IFRS 17: Insurance Contracts

A new perspective on insurance accounting

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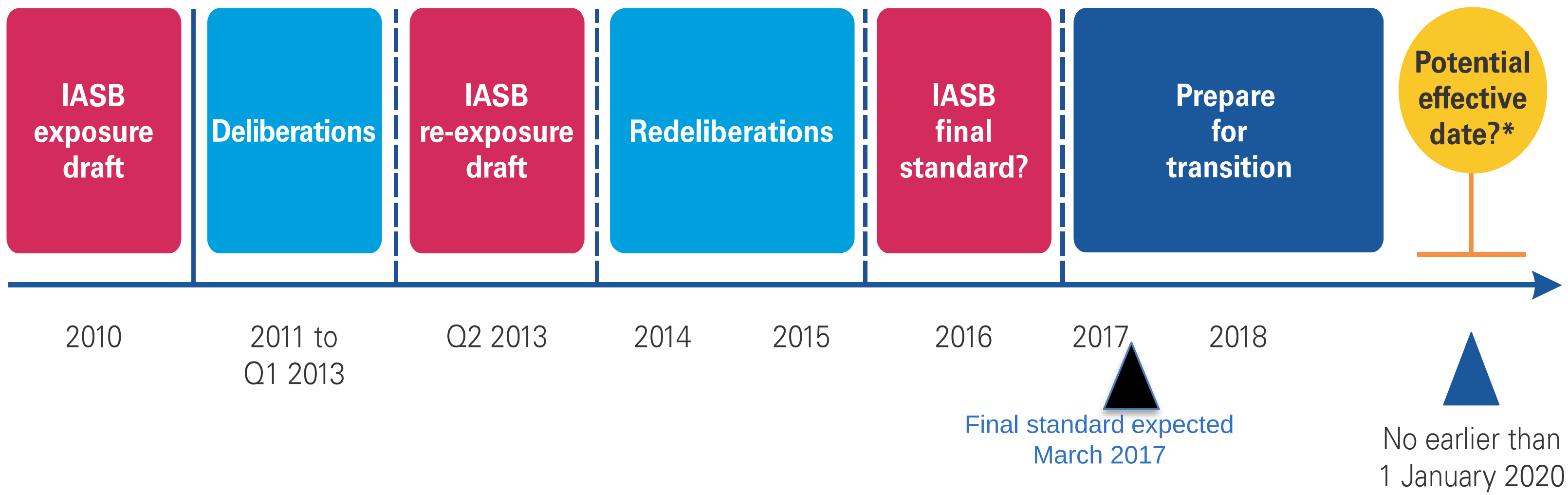
Background and overview

- Overview of IFRS 17
  - **Scope**
  - **General measurement model**
    - **Level of aggregation**
    - **Initial recognition**
    - **Subsequent measurement**
  - **Transition**

Background and overview

➢ Project milestones



* The final standard was issued in May 2017 with effective date of 1 January 2021. Earlier adoption is permitted only if an entity has adopted IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers.*

What's the issue?

- **Analysts currently have to *adjust* insurance companies' financial positions and performance to be able to compare them**

- **IFRS 17 increases *transparency* about profitability and will add *comparability***

A new, comprehensive accounting model

- **IFRS 17's *general measurement model* (GMM) is based on a fulfilment objective and uses current assumptions**
- **It introduces a *single revenue recognition principle* to reflect services provided**
- **And is *modified* for certain contracts**

The changes could significantly affect insurers'…

Profitability patterns

Volatility of financial results and equity

Level of transparency about profit drivers

Equity levels

The magnitude of the accounting change for life and non-life insurers will be different

Life insurers

Significant accounting changes **are almost certain to occur under the new standard**

Sources of complexity include…

Use of current estimates

Disaggregating changes in LRC

Tracking the CSM at a group level

Non-life insurers

Accounting for non-life insurers may have *similarities to current practice*

But *major impacts* may arise around…

Qualifying for the PAA

%

LIC discounting

Onerous contracts

Scope

Definition of an insurance contract in the proposals consistent with IFRS 4	➢ Insurance contracts, including reinsurance contracts, that the entity issues and reinsurance contracts that the entity holds ➢ Investment contracts that the entity issues with a DPF – provided that the entity also issues insurance contracts ➢ Certain financial guarantees

Scope

Proposals apply to all insurance contracts rather than insurance entities

- "A contract under which one party accepts significant insurance risk from another party by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder"
- No quantitative guidance for assessing the significance of insurance risk; however, new guidance reflecting the notion of a loss and time value of money, derived from US GAAP

