IFRS 17: Insurance Contracts

Transition from IFRS 4 to IFRS 17

Presentation by: Alex Mbai
Partner, KPMG East Africa
ambai@kpmg.co.ke, +254 729 406 468/9
ICPAK
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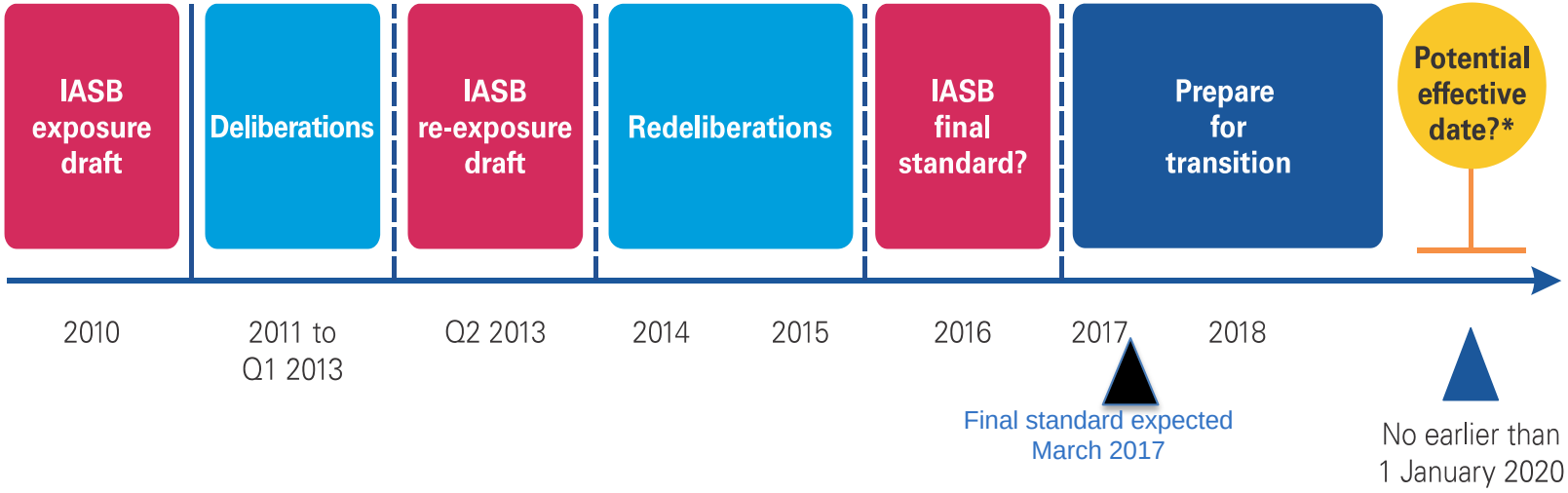
Overview of IFRS 17

- Background and transition from IFRS 4
- Recognition requirements
- General measurement model (GMM)
  - Level of aggregation
  - Initial recognition
  - Subsequent measurement
- Modifications to GMM
- Presentation and disclosures

Background

- Project milestones



* The final standard was issued in May 2017 with effective date of 1 January 2022). Earlier adoption is permitted only if an entity has adopted IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers.*

Scope

Definition of an insurance contract is consistent with IFRS 4

- "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, a new guidance reflecting the notion of a loss and time value of money, derived from US GAAP, has been introduced

Scope

Applies to insurance contracts rather than insurance entities

- 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

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)

Transition from IFRS 4:
Effect Analysis

Area	IFRS 4	IFRS 17
Insurance contract liabilities	• No clear measurement guidelines • Typically presented separately	• Clear measurement guidelines • No change in presentation compared with IFRS 4
Reinsurance contract assets	• No clear measurement guidelines • Typically presented separately	• Clear measurement guidelines • No change in presentation compared with IFRS 4
Insurance contract assets	• Typically netted with insurance contract liabilities	• Presented separately on the balance sheet
Deferred acquisition costs	• Presented separately in some cases	• Included in measurement of insurance contracts and disclosed in the notes

Transition from IFRS 4:
Effect Analysis (cont.)

Area	IFRS 4	IFRS 17
Value of business acquired	• Presented separately in some cases	• Included in measurement of insurance contracts and disclosed in the notes
Premiums receivable	• Typically presented separately as financial assets	• Included in measurement of insurance contracts and disclosed in the notes
Policy loans	• Presented separately in some cases	• Included in measurement of insurance contracts and disclosed in the notes
Unearned premiums	• Typically presented separately for non-life insurance contracts	• Included in measurement of insurance contracts and disclosed in the notes
Claims payable	• Typically presented separately as financial liabilities	• Included in measurement of insurance contracts and disclosed in the notes

Why IFRS 17?

- **IFRS 4 does not address how to measure insurance contracts**
- **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, considers time value for money and returns**

- **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 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

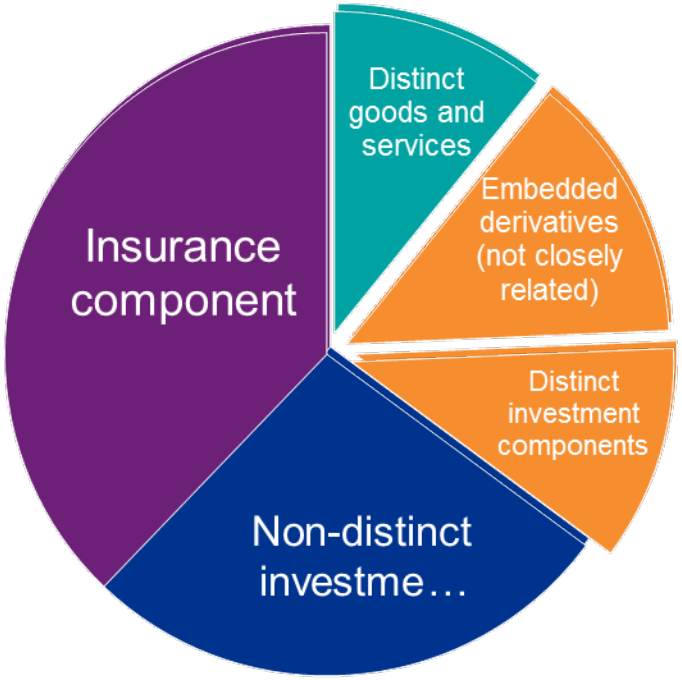
%

LIC discounting

Onerous contracts

Separating non-insurance components

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



- Measured under IFRS 17
- Measured under IFRS 17, but excluded from the aggregate premium and claims
- Measured under IFRS 9, Classification and Impairment principles also apply
- Measured under IFRS 15

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

Recognition

IFRS 17 para 25

- An entity shall recognise a group of insurance contracts it issues at the earliest of:
  - beginning of the coverage period;
  - date when the first payment from a policyholder in the group becomes due; and
  - for a group of onerous contracts, when the group becomes onerous

The general measurement model

Initial recognition

IFRS 17 para 32

- On initial recognition, an entity measures a group of insurance contracts at the total of:
  - future fulfilment cash flows (FCF); and
  - contractual service margin (CSM).
- FCFs comprise:
  - estimates of future inflows and outflows;
  - adjustment for time value of money and financial risks related to the cash flows;
  - risk adjustment for non-financial risk
- CSM represents the unearned profit, recognised over the coverage period

