Society of Actuaries in Ireland

Introduction to IFRS 17

9 November 2018

Disclaimer

The views expressed in this presentation are those of the presenter(s) and not necessarily of the Society of Actuaries in Ireland

Agenda

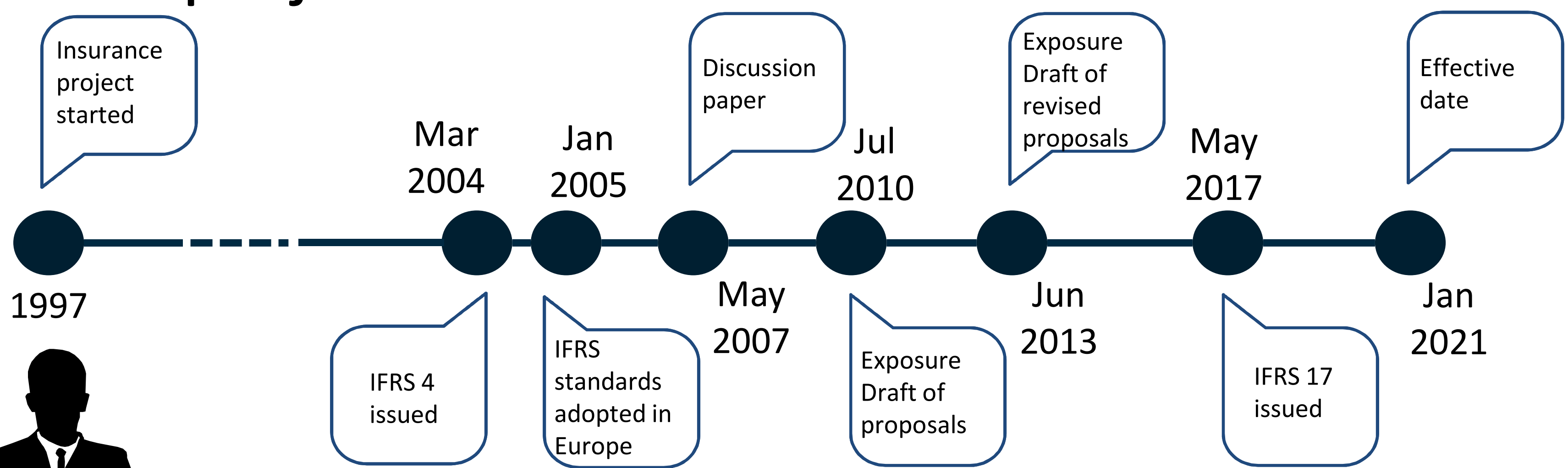
- Background and overview
- Classification and unbundling
- Aggregation level (unit of account)
- Measurement models
- Transition
- Presentation and disclosures
- IFRS 17 – wide ranging impacts
- Example steps to expected adoption date
- Summary

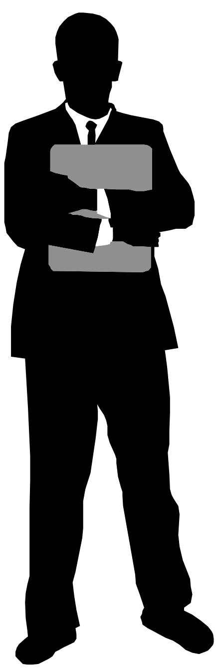
Abbreviations

AoC	Analysis of change	**IASB**	International Accounting Standards Board
BBA	Building Block Approach	**MRA**	Modified retrospective application (on transition)
BEL	Best estimate liability	**OCI**	Other comprehensive income
BoP	Beginning of period	**PAA**	Premium Allocation Approach
CoA	Chart of accounts		
CoC	Cost of capital	**RA**	Risk Adjustment
CSM	Contractual Service Margin	**RM**	Risk margin under Solvency II
EFRAG	European Financial Reporting Advisory Group	**SII**	Solvency II
EoP	End of period	**TRG**	Transition Resource Group
GM	General Model	**UoA**	Unit of account
FCF	Fulfilment cash flows	**VFA**	Variable Fee Approach
FRA	Full retrospective application (on transition)	**YE**	Year-end
FVA	Fair value approach (on transition)		

Background to the Standard

IASB's project on insurance contracts





- IFRS 9 – some insurers will use deferral option until 1 January 2021 based on IFRS 4 amendments
- IFRS 15 is effective 1 January 2018, IFRS 16 is effective 1 January 2019
- Investment contracts without discretionary participation features (e.g. unit linked investments) are in scope of IFRS 9 / IAS 39
- EU endorsement was due in 2019 (see later re potential delay)
- FASB decided to only make targeted amendments to US GAAP

Why IFRS 17?

