities do not typically compete against private sector entities in the insurance market, so the disclosure would likely have very limited value in comparing private and public sector entities.

15. Moving on to para BC216: 'The Board acknowledges concerns that disclosure of the confidence level would be burdensome to prepare and may not provide information that is directly comparable. However, the Board did not identify any other approaches that would provide quantitative disclosure that would allow users of financial statements to compare the risk adjustments for non-financial risk using a consistent methodology across entities.'
16. '...disclosure of the confidence level would be burdensome to prepare and may not provide information that is directly comparable.' The IASB acknowledges that the comparison provided is not perfect and is burdensome to prepare for private sector companies. These issues are exacerbated for public sector insurance contracts. The limited benefits of comparability are discussed above. These calculations can be particularly burdensome for many public sector insurance contracts. Many contracts issued in the public sector are unique and would not be issued by the market. They may often also have a remote possibility of crystallising and a binary set of outcomes (either the adverse event happens, or it doesn't happen- there are no in-between scenarios). This makes calculating a confidence level particularly challenging as it may not be possible to develop a probability distribution for these types of contracts (refer to [Annex 1](#) for practical examples). Additionally, where it is not possible to use the VaR or a confidence level technique to calculate the risk adjustment, which will be the case for many public sector insurance contracts, having to calculate the confidence level equivalent for the alternative technique used would be very burdensome and likely to require a significant amount of external expertise. The expert view may be that such a disclosure cannot be calculated robustly or avoid the risk of being misleading.
17. '...allow users of financial statements to compare the risk adjustments for non-financial risk...'. This links to the points made above on comparability, so they won't be repeated here.
18. To summarise this section:
 - The purpose of the risk adjustment disclosure is to improve comparability of risk appetites between reporting entities.
 - However, central government entities do not usually compete with each other or the private sector or issue similar insurance contracts- they are often unique in nature and provided as the insurance market does not provide such insurance cover.
 - Therefore, the comparability benefits of including the disclosure are diminished for central government annual reports and accounts, but the burden and costs would remain.

The benefit of a public sector adaptation

19. Some have asked whether the removal of this disclosure requirement would actually result in a significant cost or time saving. Engagement with stakeholders through the IFRS TWG and other stakeholders suggests that removal of this disclosure requirement will result in a significant time and cost saving, with the costs of including this disclosure requirement exceeding the benefits.
20. The requirements of IFRS 17 para 119 are detailed above. For entities already using the VaR statistical method, complying with this paragraph should not be problematic. However, for entities not using the VaR methodology to calculate their risk adjustment, complying with this paragraph of the standard will be highly burdensome. In order to calculate the confidence level at which the risk adjustment is measured, a confidence level technique such as VaR has to be used.
21. There are many contracts in central government where application of the VaR technique is not possible or hugely complex. Therefore, when measuring the risk adjustment in line with IFRS 17 para 37, it is likely entities will be using a different statistical methodology such as explicit loading assumptions (e.g. the risk adjustment is 5% of the probability weighted insurance liability).
22. Where entities are measuring the risk adjustment using an estimation technique other than VaR, entities will still need to apply the VaR or similar methodology to comply with IFRS 17 para 119. In these scenarios entities will need to perform two sets of calculations on the risk adjustment. Both sets of calculations will be costly and time-consuming, with the VaR calculations particularly time consuming or even impossible for many public sector insurance contracts.

Central government entities vs companies who are not insurers

23. IFRS 17 applies to all companies in the private sector, not just insurance companies. Therefore, companies who are not insurers could also be facing similar issues with calculating the risk adjustment and developing the confidence level disclosures.
24. We do not doubt that some companies (both insurers and non-insurers) will be finding the requirements in respect of the risk adjustment challenging.
25. The difference with the public sector is that a much higher proportion of insurance contracts will be one off, unique insurance contracts with a binary set of outcomes compared with the private sector. To illustrate this, there are 23 ministerial departments, of which only four (UKEF, Defra, DfE and HM Treasury) have entities within the group who regularly issue insurance type-contracts rather than one off insurance contracts.
26. For all other ministerial departments, they will have a much larger proportion of insurance contracts which are one off and binary in nature.
27. This makes this issue (insurance contracts being on-off, with a binary set of outcomes and covering a unique set of risks the private sector would not) more pervasive in the public sector and needs to be addressed.
28. Additionally, there is some intersectionality with the comparability benefits of the disclosure. As noted above, entities in the public sector issue very different insurance contracts and do not complete with each other. Contrast this with companies who are

non-insurers- they do compete with each other for market share and investment, meaning the comparability of risk aversion between companies is more meaningful than comparability between departments who issue insurance contracts.