Initial recognition

Key components

Fulfilment cash flows

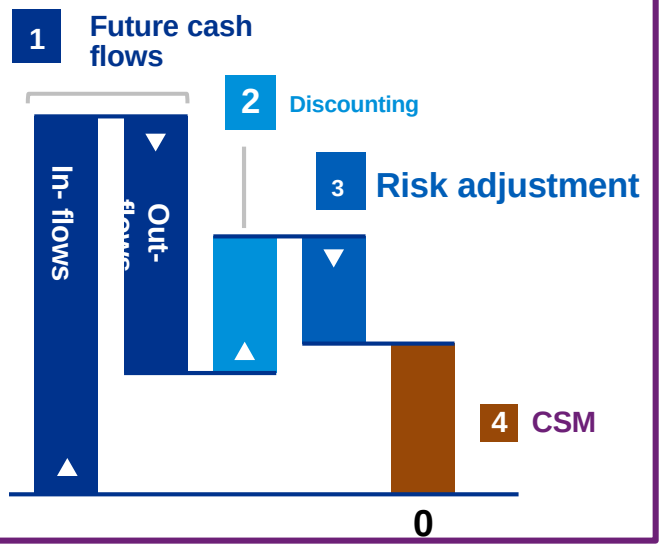
Risk-adjusted present value of future cash flows – e.g. premiums, claims

1
2
3

Contractual service margin (CSM)

Represents unearned profit – results in no gain on initial recognition

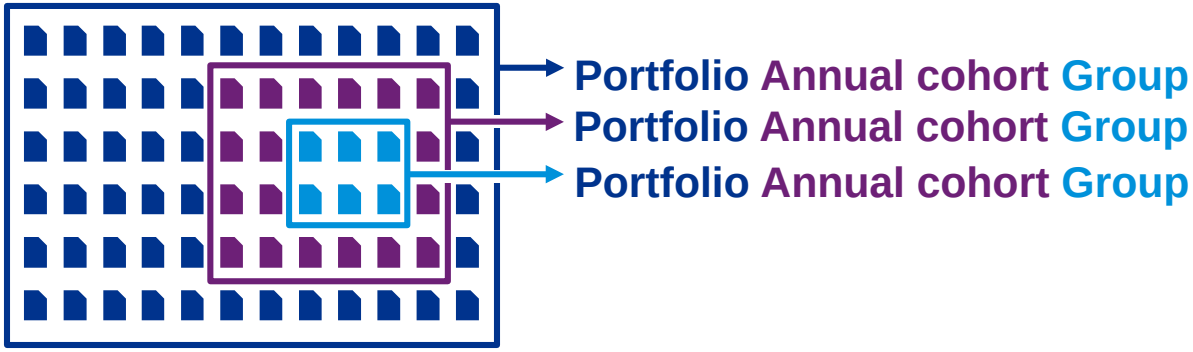
4



Net cash outflows result in *no CSM* – a *loss* is recognised immediately (onerous contracts)

Level of aggregation

The CSM is determined for groups of insurance contracts

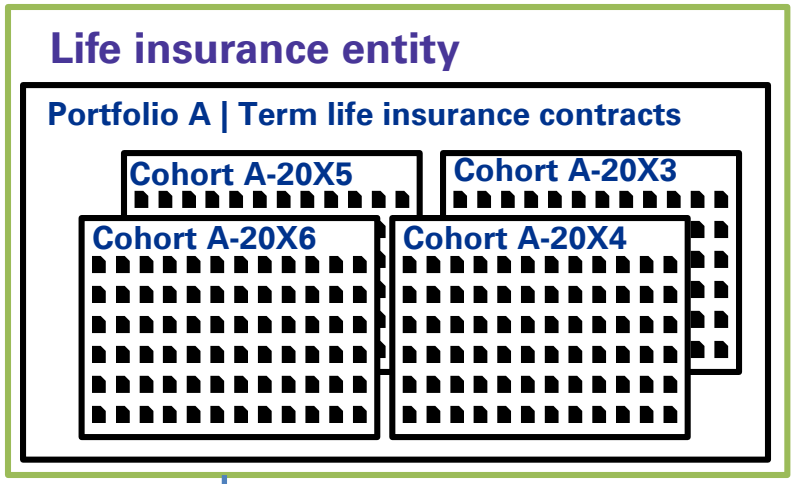


Insurers will need to:

- **Identify *portfolios* of insurance contracts (similar risks and managed together) [IFRS 17.14]**
- **Divide the portfolios into *groups***

IFRS 17 limits offsetting of onerous contracts against profitable ones

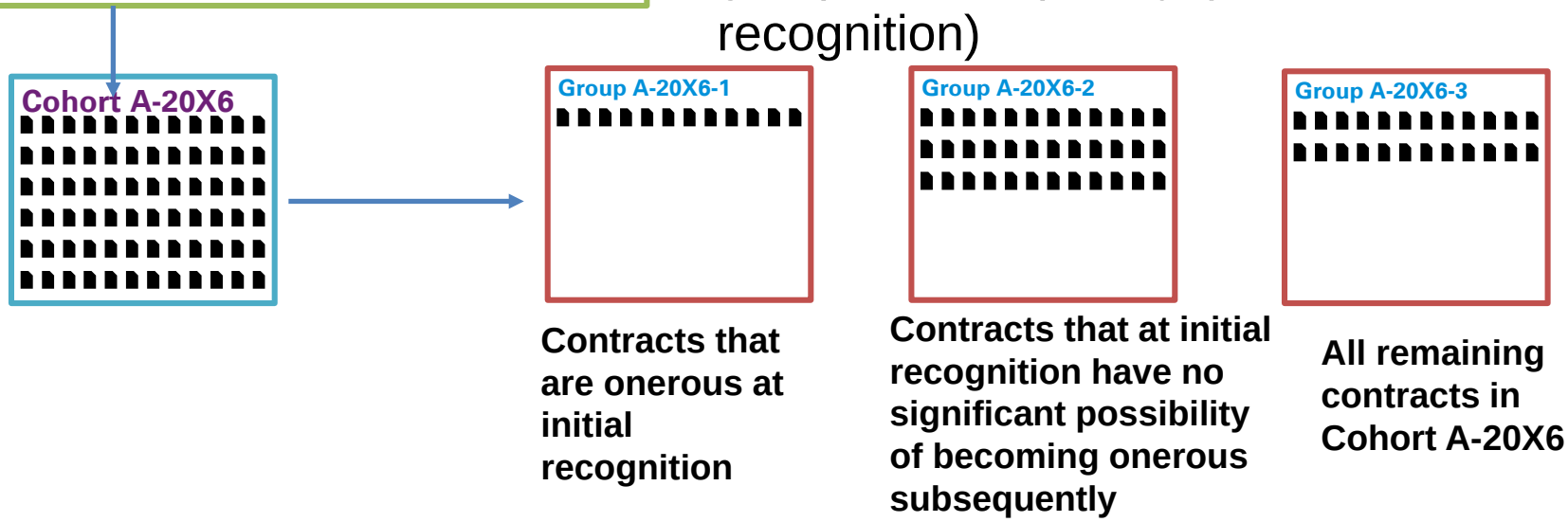
Level of aggregation



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)

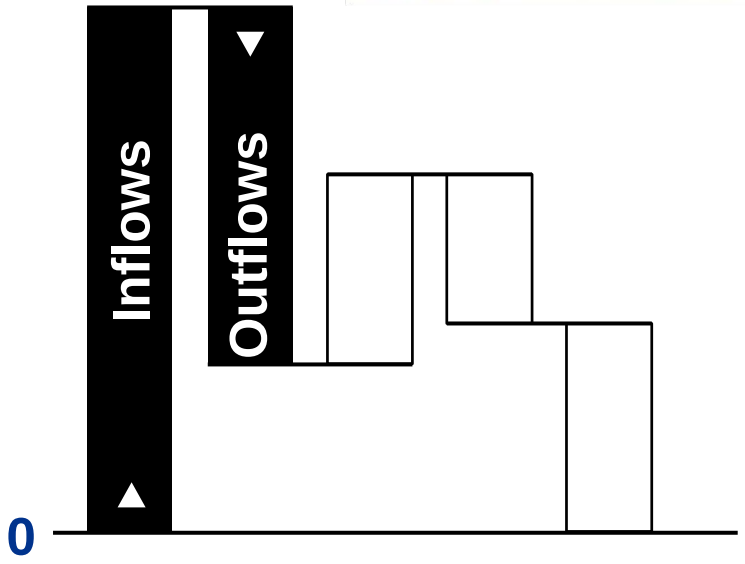


Issuing contracts over multiple reporting periods

- 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 reporting period in which the new contracts are added to the group.