Existing issues	How IFRS 17 improves accounting
Variety of treatments depending on type of contract and company	Consistent accounting for all insurance contracts by all companies
Estimates for long-duration contracts not updated	Estimates updated to reflect current market-based information
Discount rate based on estimates does not reflect economic risks	Discount rate reflects characteristics of the cash flows of the contract
Lack of discounting for measurement of some contracts	Measurement of insurance contract reflects time value where significant
Little information on economic value of embedded options and guarantees	Measurement reflects information about full range of possible outcomes

The information presented on the slide was prepared by IFRS Foundation.
http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Documents/2016/project-overview-Feb-2016.pdf

Scope of IFRS 17

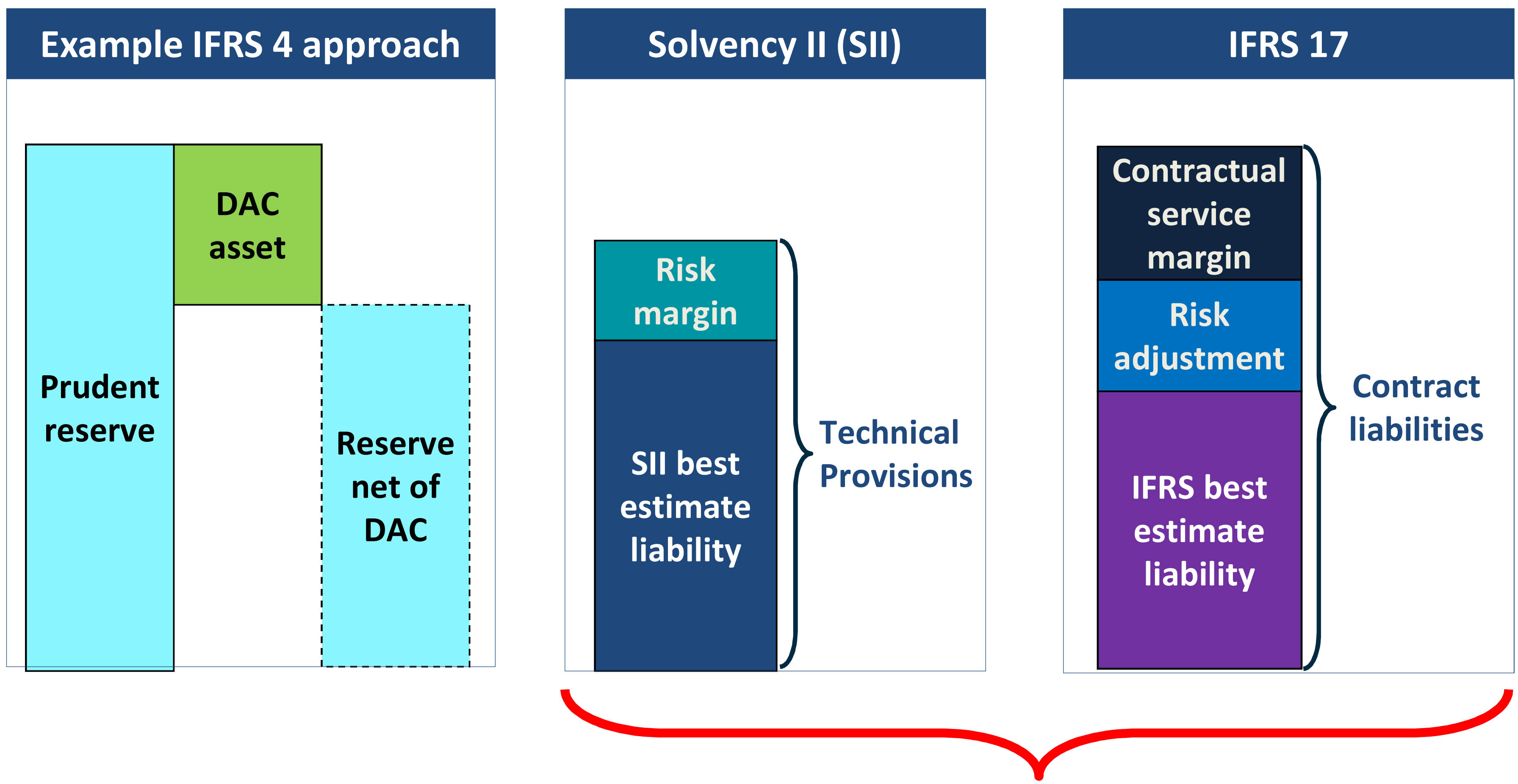
- IFRS 17 is the new international accounting standard for insurance contracts
  - **replaces the existing IFRS 4 standard**
  - provides a single global accounting standard for insurance contracts
  - will fundamentally change the measurement and reporting of insurers' insurance contracts and it will involve **significant change to organisations' business models**.