29. To conclude on this section, though companies who are non-insurers may also face challenges when calculating the confidence level at which the risk adjustment is measured, this differs with central government as:
- The issue of entities having to issue one off contracts with binary outcomes is a lot more pervasive in central government than the private sector; and
 - Comparability of the confidence level is less meaningful in central government as entities typically issue different types of insurance contracts, do not compete with each other and issue contracts as a matter of policy.

A 'wait and see' approach

30. Members of FRAB suggested a 'wait and see' approach to deciding whether to remove this disclosure requirement or not. Some entities will early-adopt IFRS 17, and private sector insurers will adopt the Standard from 1 January 2023. It was therefore suggested that we can wait until the first sets of accounts applying IFRS 17 have been published to see what the disclosures look like and whether they will be useful.
31. Feedback from reporting entities is they want and need certainty over the Standards they are reporting under. A wait and see approach would result in a nearly complete adapted Standard, except for whether work needs to be completed on the confidence level disclosure.
32. Entities need sufficient lead time to prepare and implement the Standard and having this particular disclosure requirement open so close to the implementation date would undermine the smooth planning and preparation for implementation. Preparers value advanced certainty in the framework they are applying. The work needed to complete the confidence level disclosure is significant and requires resource planning and procurement of specific expertise.
33. Additionally, the experiences of early adopters may not apply to later adopters. Early adopters are expected to be entities with large numbers of insurance contracts who will be able to apply the VaR technique. Departments who mainly have insurance contracts with highly skewed distributions will not be able to apply this technique, so the 'lessons learnt' from early adopters may not be applicable to later adopters of the Standard.

Mandating certain approaches to the risk adjustment

34. FRAB also suggested mandating aspects of the calculation of the risk adjustment, whether it be the calculation methodology, the confidence level percentage or something else. Mandating a certain approach has significant drawbacks. The Standard allows differing measurement and calculation methodologies as there is not a one-size-fits-all approach. Indeed, it may be impossible to apply certain statistical techniques to certain insurance contracts due to the nature of those contracts, the ability to produce a probability distribution etc.
35. Consider a scenario where HM Treasury mandate the VaR approach to calculating the risk adjustment. We have already established above that VaR will not be feasible for all

insurance contracts. Indeed, it will be disproportionately difficult to apply VaR in the public sector due to the types of insurance contracts issued as detailed above.

36. A confidence level cannot be mandated either. This is because if a 75% level of confidence was mandated this could lead to negative risk adjustments (see example above) which do not comply with IFRS 17 or risk adjustments which are not appropriate to the group of insurance contracts.
37. Therefore, it would be inappropriate and not in the spirit of the Standard to mandate large parts of the risk adjustment judgement and calculation.

Conclusion

38. To summarise:

- The purpose of the confidence level disclosure is to improve comparability of annual reports and accounts to understand entity-specific attitudes to risk aversion.
- However, public sector entities do not compete with each other or private sector entities as they do not issue similar groups of insurance contracts. The reason public sector entities issue these contracts is typically because the market does not.
- This method of comparison has already been acknowledged as imperfect by the IASB and is clearly burdensome to prepare.
- Consequently, the comparability benefit of disclosing the confidence level or confidence level equivalent at which the risk adjustment is calculated is lost.
- Entities in the public sector are more likely to use a technique other than VaR to calculate the risk adjustment, but will subsequently need to use a confidence level technique to calculate the confidence level, meaning two sets of complex calculations are required. Performing the additional set of calculations for the confidence level is more complex in the public sector due to the nature of contracts issued.
- Therefore, the costs of including the confidence level disclosure exceed the already diminished benefits.
- HM Treasury does not agree that waiting to see what other entities do is viable as reporting entities need certainty over the Standard they are reporting under.
- Mandating a specific approach to calculate the risk adjustment could lead to incorrect or inappropriate risk adjustment values and not be within the spirit of the Standard to assess these adjustments based on their own risk profile.