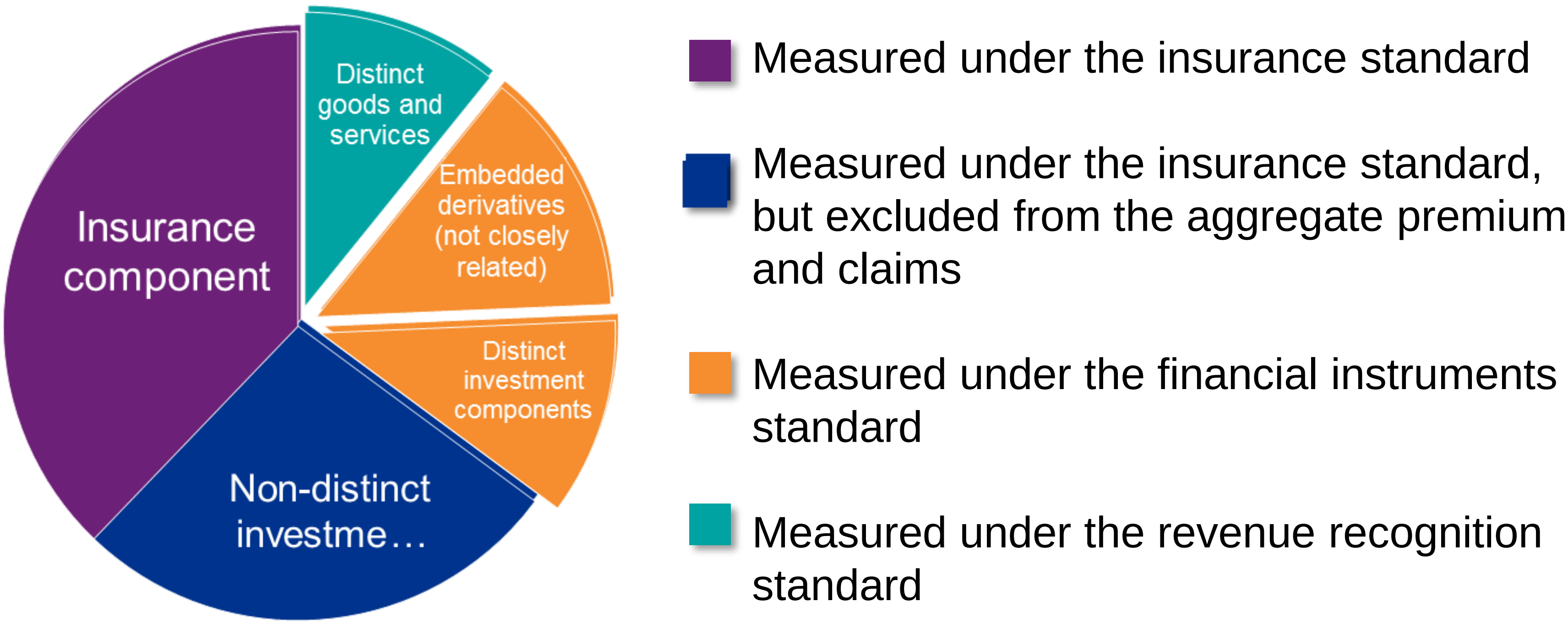
Scope

Scope exclusions	➢ Scope exclusions in IFRS 4 carried forward ➢ Additional scope exclusions added: ▪ residual value guarantees provided by a manufacturer, dealer or retailer; ▪ certain fixed-fee service contracts (Note: this scope exclusion is permitted as the application of IFRS 15 *Revenue from Contracts with Customers* is optional via an accounting policy choice)

The general measurement model

Separating non-insurance components

- The separation of certain components from an insurance contract will be required.



- Provides guidance on closely related embedded derivatives, distinct investment components and distinct goods and services.

Initial recognition

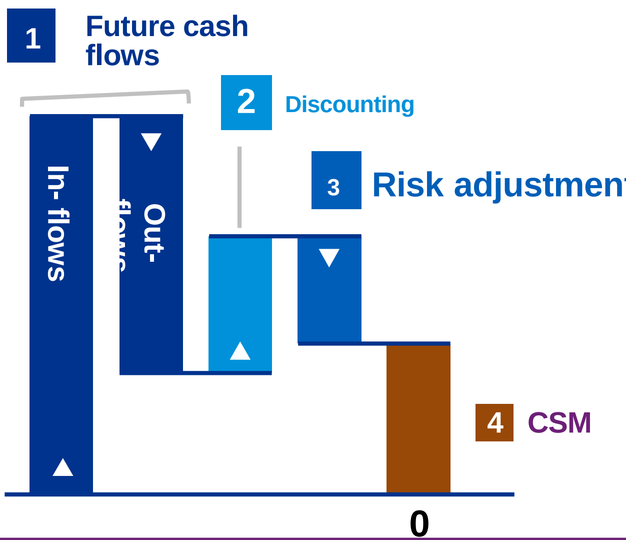
Key components

Fulfilment cash flows 1 2 3

Risk-adjusted present value of future cash flows – e.g. premiums, claims

Contractual service margin (CSM) 4

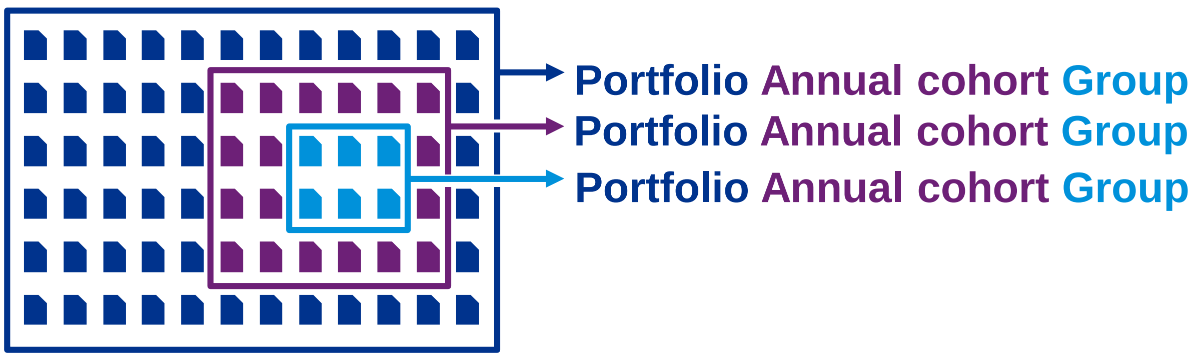
Represents unearned profit – results in no gain on initial recognition