- Applies to annual periods **beginning on or after January 1, 2021**
  - comparative balance sheets will need to be prepared for **both December 31, 2021 and 2020**
  - earlier application is permitted if IFRS 15, Revenue from Contracts with Customers, and IFRS 9, Financial Instruments, are also applied

- Requires a **fully retrospective implementation on transition** to all in-force contracts
  - simplification options exist where insufficient data is available to apply a full retrospectively methodology (i.e. modified/simplified retrospective approach and/or fair value approach).

How does IFRS 17 compare to IFRS 4 and SII?

NB: relative component sizes are for illustration purposes only!



Similar methodologies
but some significant differences!

Contract classification

An entity **applies IFRS 17 to contracts** that are:

- insurance or reinsurance contracts issued (i.e. sold);
- reinsurance contracts issued and held (i.e. sold and acquired); or
- investment contracts with discretionary participation features issued, if the company also issues insurance contracts.

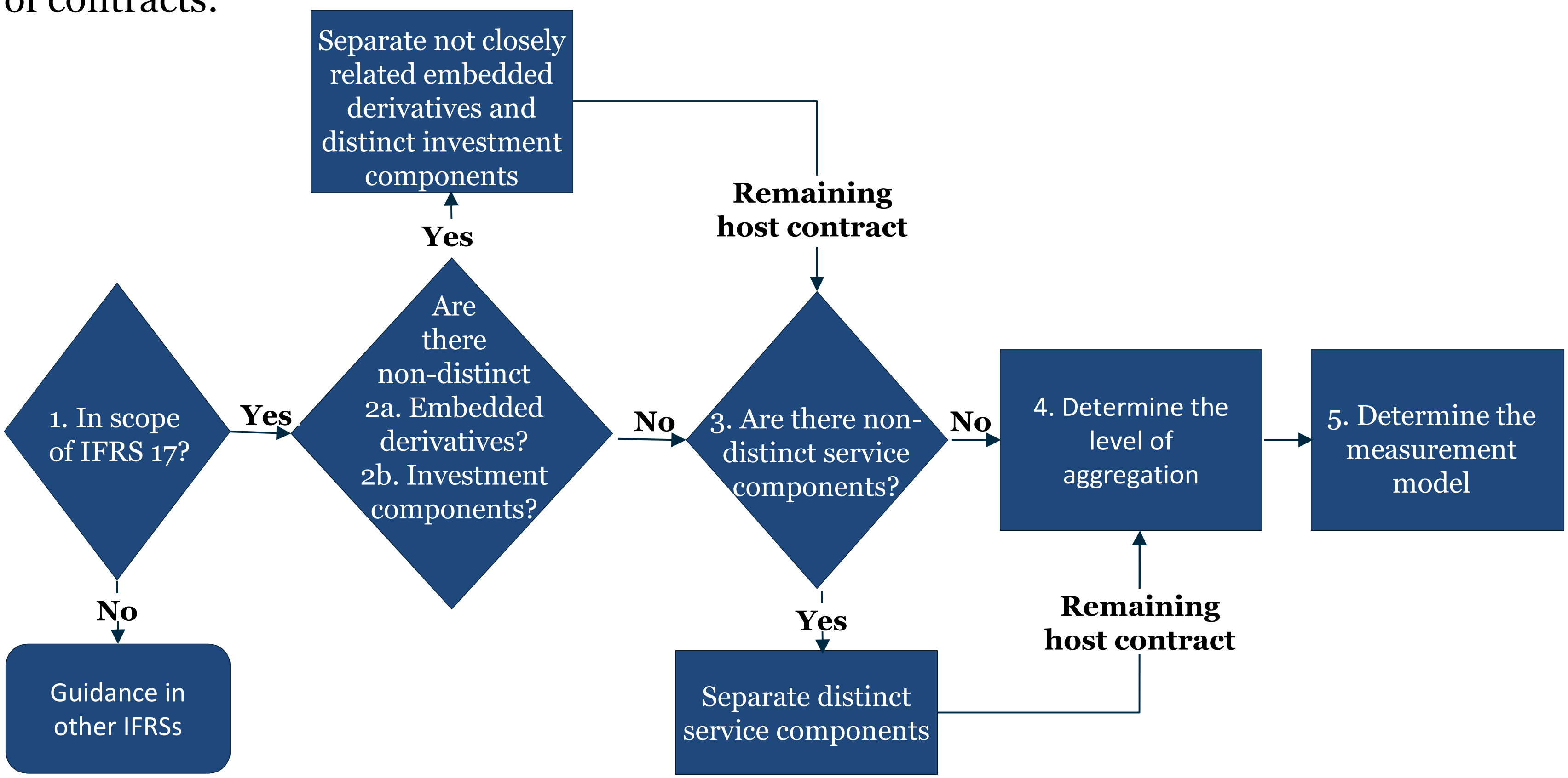
IFRS 17 defines **insurance contracts** as contracts under which significant insurance risk is transferred.