Estimates of future cash flows

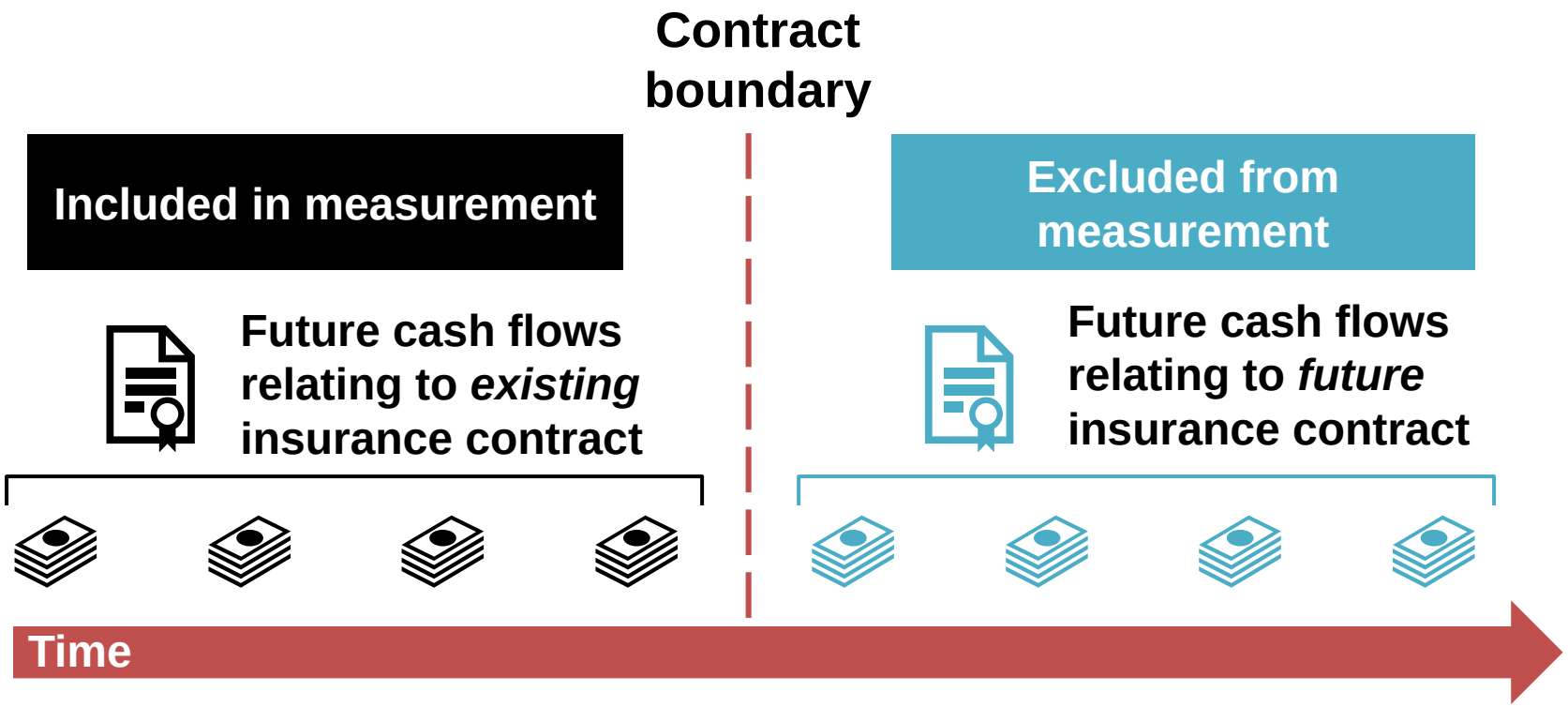
- Includes all *reasonable and supportable information available* without undue cost or effort.
- Estimated based on the *entity's perspective* but consistent with observable market prices for market variables.
- The cash flows *may be estimated at a higher level* than the group of contracts level.



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

-

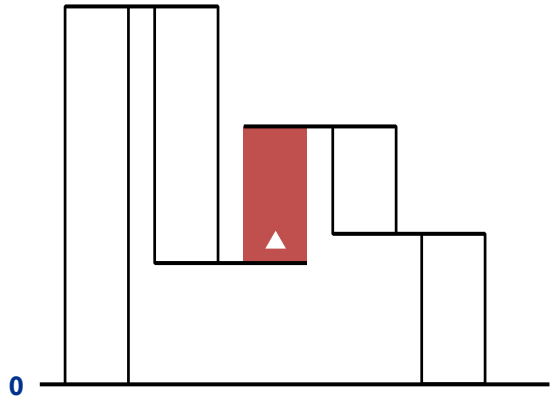
Costs of providing benefits in kind

-

\+ 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.

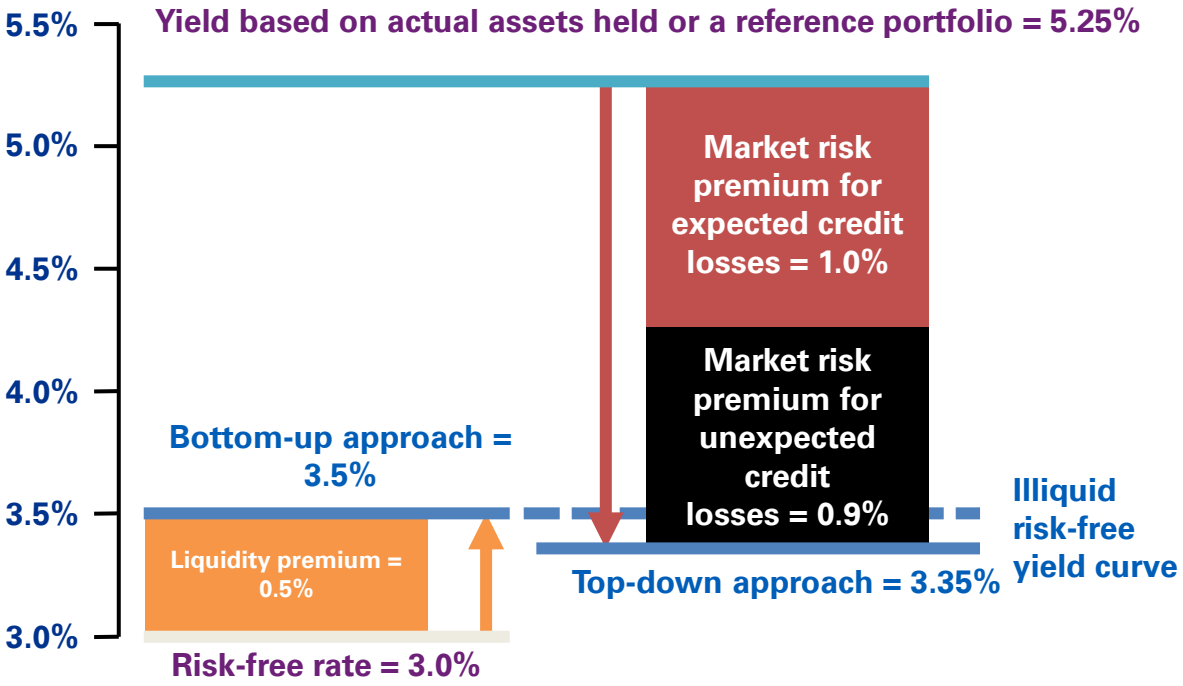


2 Discounting

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.