Net cash outflows result in *no CSM* – a *loss* is recognised immediately

Level of aggregation

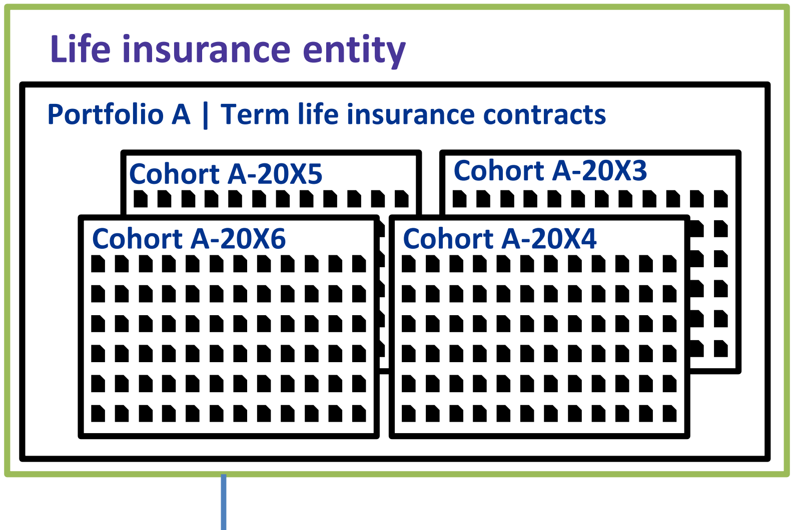
The CSM is determined for groups of insurance contracts



Insurers will need to account for their business performance at a more granular level

IFRS 17 limits offsetting of onerous contracts against profitable ones

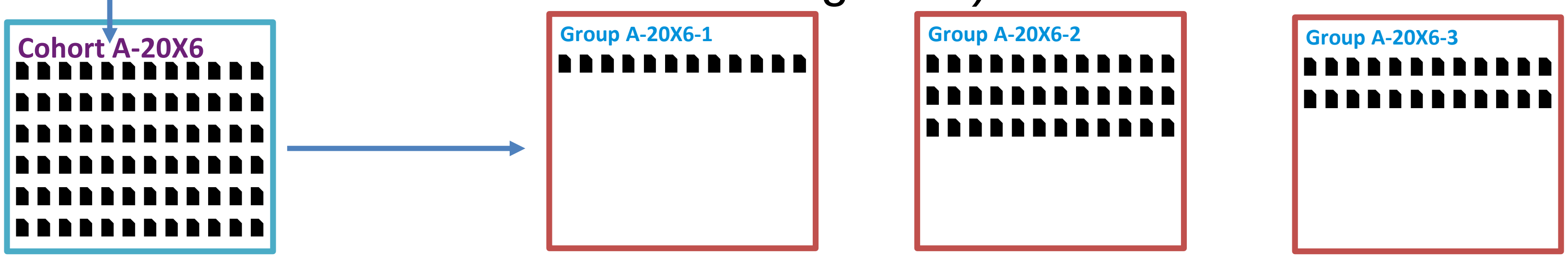
Level of aggregation



Each portfolio should have *at least 3 groups*, unless no contracts fall into one or more of the groups.

Groups are limited to *contracts issued no more than one year apart*.

Do not reassess the composition of the groups subsequently (after initial recognition)



Contracts that are onerous at initial recognition

Contracts that at initial recognition have no significant possibility of becoming onerous subsequently

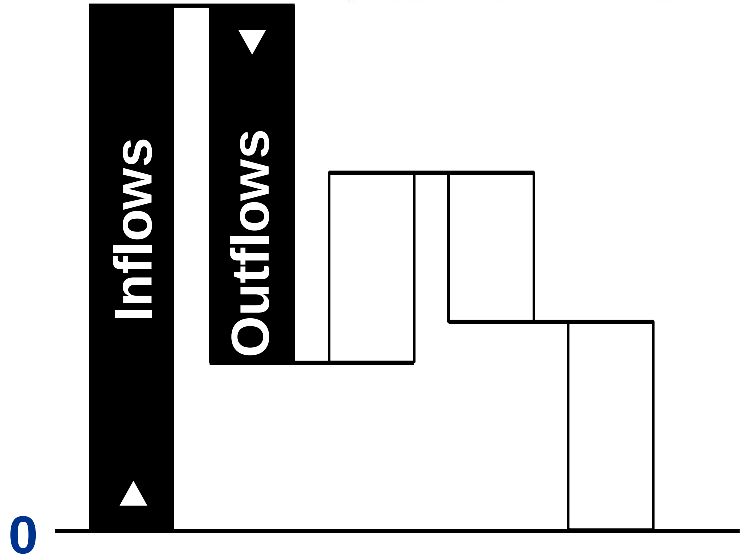
All remaining contracts in Cohort A-20X6

Issuing contracts over multiple reporting periods

- Contracts can be *added to a group after a reporting date*, subject to the annual cohort requirement. However, *an entity cannot change the treatment of accounting estimates* from previous periods in subsequent periods.
- Discount rates at initial recognition *can be determined using a weighted-average* over the period that contracts in the group are issued.
- The *weighted-average discount rate* on initial recognition would be *revised and applied* from the start of the repotting period in which the new contracts are added to the group.