39. HM Treasury's proposed approach is as follows:

- The requirement to measure a risk adjustment for non-financial risk per IFRS 17 para 37 will **remain**. We consider that, if material, including this adjustment is important.
- However, the requirement to disclose the confidence level at which the risk adjustment has been measured (IFRS 17 para 119) **will be removed**. This is for

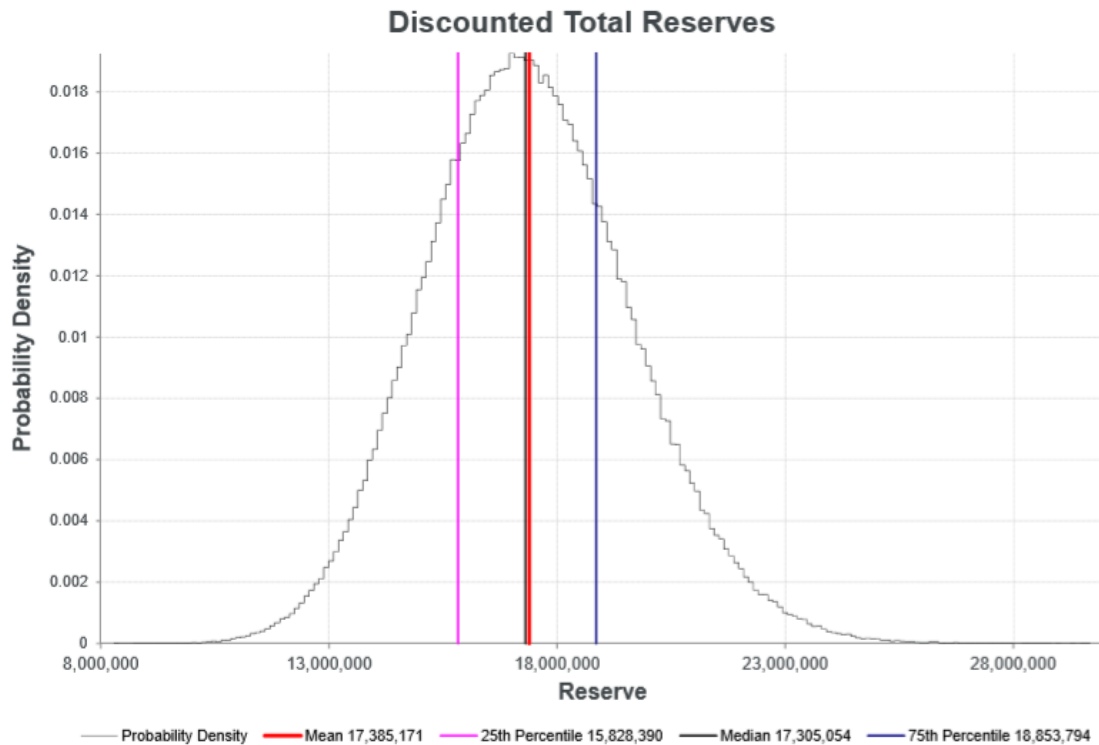
the reasons noted above, but primarily due to the burden it will place on entities to derive the corresponding confidence level for the technique used which exceeds the diminished benefits of the disclosure in central government.