Discounting: Example

Discount determination: bottom-up and top-down approaches



Under the top-down approach, an entity does not need to adjust for differences in liquidity characteristics

Risk adjustment (RA) for non-financial risk

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

Cost of Capital Appoach RA $= \sum_{i=1}^{n} \frac{r_t \cdot SCR_t}{(1+d_t)^t}$

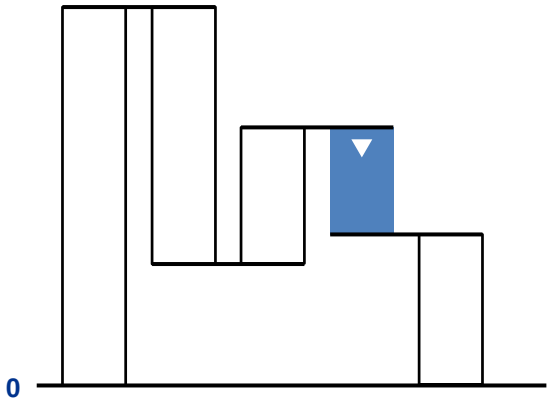
where

SCR_t – capital amount at time t,

r_t – cost of capital rate,

d_t – selected discount rate(s) that reflect the yield curve.

SCR is calibrated in such a way that with 99.5% probability the company can fulfil its liabilities over 1-year horizon.



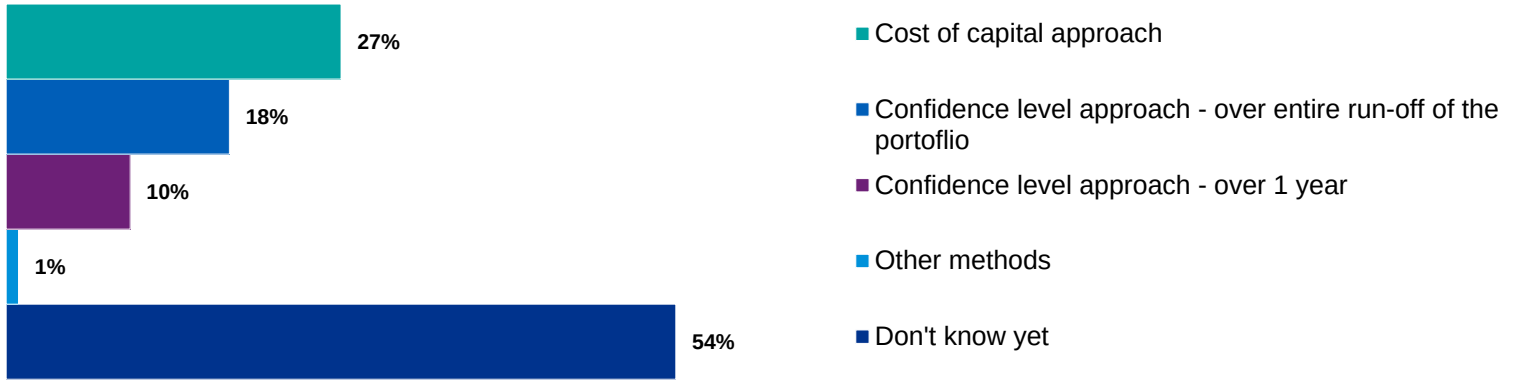
3 Risk adjustment for non-financial risk

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, ***IFRS 17.37***

Risk adjustment methods

Two main methods of risk adjustment calculation are being discussed in the industry

Companies' expectations regarding the risk adjustment calculation method, 2018*



* KPMG research "In it to win it ", 2018 Q2, 160 insurers from more than 30 countries

Cost of capital approach

- Use of cost of capital calculation methodology from Solvency II for risk adjustment calculation
- Risk adjustment calculation approach almost completely follows the method of risk margin calculation (however only non-financial risks should be considered)

Confidence level approach (VaR)

- Risk adjustment is calculated as an amount that needs to be added to the best estimate for fulfilling the company's liabilities within a certain time internal with a given probability
- For example, the time interval can be determined as full expiration of liabilities for the portfolio or 1 year

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

Lower risk adjustment

- 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

Higher risk adjustment

RA for different types of liabilities

IFRS 17 separates liabilities for remaining coverage and liabilities for incurred claims

IFRS 17.40

- Calculation of risk adjustment for liability for remaining coverage is required when applying GMM and VFA.
- For PAA, risk adjustment for liability for remaining coverage is not calculated, as it is determined on the unearned premiums basis

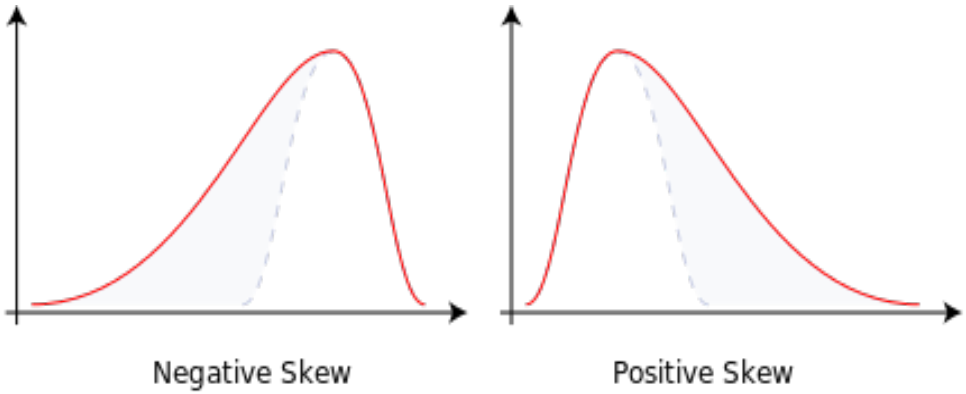
- Risk adjustment calculation for liability for incurred claims is closely related to existing estimation techniques of incurred claims: chain ladder method, Bornhuetter-Ferguson method, etc.

- According to KPMG research* **84% of insurers** expect that more than **80% of their non-life insurance business** will comply with the requirements for **PAA application.**
- **Non-life insurance:** the most material issue will probably be the calculation of risk adjustment for **lability for incurred claims**
- **Life insurance:** due to long-term guarantees embedded in life contracts it is expected that the most material issue will be the calculation of risk adjustment for **liability for remaining coverage.**

* KPMG research “In it to win it ”, 2018 Q2, 160 insurers from more than 30 countries

RA: Probability characteristics

1. Skewness

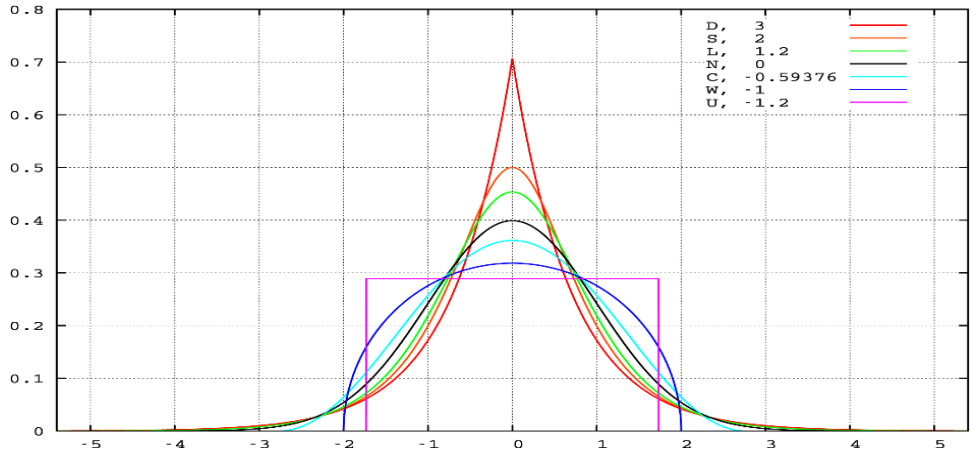


- Skewness reflects the slope of distribution density:

$$\gamma = \frac{E\ (L - m)^3}{\sigma^3}$$

- Distributions with positive skewness have longer right tail, which can influence the confidence level for a given level of provisions for liabilities. .