Estimates of future cash flows

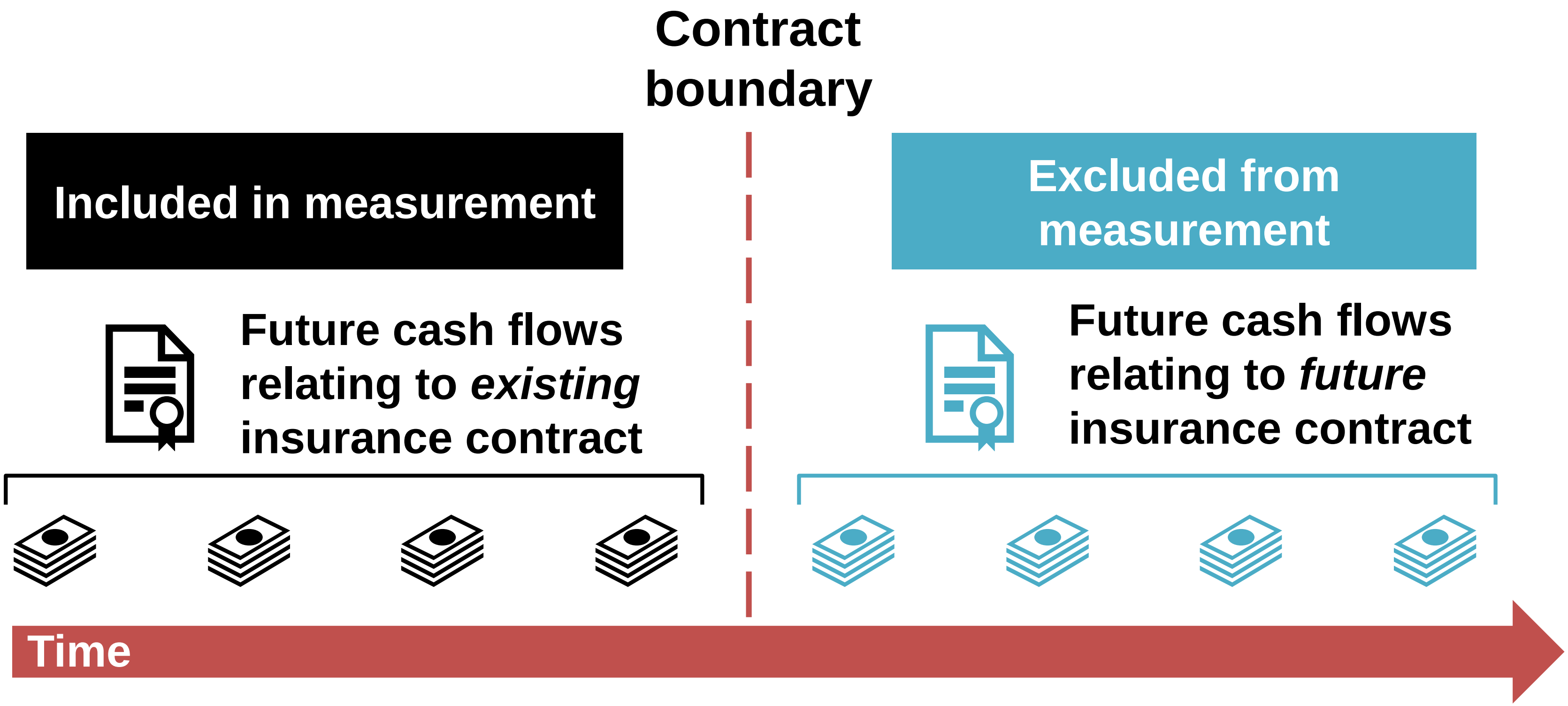
- Includes all *reasonable and supportable information available* without undue cost or effort.
- Estimated based on the *entity's perspective* but consistent with observable market prices for market variables.
- The cash flows *may be estimated at a higher level* than the group of contracts level.



1 Future cash flows

Explicit, current, unbiased, and probability-weighted estimates of future cash flows that will arise as the insurer fulfils the contract.

Contract boundaries



Contract boundaries

- Cash flows are within the contract boundary if they arise from substantive rights and obligations that *exist during the period* in which the entity:
  - Can *compel the policyholder to pay* the premium, or
  - Has a *substantive obligation to provide* the policyholder with coverage or other services.
- *A substantive obligation to provide services ends when…*

— …the entity has the 'practical ability' to reassess the risks and can set a price or level of benefits that fully reflects those reassessed risks.

Cash flows within contract boundaries

Examples of cash flows in the boundary of an insurance contract

Payments to, or on behalf of, a policyholder
-

Allocation of fixed and variable overheads directly attributed to fulfilling contracts
-

Cash flows from options and guarantees that were not separated from the contracts
-

Premiums and any other costs specifically chargeable to the policyholder
+

Insurance acquisition cash flows directly attributable to the portfolio of contracts and allocated to the contract
-

Claims and benefits payable to policyholders (including IBNR)
-

Policy administration and maintenance costs
-

Claims handling costs – investigating, processing and resolving claims
-

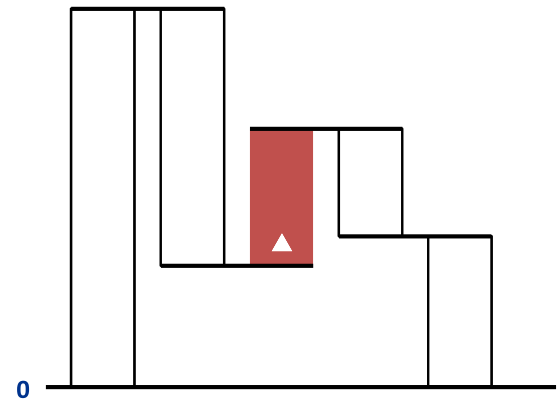
Costs of providing benefits in kind
-

\+ Indicates a cash outflow /
– Indicates a cash inflow

Discounting

- When cash flows do not vary based on the underlying items – *risk free, liquidity adjusted rate*.

- When cash flows do vary based on the underlying items – *that variability should be reflected* in the expected future cash flows or discount rate.

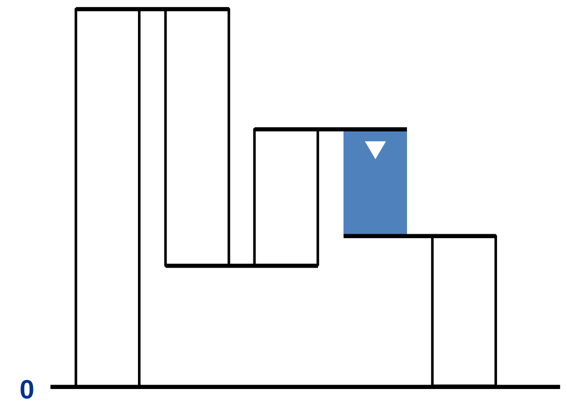


2 Discounting

Cash flows are discounted to reflect the time value of money. The discount rate used is consistent with observable current market prices and reflects the cash flows' characteristics and the contract's liquidity.