Question for FRAB

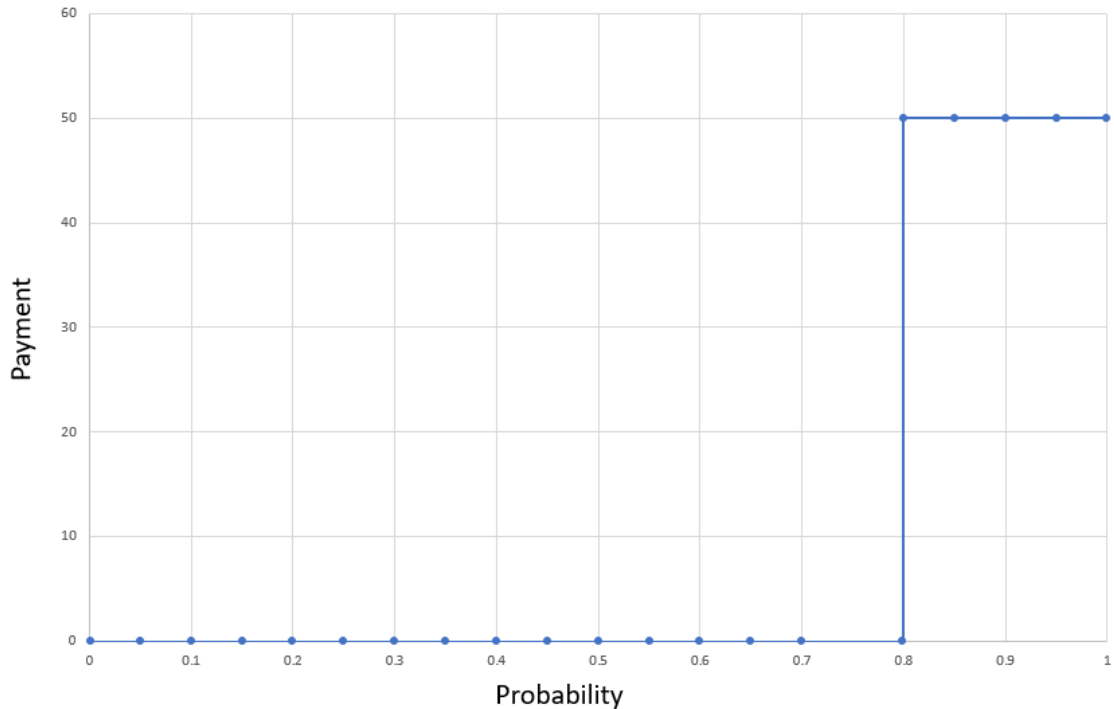
40. Do you agree with the proposed adaptation to remove the IFRS 17 para 119 disclosure requirement?

Annex 1 - Practical examples of probability distributions

1. In order to apply the VaR technique (which is needed to calculate the confidence level at which the risk adjustment is measured) an entity needs to generate a probability distribution. Where an entity issues lots of insurance contracts a probability distribution can be developed relatively easily any may look like this:



2. Based on this illustrative probability distribution, the potential outstanding claims have a 75% probability of being less than £18,853,794 and has a mean of £17,385,171. Assuming the entity chooses a confidence level of 75% (it is expected many entities in the general insurance sector will use a confidence level of 70% - 75%) the risk adjustment is £1,468,623.
3. However, consider an example of a contract with a remote probability of the insured event crystallising and the contract having a binary set of outcomes (either the insured event happens, or it doesn't happen- there is no in-between scenario). The probability distribution may look something like this (see next page):



4. The above distribution illustrates a scenario where there is an 80% chance of a £nil claim and a 20% probability of a claim of 50 (i.e., the probability of the liability crystallising is very low and there are binary outcomes; either the adverse event happens, or it does not). The mean in this scenario is therefore 10 ((80% x £0) + (20% x £50)). If the entity was to take the 75th percentile as the confidence level the risk adjustment would be -£10 (at the 75th percentile the value of potential outstanding claims is £nil less the mean of £10 gives to -£10)- this result may be confusing to the readers of the accounts.
5. An entity could set a confidence level of 90%, with the value at the 90th percentile being £50 and giving a risk adjustment of £40 (£50 less the mean of £10). This would mean the expected value of the claim plus the risk adjustment would be close to the maximum possible value of the claim, which should not be the outcome of the risk adjustment (i.e., the majority of the value of the insurance liability consists of the risk adjustment).
6. Similarly, if another hypothetical claim has a 1% probability of occurring, but the amount paid if it did crystallise was £100m, then the probability weighted value is £1m but the entity would have to hold £99m as the risk adjustment if the risk adjustment was set at the 99th percentile or higher; if the risk adjustment percentile was set at anything lower than 99% it would be negative. This is not what the risk adjustment calculation is trying to achieve and would have significant implications for budgeting purposes.
7. BC217 notes that the usefulness of the confidence level technique diminishes when the probability distribution is not statistically normal. Though skewed distributions are not unique to the public sector, they will be relatively more prevalent due to the nature of the insurance contracts issued by the public sector (i.e., there may be departments which only issue insurance contracts with very highly skewed distributions as the market

will not provide the cover). Additionally, some government risks covered are one off policy areas and therefore would not have a distribution of outcomes compared with general insurers who issue thousands or even millions of policies.

8. This will likely add a significant reporting and cost burden to entities. Given that the comparability benefits of including the disclosure are diminished as these contracts are not issued by anyone else in the market, it is the view of HM Treasury that the disclosure would be too burdensome, and the costs outweigh the benefits.