2. Kurtosis



- Kurtosis reflects the shape of distribution density and affects a distribution's tail length

$$\kappa = \frac{E\ (L - m)^4}{\sigma^4} - 3$$

- With increase of kurtosis the number of statistical outliers increases together with their deviation from the mean, which can affect the confidence level for a given level of provisions for liabilities

RA: Confidence level disclosure for LRC – Non-Life Insurance

IFRS 17.119

Line 1: Property

Claims development				
	1	2	3	4
20XXQ1	XXX	XXX	XXX	**XXX**
20XXQ2	XXX	XXX	**XXX**	XXX
20XXQ3	XXX	**XXX**	XXX	XXX
20XXQ4	**XXX**	XXX	XXX	XXX

Line 2: Motor

Claims development				
	1	2	3	4
20XXQ1	XXX	XXX	XXX	**XXX**
20XXQ2	XXX	XXX	**XXX**	XXX
20XXQ3	XXX	**XXX**	XXX	XXX
20XXQ4	**XXX**	XXX	XXX	XXX

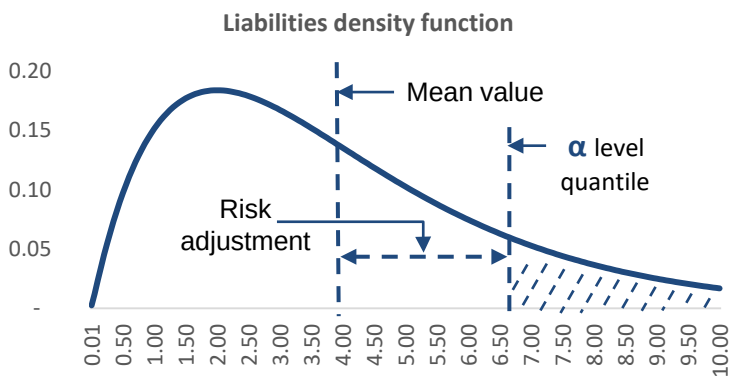
Line 3: …

Claims development				
	1	2	3	4
20XXQ1	XXX	XXX	XXX	**XXX**
20XXQ2	XXX	XXX	**XXX**	XXX
20XXQ3	XXX	**XXX**	XXX	XXX
20XXQ4	**XXX**	XXX	XXX	XXX

Step 1: Derive parameters of liabilities' distribution for each business line. For instance:

- Mean
- Standard deviation
- Skewness
- Kurtosis

Dependence between lines of business: $Corr_{ij}$

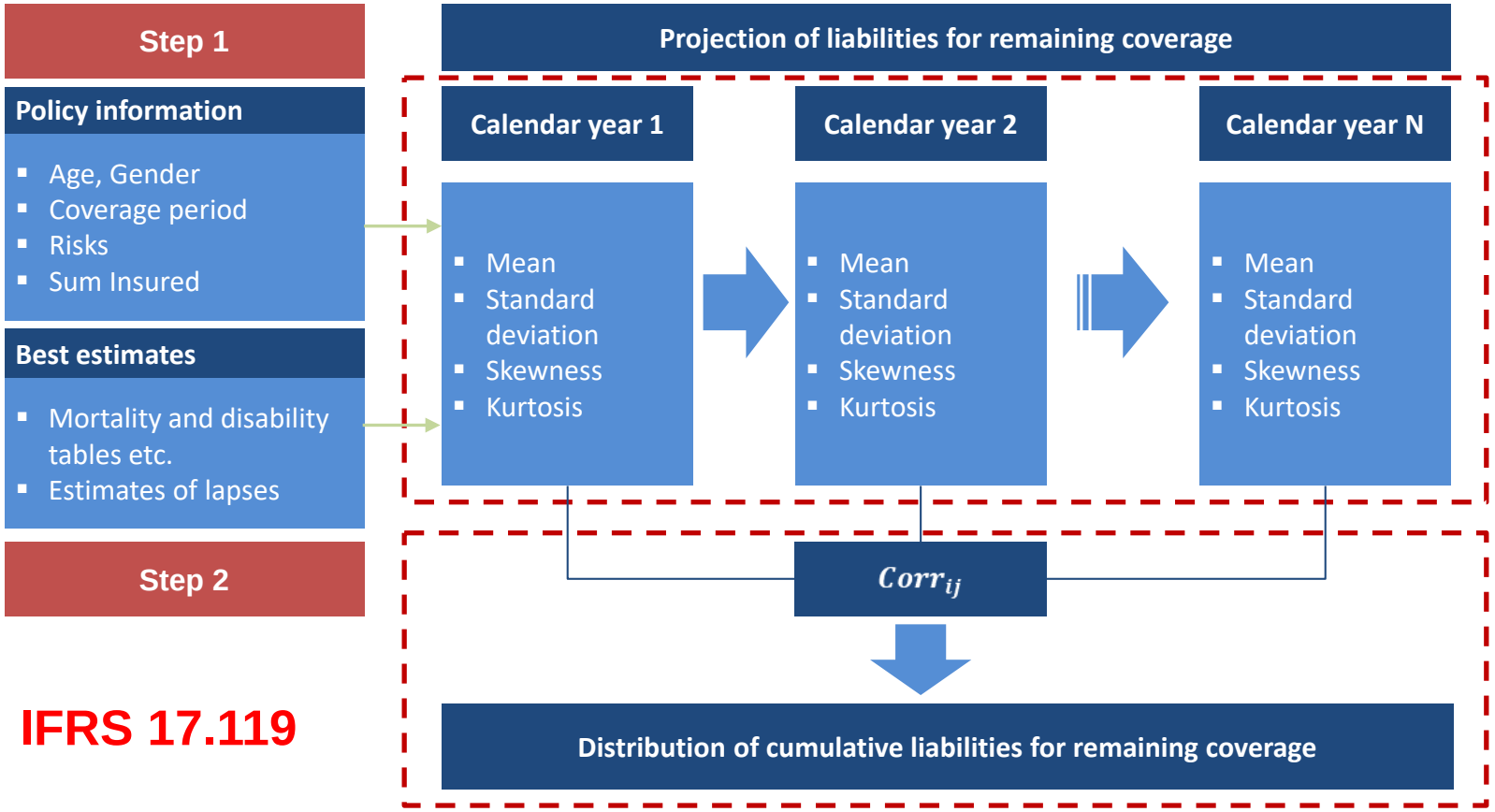


Step 2: Assessment of dependence between business lines, aggregation of business lines and fitting or approximation of liabilities distribution for the whole portfolio.