Risk adjustment for non-financial risk

- It reflects the *entity's perception* of the economic burden of the risk that it bears.
- *No specific method* prescribed. However, the confidence level corresponding to the result of other techniques used is *required to be disclosed*.



3 Risk adjustment for non-financial risk

An adjustment to reflect the compensation an entity requires for bearing the uncertainty about the amount and timing of cash flows that arises from non-financial risk as the entity fulfils the contract.

Characteristics of underlying risk

- High-frequency and low-severity
- Short-duration contracts
- Narrow probability distributions
- More-known-about trends and current estimates
- Emerging claims experience that reduces uncertainty about estimates

- Low-frequency and high-severity – e.g. catastrophe risk
- Long-duration contracts
- Wide probability distributions
- Little-known-about trends and current estimates
- Emerging claims experience that increases uncertainty about estimates

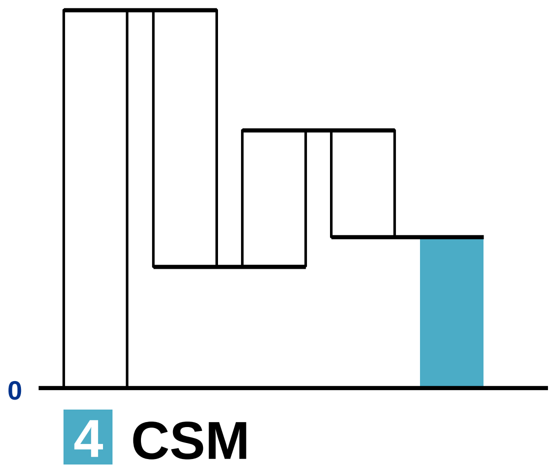
Lower risk adjustment

Higher risk adjustment

Contractual service margin

For profitable groups of contracts it:

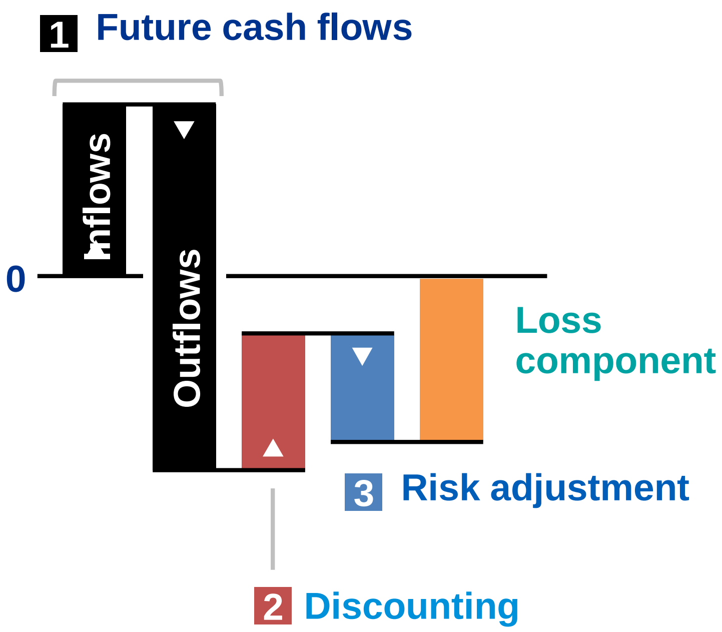
- Represents *unearned profit*, and
- Results in *no gain arising on initial recognition* of the group.



The unearned profit that the entity will recognise as it provides services in the future under the insurance contract.

Loss component

- When the fulfilment cash flows represent a loss, it results in:
  - *Onerous contracts*, and
  - A *loss being recognised immediately in profit or loss* for the entire net fulfilment cash out flows.
- There is *no CSM*, but a *loss component needs to be tracked*.



Example 1: *Initial recognition*

- Fact pattern:
  - Group of 50 contracts, each with a coverage period of 4 years.
  - Single premiums of 30 per contract received immediately after initial recognition.
  - Directly attributable insurance acquisition cash flows of 100 are allocated to the group.
  - Expected claims and expenses of 800, expected to be incurred evenly over the coverage period.
    - The cash outflows are paid immediately upon claims being incurred.
  - Risk adjustment of 80, released evenly to SCI over the period.
  - For simplicity, the discount rate is negligible.

Example 1:
Initial recognition (continued)

- Below is the determination of the FCFs and CSM at initial recognition for the group over the coverage period:

	LRC
Exp. Inflows	1,500
Exp. outflows	(900)
Risk adj.	(80)
FCFs	**520**
CSM	(520)
Total liability	**0**

Example 2:
Initial recognition

- Fact pattern:
  - Group of 50 contracts, each with a coverage period of 4 years.
  - Single premiums of 25 per contract received immediately after initial recognition.
  - Directly attributable insurance acquisition cash flows of 100 are allocated to the group.
  - Expected claims and expenses of 1400, expected to be incurred evenly over the coverage period.
    - The cash outflows are paid immediately upon claims being incurred.
  - Risk adjustment of 120, released evenly to SCI over the period.
  - For simplicity, the discount rate is negligible.