What is ***significant*** insurance risk?

- An insurance risk is only significant if there is at least one scenario in which the insured event results both in significant additional payments and also in an overall loss for that particular contract. To assess whether this is the case, **the insurer assesses a possibility of a loss on a present value basis**. This requirement did not exist in IFRS 4.
- The significance of the insurance risk is assessed on a contract-by-contract basis. Accordingly, the insurance risk can be significant, even if there is minimal probability of significant losses for a portfolio or a group of contracts.

Unbundling

Flowchart showing the walk from initial recognition of contracts through to measurement of contracts:



Aggregation (unit of account)

1. Objective

Profitable vs onerous contracts

No CSM at the end of coverage period

2. Aggregation requirements*

Top-down approach:
Start at portfolio level (similar risks, managed together)

3 groups at inception **:
- Onerous;
- Profitable with no significant risk of becoming onerous; and
- Other profitable contracts

Risk of contracts becoming onerous:
- Internal reporting
- Sensitivity of fulfilment cash flows

Requires that a group shall not include contracts issued more than one year apart

Effect of regulation

Some laws or regulations prevent insurers from pricing for certain risk indicators (eg gender)

If a law or regulation specifically constrains
- insurer's practical ability to set a different price or level of benefits for policyholders with different characteristics,
- then ignore that characteristic for grouping (eg male or female drivers)

*Exception for the level of aggregation on transition.
**There may be no contracts in one or two of the indicated profit groups.

Aggregation (unit of account)

Examples

1

100 'identical' contracts are written with a probability that 5 of the policyholders will claim.

IFRS 17

100 contracts are a group; company does not treat the 5 contracts as a separate group

2

A company issues 500 contracts; there is information that 200 'identical' contracts are onerous (loss making), but the company expects that the 300 profitable 'identical' contracts will cover losses on the 200 onerous contracts.

IFRS 17: Group A

Losses on the 200 onerous contracts are recognised immediately

IFRS 17: Group B

Profits on 300 contracts recognised over the coverage period

Aggregation (unit of account)

- **Companies will need to set a definition of 'similar risks' and 'managed together' and complete a profitability analysis**
- **Significant impact on modelling and data storage requirements**
- **Unit of account granularity can impact profit levels and increase volatility of profit**

Introduction to Measurement under IFRS 17

Premium Allocation Approach

- Short-term general insurance
- Short-term life and certain group contracts

Building Block Approach

- Long-term business
- Whole life insurance,
- Term assurances,
- Protection business
- Annuity Contracts
- Reinsurance written
- Certain general insurance contracts

Variable Fee Approach

- Unit-linked contracts,
- Variable annuities and equity index-linked contracts
- Continental European 90/10 contract
- UK with profits contracts
- Unitised with profits

Building Block Approach/General Model

The general model a.k.a the building blocks approach ("BBA")

Principles

- Measurement uses **current estimate** assumptions
- Contracts are **grouped by portfolio, year of sale** and one of the **three possible profitability levels**
- Profit measured and reported based on the delivery of the **"insurance coverage service"**
- Deferred profit absorbs assumption changes for future coverage (**"Unlocking"**)
- **Discount rates based on market interest rates** (currency, duration, liquidity)
- **Expected profit from participating contracts revalued based on assets**