Estimation of confidence level that corresponds to a given risk adjustment amount

! The method can be used not only for confidence level calculation, but also for risk adjustment calculation using VaR method.

RA: Confidence level disclosure for LRC – Life Insurance

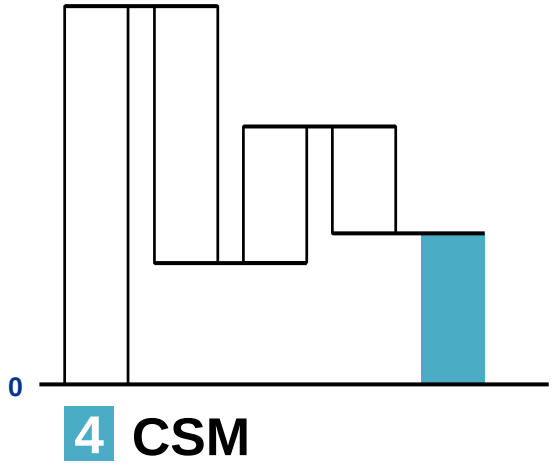


IFRS 17.119

Contractual service margin

For profitable groups of contracts it:

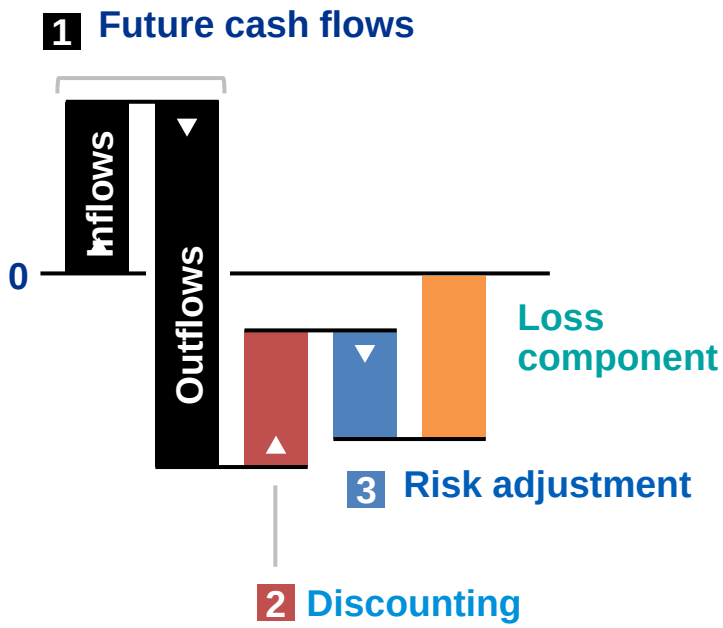
- Represents *unearned profit*, and
- Results in *no gain arising on initial recognition* of the group.



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

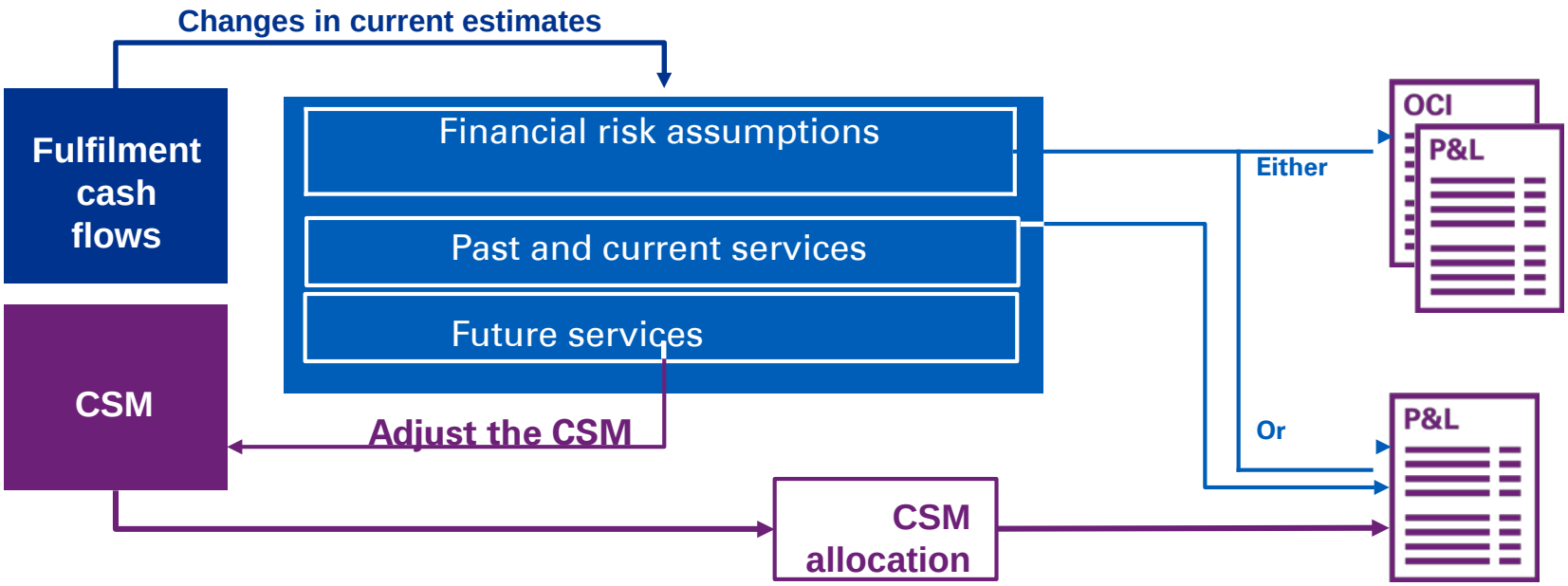
- Fact pattern:
  - Group of 50 contracts, each with a coverage period of 4 years.
  - Single premiums of 25 per contract received immediately after initial recognition.
  - Directly attributable insurance acquisition cash flows of 100 are allocated to the group.
  - Expected claims and expenses of 1400, 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



Subsequent measurement – financial position

IFRS 17 para 40

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)

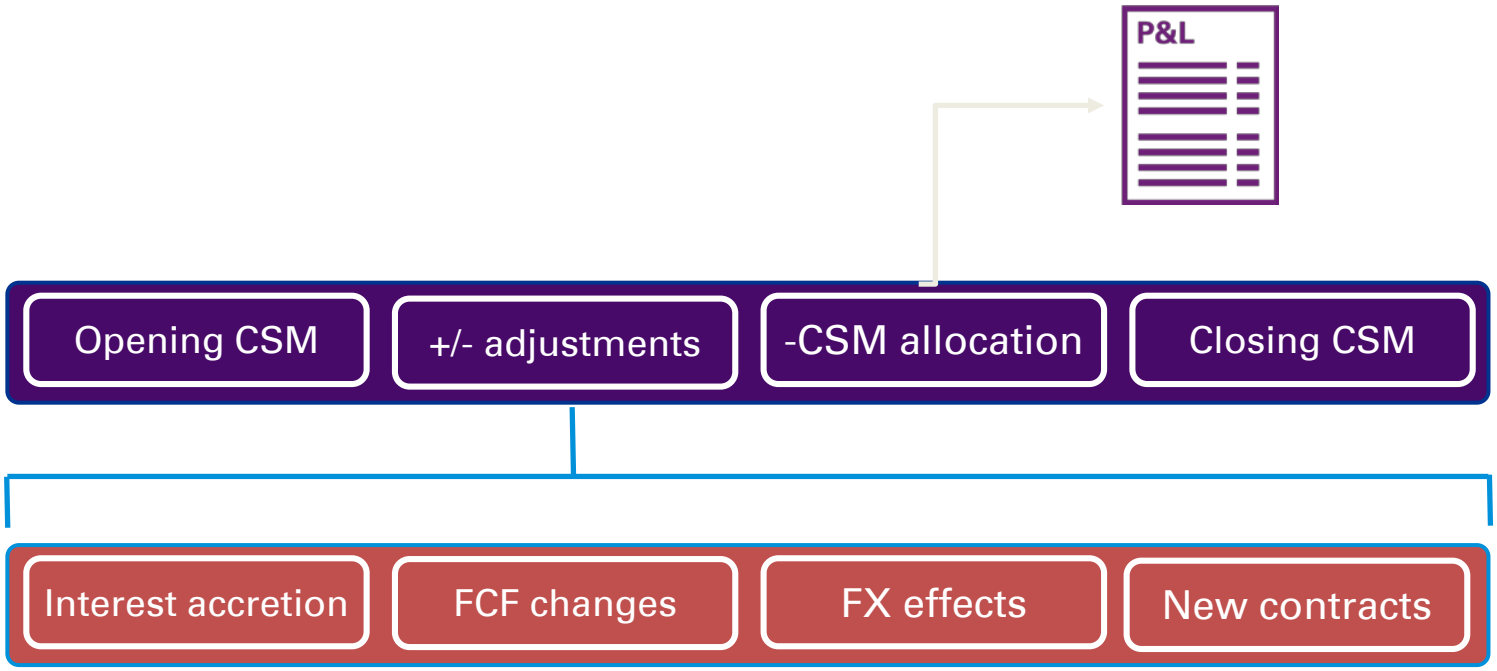
Fulfilment cash flows for claims incurred, but not yet paid