Appendix 2: IFRS 17 Discount Rates

Discount rate requirements and background

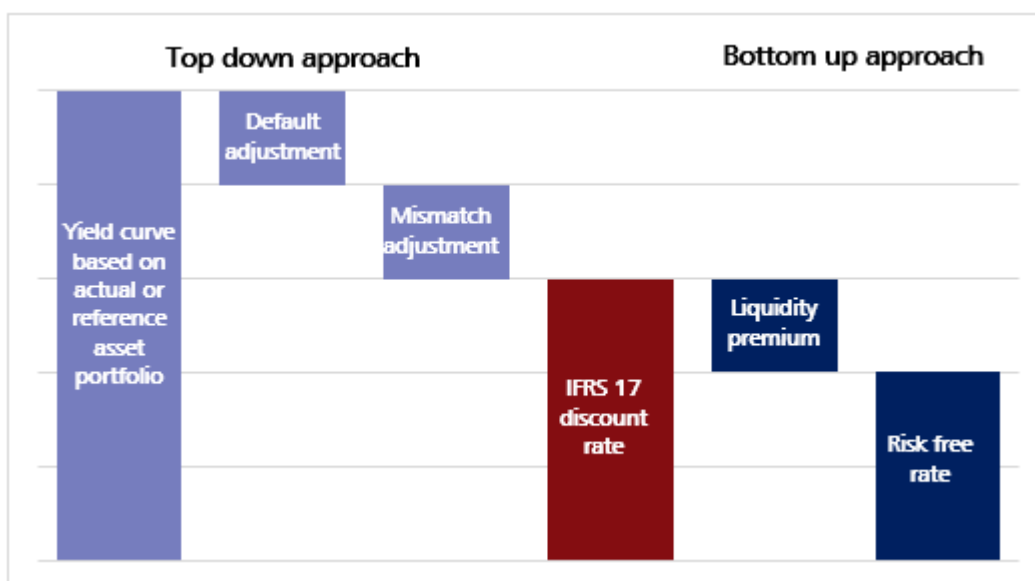
1. IFRS 17 para 36 requires the following in respect of discount rates:

“An entity shall adjust the estimates of future cash flows to reflect the time value of money and the financial risks related to those cash flows, to the extent that the financial risks are not included in the estimates of cash flows. The discount rates applied to the estimates of the future cash flows described in paragraph 33 shall:

- (a) reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts;
 - (b) be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity; and
 - (c) exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance contracts.
2. The Standard provides guidance on two different techniques that can be used to calculate the discount rate, being the bottom-up approach and the top-down approach.
 3. The bottom-up approach involves taking the yield curve for risk free instruments and adjusting to reflect the liquidity characteristics of the group of insurance contracts².
 4. The top-down approach starts with the yield curve reflecting the current market rates of return of a reference portfolio of assets and adjusts that curve to remove risk premiums for credit risk and mismatches between the amount, timing and uncertainty of the cash flows of the assets in the portfolio and the amount, timing and uncertainty of the cash flows of the insurance contracts³.
 5. The two approaches are illustrated below:

² IFRS 17 para B79

³ IFRS 17 paras B81-B83



6. As illustrated above both approaches should result in the same (or very similar) discount rate in theory⁴.

The issues for consideration

7. HM Treasury currently provide central discount rates to be used in the accounting for financial instruments, finance leases, provisions and pensions. Reasons for providing a central discount rate include consistency between annual reports and accounts and ease of implementation for accounts preparers; individual entities developing their own discount rates would be a costly exercise for government.
8. The requirements of IFRS 17 relating to discount rates requires adjustments to be made based on the characteristics of the insurance contracts:
- For the bottom-up approach, the risk-free rate is adjusted based on the liquidity characteristics of the insurance contract.
 - For the top-down approach, an adjustment is made for mismatches between the amount, timing and uncertainty of the cash flows of the assets in the portfolio and the amount, timing and uncertainty of the cash flows of the insurance contracts.
9. In theory, for insurance contracts that do not vary based on the returns on assets, there is a single illiquid risk-free yield curve that eliminates all uncertainty around the amount and timing of cash flows⁵. In practice, whether all public sector insurance contracts are fully illiquid is up for debate. For example:
- A public sector insurance contract with a cancellation option and refund is more liquid than one which does not have this option.
 - A public sector insurance contract which pays out claims immediately is more liquid than one which is more complex and takes more time to pay out claims.