Example 2:
Initial recognition (continued)

- Below is the determination of the FCFs and CSM at initial recognition for the group over the coverage period:

	LRC
Exp. inflows	1250
Exp. outflows	(1,500)
Risk adj.	(120)
FCFs	**(370)**
CSM	0
Total liability	**(370)**
Loss component	**(370)**

Subsequent measurement – Composition

Total liability of a group of insurance contracts

Liability for remaining coverage (LRC)

Fulfilment cash flows related to future services, plus

CSM (unearned profit)

remaining

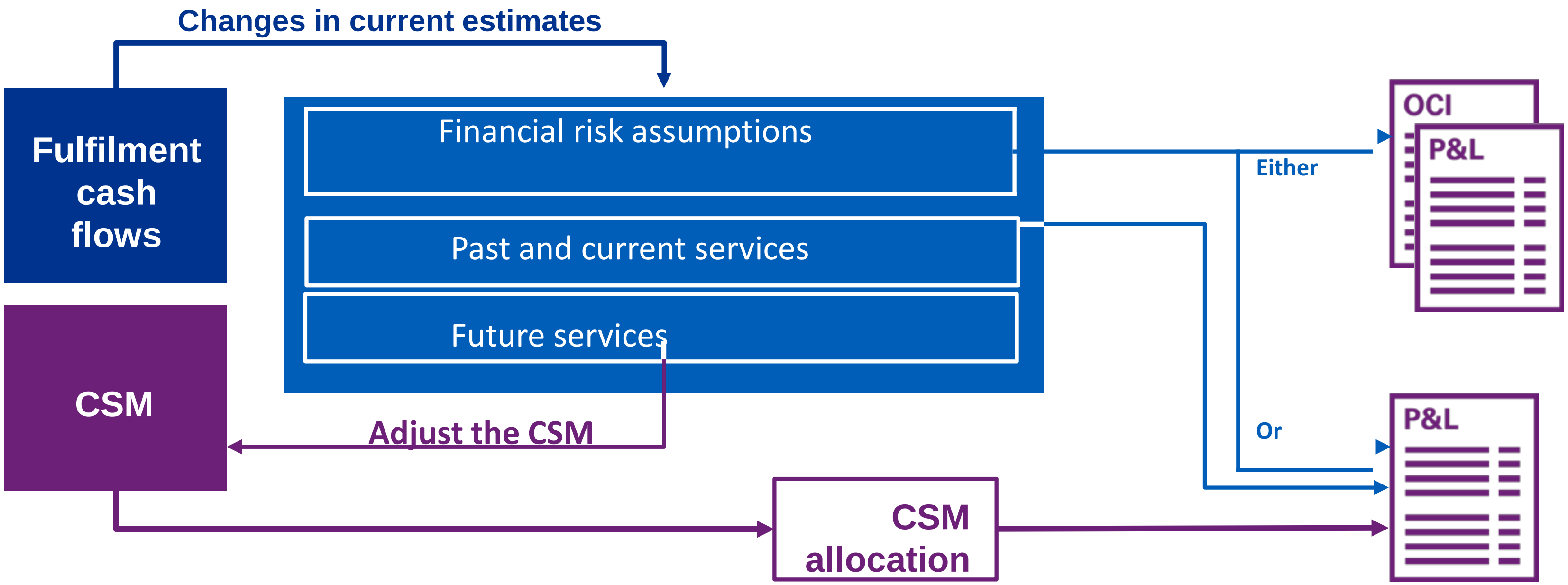
+

Liability for incurred claims (LIC)

Fulfilment cash flows

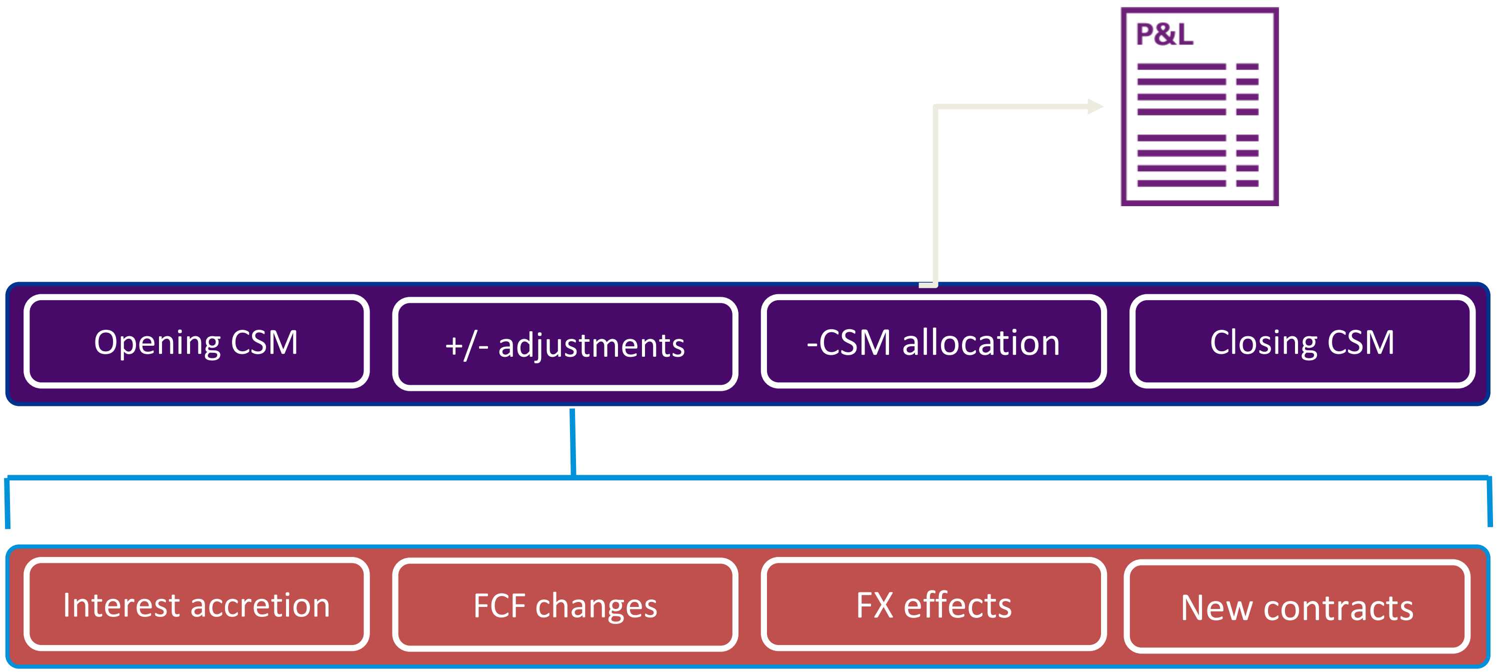
for claims incurred, but not yet paid

Subsequent measurement



CSM allocation

- The amount recognised in PL is determined *after all other adjustments have been made* in the period.