Subsequent measurement – profit or loss

Caption	Changes in LRC [IFRS 17.41]	Changes in LIC [IFRS 17.42]
Insurance revenue	• Reduction in LRC because of services provided in the period	• Not applicable
Insurance service expenses	• Losses on groups of onerous contracts • Reversals of such losses	• Increase in LIC because of claims and expenses incurred in the period • Subsequent changes in FCFs relating to incurred claims and expenses
Insurance finance income or expenses	• Effect of time value of money and financial risk	• Effect of time value of money and financial risk

CSM allocation

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



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

Subsequent measurement Refer to example 1:

- 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)
Claims paid	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)

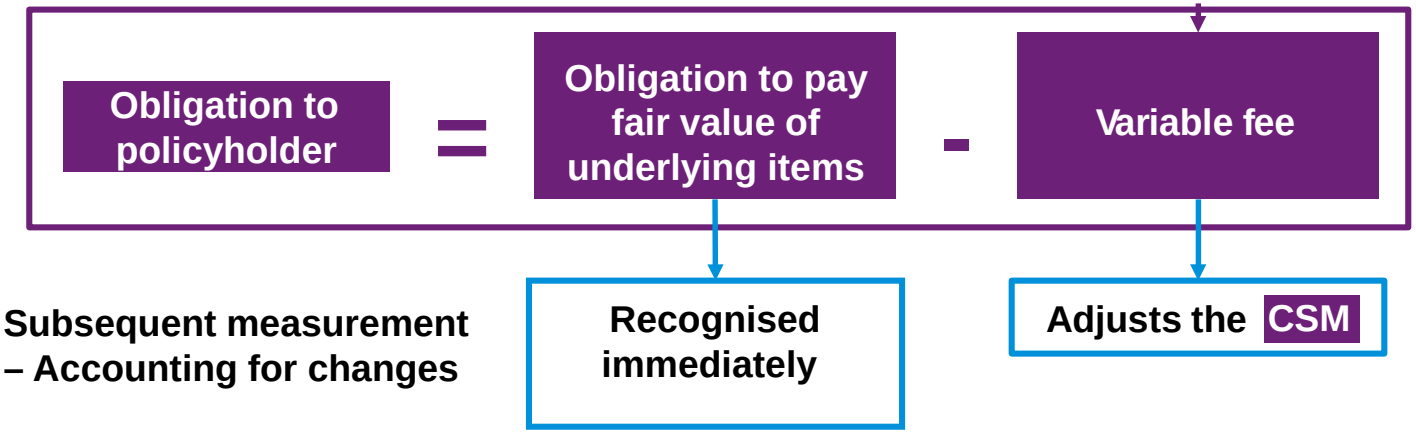
May need to be discounted

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



The VFA reduces the volatility of net results

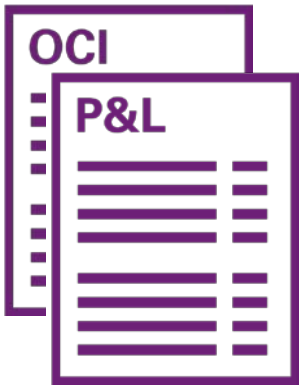
For reinsurance contracts held…

- **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***

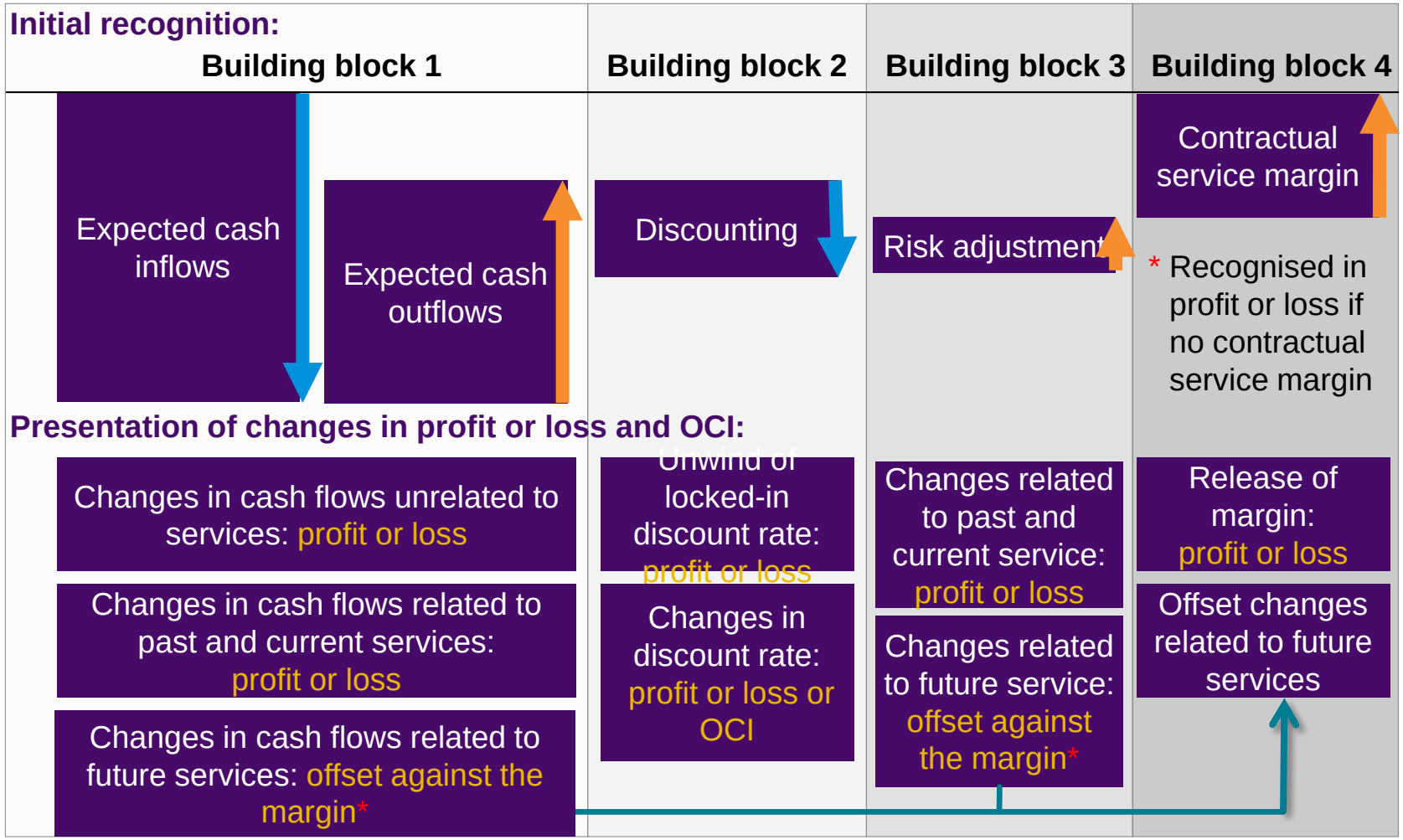
Presentation and disclosures

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



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

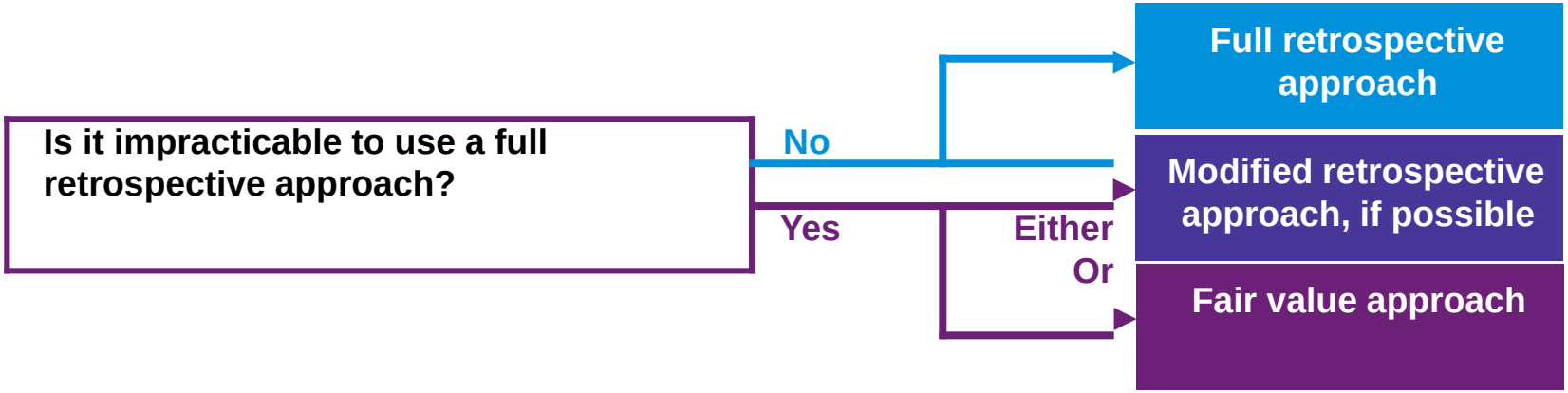
Cash flows

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

Implementation

Full retrospective approach is required…

… but *expedients can be used*

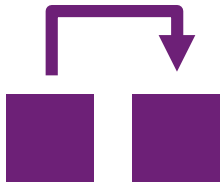


A company can apply *different approaches for different groups*

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 and testing***
- ***Review your contracts and processes***
- ***Engage your specialists – Actuaries, IT etc***
- ***Plan your accounting policy decisions***