⁴ IFRS 17 para B84

⁵ IFRS 17 para B84

10. There should be a balance between using a reasonable discount rate which provides a materially correct insurance liability value and the costs for entities having to develop their own discount rates, which will likely need significant input of actuarial/ corporate finance professionals, plus the individual discount rates being audited by different external auditors.
11. As additional context it is expected that regulated insurers in the private sector will be able to use their existing calculations for Solvency 2 (S2)⁶ for discount rate calculations. Though there are differences between IFRS 17 and S2 for discount rates, there are similarities which mean many insurers do not necessarily have to start from scratch. This differs significantly from departments outside of the remit of the insurance regulators.
12. Centrally set discount rates improve consistency in approach and in some ways improves comparability of central government annual reports and accounts. With all other Standards where discounting is required, HM Treasury set a central rate, so continuing to issue central discount rates maintains consistency of approach. Additionally, it's not clear that for the public sector the benefits of individual rates are as pronounced as in the private sector as the investor perspective is the not the dominant user perspective.
13. It should be noted that a discount rate is unlikely to ever be 100% accurate. Indeed, IFRS 17 BC189 notes '[Absolute precision is unattainable, but it is also unnecessary.](#)'
14. In the next few paragraphs, we have taken the reasons for discounting in BC189 and discussed these further in the public sector context:
 - '[Measuring a group of insurance contracts using undiscounted cash flows would fail to represent faithfully the entity's financial position and would be less relevant to users of financial statements than a measurement that includes the discounted amounts.](#)' HM Treasury accept the general argument that discounted values provide more useful information than undiscounted amounts. HM Treasury is therefore exploring whether a simplified discounting methodology can be used for public sector insurance contracts.
 - '[The Board \(IASB\) also concluded that discount rates and the amount and timing of future cash flows can generally be estimated without excessive measurement uncertainty at a reasonable cost.](#)' HM Treasury is less convinced that discount rates can be developed by individual entities at a reasonable cost compared to the benefits of developing individual discount rates. Aside from entities who provide insurance contracts as part of their business model (UKEF and FloodRe) other entities will be issuing insurance contracts on an ad hoc/ exceptional basis and for policy reasons (e.g., providing indemnities to suppliers to work on a large infrastructure project). Public sector entities may not have the internal expertise to develop their own discount rates or have S2 calculations to base discount rates on, meaning engagement with external experts is needed at significant financial cost.
 - '[The Board is of the view that the measurement uncertainty caused by discounting does not outweigh the additional relevance of the resulting measurement of the entity's obligations.](#)' We agree this is applicable to the public sector to a point. We agree with the merits of discounting to reflect the

⁶ [Solvency II | Bank of England](#)

time value of money, but not to the point where developing individual discount rates becomes too costly and onerous to individual entities, which we expect in the public sector where insurance is not a common business activity.

- ‘Furthermore, many entities have experience in discounting, both to support investment decisions and to measure items for which other IFRS Standards require discounting, such as financial instruments, employee benefit obligations and long-term non-financial liabilities.’ This argument is weaker in the public sector as central discount rates are provided for financial instruments, provisions, pensions and finance leases centrally by HM Treasury. Additionally, many reporting entities will not have experience with developing discount rates as described in IFRS 17 as the previous reporting framework (IFRS 4) did not have these specific requirements; the accounting may significantly change once IFRS 17 is adopted.
- ‘Additionally, the Board has learned that, for internal managerial purposes, some insurance entities discount some of their non-life insurance portfolios or groups of insurance contracts.’ This is very much an argument based on what insurance entities in the private sector do. Many entities in the public sector may not develop discount rates for insurance-type arrangements and use the Green Book to inform investment decisions, so this argument is not entirely applicable to the public sector.

15. Given the complexities involved with developing discount rates and the anticipated cost involved, HM Treasury is exploring options to reduce the burden of implementing the Standard by issuing central discount rates that meet the requirements of the Standard as closely as reasonably possible.

What is liquidity in this context?