Recognising insurance revenue

- Insurance revenue is derived from the *changes in the LRC* for each reporting period, covering…

Expected insurance claims and expenses	Risk adjustment	CSM allocation	Acquisition cash flows

These items represent a company's consideration for providing services

Example: *Subsequent measurement*

- At the end of year 1, what was expected to occur actually occurs. The movements of the liability are as follows:

	Exp. PV of CF	Risk adjustment	CSM	Total liability
Beginning bal.	600	(80)	(520)	0
Inflows	(1,500)			(1,500)
Expected claims	200			200
Acquisition cash flows	100			100
Release to SCI		20	130	150
Closing bal.	**(600)**	**(60)**	**(390)**	**(1,050)**

Modifications to the General Measurement Model

Premium allocation approach (PAA)

The PAA is an *optional*, simplified model for *measuring the LRC*

Total liability of a group of insurance contracts

Liability for remaining coverage (LRC)

PAA replaces the GMM for short-duration contracts

+

Liability for incurred claims (LIC)

May need to be discounted

While unearned premium is a familiar concept, the revenue recognition pattern could differ

Premium is recognised *over time* as revenue unless release of risk follows *a different pattern*

Variable fee approach (VFA)

The approach considers the *variable fee* associated with direct participating contracts

Obligation to policyholder = Obligation to pay fair value of underlying items - Variable fee

Subsequent measurement – Accounting for changes

Obligation to pay fair value of underlying items → **Recognised immediately**

Variable fee → **Adjusts the CSM**

The VFA reduces the volatility of net results

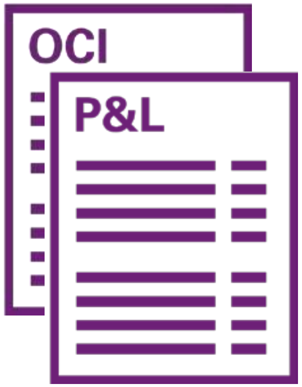
For reinsurance contracts held…

- **The GMM and PAA still apply, with modifications**
- **The reinsurance contract held is *accounted for separately* from the underlying direct contract**
- **Reinsurance gain or loss is recognised as reinsurance services are *received***

Presentation and disclosures

Presentation

- ***Investment components are excluded*** **from insurance revenue and service expenses**
- **Entities can choose to present the effect of changes in discount rates and other financial risks in *profit or loss or OCI to reduce volatility***



Presentation

Statement of profit or loss and OCI

Initial recognition:

Building block 1		Building block 2	Building block 3	Building block 4
Expected cash inflows	Expected cash outflows	Discounting	Risk adjustment*	Contractual service margin

Zero gain at initial recognition

* Recognised in profit or loss if no contractual service margin

Presentation of changes in profit or loss and OCI:

Building block 1	Building block 2	Building block 3	Building block 4
Changes in cash flows unrelated to services: profit or loss	Unwind of locked-in discount rate: profit or loss	Changes related to past and current service: profit or loss	Release of margin: profit or loss
Changes in cash flows related to past and current services: profit or loss	Changes in discount rate: profit or loss or OCI	Changes related to future service: offset against the margin*	Offset changes related to future services
Changes in cash flows related to future services: offset against the margin*			

Example:

Statement of profit or loss and OCI - e

- Insurance contract revenue (premium) is allocated to periods in proportion to the value of coverage (and other services) by reference to the estimated pattern of expected claims and expenses.
- Insurance contract revenue excludes the amounts to be paid to policyholders regardless of whether an insured event occurs ('the investment component')
- Written and earned premiums will be replaced by a new measure, insurance contract revenue that is fundamentally different.
- Amounts related to reinsurance ceded will continue to be separately presented from amounts related to direct insurance contracts.

Presentation (an example)	
Insurance contract revenue	**475**
Claims and benefits incurred	(320)
Fulfilment expenses incurred	(60)
Recognition of acquisition costs	(20)
Changes in estimates of future cash flows (if not offset against the contractual service margin)	(10)
Losses on initial recognition of insurance contracts	(30)
Unwind of previous changes in estimates	5
Underwriting result (Gross margin)	**40**
Investment income	60
Insurance finance expense (i.e. Interest on insurance liability)	(54)
Profit or loss	**46**
Other comprehensive income:	
Change in insurance contract liability due to changes in discount rate	9
Fair value movements on FVOCI assets	(10)
Total comprehensive income	**45**

Presentation

- **Statement of financial position**
  - **Presentation of statement of financial position**
    - **An entity presents separately:**
      - **portfolios of insurance contracts that are in an asset position; and**
      - **portfolios of insurance contracts that are in a liability position**
    - **Reinsurance contract assets/liabilities would be presented separately from insurance contract assets/liabilities**
    - **General IAS 1 presentation requirements apply.**

Disclosures

Information should be disclosed at a *level of granularity* that helps users assess the effects contracts have on…