- ***Determine your needs for IT system/ resource changes, new designs, dry runs and use of subject matter experts***

Effective date

1 January 2022

Data and system requirements

1 Data requirements

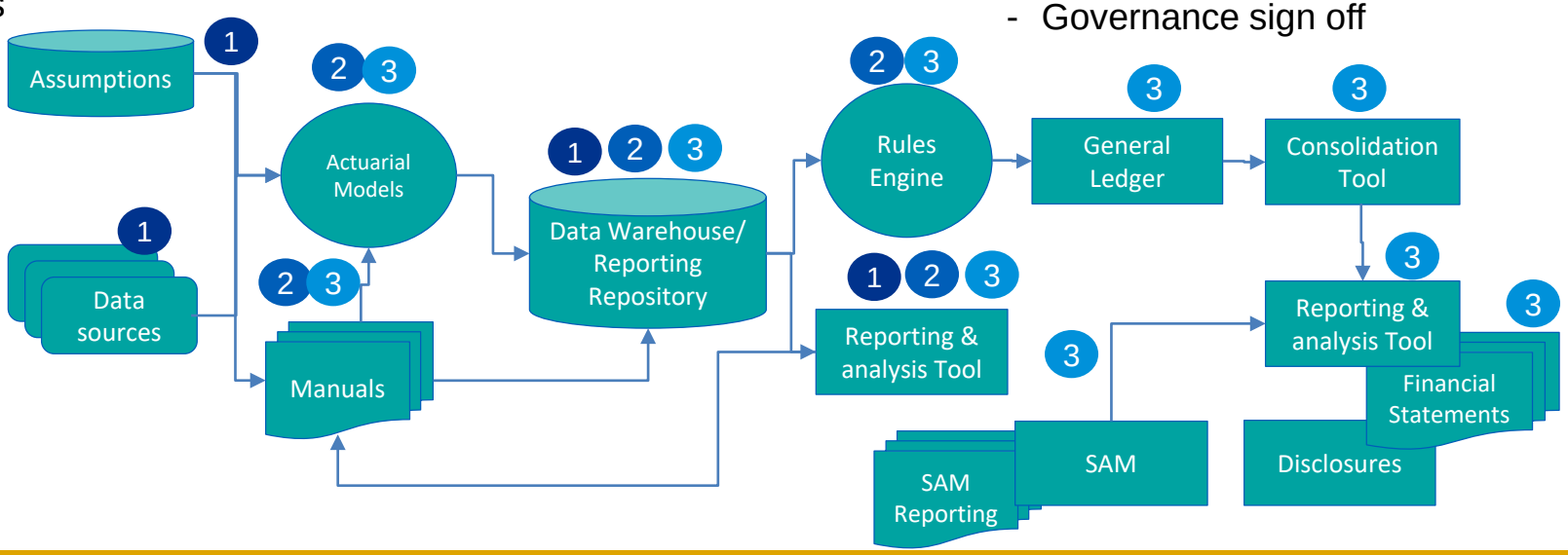
- Estimates of present value of future cash inflows
- Estimates of present value of future cash outflows
- Discount rate
- Risk adjustment
- Data in the original currency
- Retained every time a factor changes

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



Implementation work streams

Project and change management

Manage the project and deliverables
Provide progress updates and weekly monitoring

Define change management strategy
Support people change assessment and communication strategy

Finance and accounting

Assess accounting options
Support in the assessment of technical accounting options and functional requirements

Assess the impact on financial information
Assess the impact on primary statements, KPIs and new disclosures and define approach to external communication

Actuarial methods and modelling

Assess actuarial hypothesis
Support with the definition of actuarial hypotheses for the calculation of IFRS 17 liabilities

Assess actuarial calculation and tools impacts
Identify changes required in the model to support the new calculation and changes in profit profiles

Data, systems and processes

Assess impact of current system architecture and data flows
Support validating current as-is and identify key elements of the architecture impacted, including data

Define high level architectural design
Support in the definition of the changes required in the system architecture, data flows and process to support new requirements

Wrap up

Key decisions will need to be made to formulate assumptions upon which process, data, systems and reporting solution implications can be assessed

Q&A