16. A liquidity premium usually refers to the additional amounts investors require when assets held cannot easily be converted into cash for their fair value. This concept is difficult to apply to insurance contracts as there is no transparent or liquid market for trading such contracts.
17. Bearing in mind there is no market for all public sector insurance contracts, applying the liquidity premium to public sector insurance contracts will be even more difficult.
18. IFRS 17 is not prescriptive regarding what liquidity means and there is not necessarily a single way of calculating the liquidity premium under corporate finance theory. However, a common way to calculate the liquidity premium is as follows:

$$\text{Liquidity risk premium} = \text{Yield to maturity on a reference portfolio} - \text{risk free rate} - \text{credit risk premium}$$

19. For public sector entities, one could argue that the yield on the reference portfolio and risk-free rate are the same. This is because the reference portfolio would be Treasury Gilts (as these are public sector entities) and the risk-free rate is also the return on Treasury Gilts. The credit risk premium for these entities will also be nil/ negligible as these are public sector entities in the UK (UK Government’s rating per [Fitch](#) was AA- at the time of writing).

Option 1 – Mandate the bottom-up approach and provide the risk-free rate

20. The bottom-up approach takes the risk-free rate and adds a premium for illiquidity. The risk-free rate can be obtained by reference to Treasury Gilts.
21. It would then be up to individual entities to adjust the risk-free rate with a liquidity premium based on their insurance contracts (should such an adjustment be required).
22. This option is arguably the most aligned to the principles of IFRS 17. However, calculating liquidity premiums in the public sector will (in most instances) be new and likely need input from external actuaries where skills are not in-house.
23. The calculation of the liquidity premium could be particularly burdensome and costly given the unique nature of the insurance contracts in the public sector and that it may be calculated for only a small group of insurance contracts. [contrast this with a regulated insurer who has a significant number of insurance contracts, in house experts to advise on discount rates and the infrastructure to calculate IFRS 17 discount rates due to compliance with Solvency 2 requirements]

Option 2 – Provide a central discount rate which can be used by all entities within central government

24. HM Treasury provides central discount rates for many balances, such as financial instruments, finance leases, provisions and pensions. This is to ensure consistency in financial reporting across central government and to ease the financial reporting burden for reporting entities.
25. Option 2 explores the possibility of providing a central discount rate to be used by all entities for all groups of insurance contracts.
26. As noted above, it is likely to be burdensome and costly to calculate discount rates for public sector insurance and it is more likely external expertise will need to be procured to develop discount rates.
27. What we wish to highlight here is that HM Treasury is seeking to provide a discount rate which is reasonable and will result in financial statements which are not materially misstated.
28. A reasonable discount rate can be developed using the top-down approach as follows:

Input	HMT Explanation
Yield curve based on a reference portfolio of assets	For central government entities, a reference portfolio of assets will be Treasury Gilts; it would be these which back crystallised insurance liabilities if entities were able to hold assets for this reason.
Default risk	As these are public sector entities, the default risk is nil or negligible. As noted above, the UK Government still has a strong credit rating.

Mismatch adjustment	<p>This is the adjustment which is not possible to provide for all groups of insurance contracts. However, this adjustment is unlikely to have a material impact on insurance liabilities as demonstrated in the example below.</p> <p>The discount rate is an estimate and won't be 100% accurate. There is a level of tolerance that can be accepted.</p> <p>Consider this example:</p> <ul style="list-style-type: none">- DCMS is one of the smaller departments by expenditure. Assuming materiality of 1% of gross expenditure, materiality in 2019-20 would be c£57m.- Assume DCMS has an insurance contract with a balance sheet value of £1bn (unlikely for DCMS, but for the purposes of stress testing the approach).- Even with a mismatch adjustment of 5% the impact on the liability would be £50m, which is immaterial. <p>The above illustration shows there would need to be extremely high insurance liabilities and high mismatch adjustments for the impact to be material to the financial statements.</p>
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29. The above table demonstrates that a materially correct central discount rate can be developed using the principles set out in IFRS 17.
30. The outcome from the above calculation would be a discount rate = the Treasury Gilt yields. Treasury Gilt yields are also the basis for the financial instrument rate.

Conclusion

31. HM Treasury's preferred option is **option 2**- to provide a central set discount rate that all entities may use in central government using the top-down methodology as described above.
32. Note HM Treasury would not mandate the discount rate, but instead there would be a rebuttable assumption that the rate would be used, with the exception of regulated insurers and entities whose principal business is insurance activities. This is important as there are two entities within central government (one of which is regulated) with significant insurance operations who wish to use their own discount rates.