Financial position

Financial performance

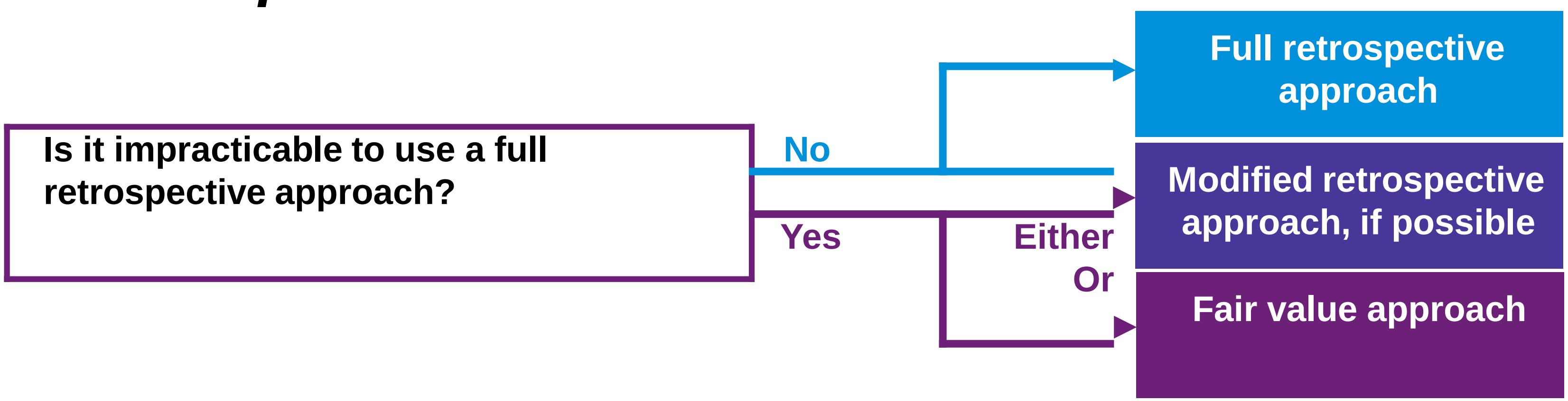
Cash flows

New disclosures relate to *expected profitability* and *attributes of new business*

Transition

Full retrospective approach is required…

… but *expedients can be used*



A company can apply *different approaches for different groups*

Making the transition

Comparative information is *restated*

***Limited ability to redesignate* some financial assets on initial application**

Effective date and next steps

Get ready

Fundamental *operational challenges* lie ahead and there isn't much time

You need to NOW…

- ***Complete an initial assessment***
- ***Review your contracts and processes***
- ***Engage your specialists – Actuaries, IT etc***
- ***Plan your accounting policy decisions***
- ***Determine your needs for IT system/ resource changes and use of subject matter experts***

Effective date

Data and system requirements

1 Data requirements

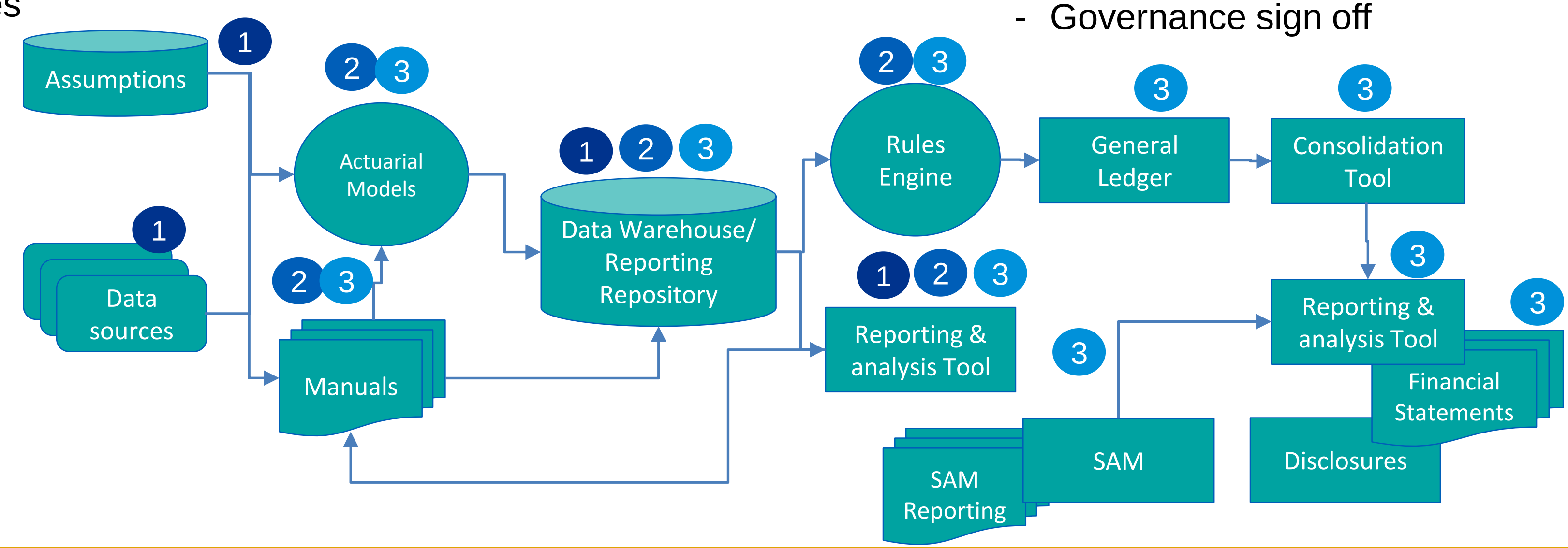
- Estimates of present value of future cash inflows
- Estimates of present value of future cash outflows
- Discount rate
- Risk adjustment
- Data in the original currency
- Retained every time a factor changes

2 Calculations

- Contractual service margin (CSM)
- Risk adjustment
- CSM allocation, unwind
- Interest accretion
- Automated journals
- Separation of investment portion

3 Structures and formats

- New reconciliations
- General ledger structure
- New chart of account lines
- Financial Statements
- Reporting analysis tables
- Governance sign off



Questions & Answers


Thank You


STOP
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