Questions for FRAB

33. Do you agree with HM Treasury's proposal to issue a central discount rate based on Treasury Gilt yields and, to support consistency across IFRS 9 and IFRS 17 liabilities, for this to be the same as the financial instrument rate?

Appendix 3: IFRS 17 Implementation Timing

Detail

1. At FRAB 145 in November 2021 HMT Treasury presented its proposition to delay the implementation of IFRS 17 in the public sector by at least 1 year.
2. IFRS 17 is to be applied by entities for accounting periods beginning on or after 1 January 2023. A delay of at least 1 year would mean the earliest implementation date of 1 April 2024 in central government.
3. As stated at the last FRAB meeting the reasons for delaying the implementation of the Standard are as follows:
 - IFRS 17 is a detailed and complex Standard needing some time to implement, set up new systems, processes etc. with the private sector having had a long lead time to prepare. However, the work plan for implementation in the public sector is based on the final standard once issued, requiring additional time to assess its application in the public sector.
 - The potential adaptations and interpretations are still being considered with the proposed application guidance in development leaving insufficient notice for the public sector to prepare for and implement the Standard by financial year 2023-24.
 - There are significant ongoing delays to the publication of public sector annual reports and accounts due to the impact of COVID-19, impeding transparency and accountability over the use of public funds by public sector entities. In central government, the return to a pre-recess laying timetable for almost all entities is expected to be achieved by 2022-23 at the earliest. Entities also need to implement IFRS 16 from financial year 2022-23, which creates another major reporting challenge. Mandatory adoption of IFRS 17 from 2023-24 may result in further delays to the financial reporting process as well as on the compilation of the WGA.
4. FRAB requested a clearer explanation of when HM Treasury intend on mandatory implementation of the Standard.
5. As a starting point, HM Treasury needs to finalise the IFRS 17 application guidance, including agreeing any adaptations and interpretations and budgeting impact of the Standard (which also requires engagement with the Office for National Statistics). It is anticipated that the application guidance will be finalised this year (i.e. within the 2022-23 financial year) as much of the work on core issues such as scope of the Standard and transition arrangements has been completed.
6. We propose a two-year lead time between finalisation of the application guidance and mandatory adoption in Central Government. This means a proposal of mandatory adoption of IFRS 17 in financial year 2025-26 (i.e., from 1 April 2025).

7. The two-year lead time is consistent with the time the private sector has had to implement IFRS 17 (the finalised Standard was amended in June 2020 with adoption from 1 January 2023). In this two-year lead time HM Treasury will also be providing training and engaging with departments as support.
8. There are a number of risks to the adoption of the Standard as set out below.
9. The HM Treasury work plan for IFRS 17 can be seen in [Annex 2](#) at the end of this paper.
10. As previously discussed, HM Treasury will allow early adoption of the Standard on a case-by-case basis.

Risks

11. **Pre-recess laying of accounts:** The progress in recovering the timeliness of central government accounts (i.e. achieving pre-recess) has an interaction with the implementation date for IFRS 17. Were recovery to be considerably slower than planned, and implementation of IFRS 17 is judged as a significant barrier to achieving recovery, then the timetable may be revisited.
12. **Scale of IFRS 17 within central government:** though there is agreement of the scope of the Standard in the public sector, the impact is yet to be determined (e.g., could this lead to very large numbers of contingent liabilities being reclassified to IFRS 17, needing significant amounts of insurance and actuarial expertise?). The scale of impact could affect the deliverability of the two-year implementation window that is planned. To combat this risk HM Treasury will be undertaking an exercise with the IFRS 17 TWG to reach out and understand the possible extent of contracts which are likely to fall within the scope of the Standard.
13. **Finalisation of the application guidance:** though good progress has been made on the application guidance, adaptations and interpretations (e.g. scope, transition arrangements), there are some large areas outstanding, namely the budgeting impact of IFRS 17, which generates significant interest within central government and informs budgetary planning.
14. **UK Endorsement of IFRS 17:** as it stands, IFRS 17 has not yet been adopted by the UK Endorsement Board, though we are assuming the Standard will be adopted in the UK before April 2025.

Question for FRAB

15. Does FRAB agree to the revised planned mandatory adoption date for the Standard (2025-26 financial year), with early adoption permitted on a case-by-case basis by HM Treasury.

Annex 2 – HM Treasury IFRS 17 Workplan