Total IFRS Insurance Liability

Block 4: Contractual Service Margin ("CSM")

Measured at inception as the expected contract profit to be earned as services are fulfilled. It is **adjusted for changes in non-financial variables** affecting future coverage cash flows. It **accretes interest based on day 1 discount rate** (locked-in rate)

Fulfilment cash flows

Block 3: Risk Adjustment

An entity-specific assessment of the uncertainty about the amount and timing of future cash flows

Block 2: Time Value of Money

An adjustment that converts future cash flows into current amounts

Block 1: Expected Future Cash Flows (unbiased probability weighted mean)

Expected (probability-weighted) cash flows from premiums, claims, benefits, expenses and acquisition costs

Building Block Approach/General Model

Initial Recognition

Earliest of

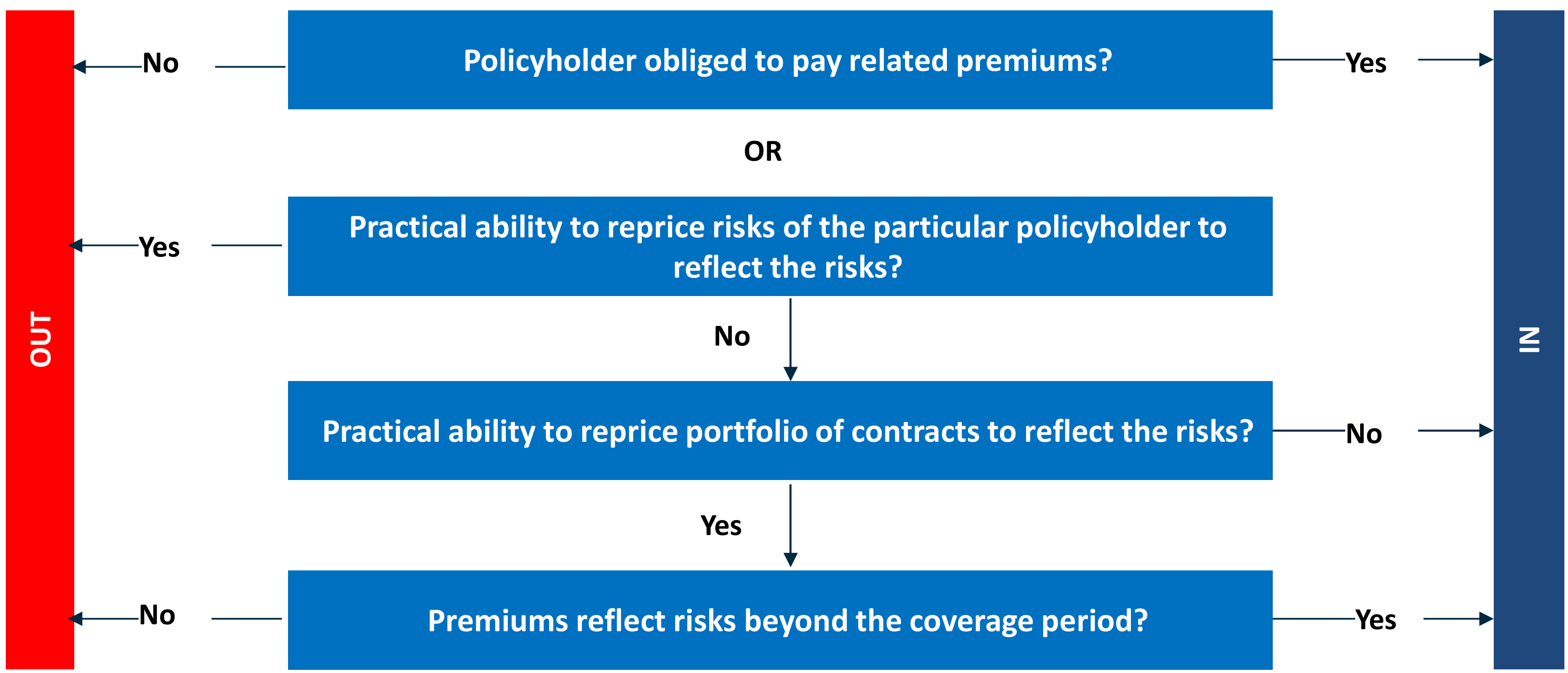
- Coverage period starts
- First payment from policyholder is due or actually received
- Group of contracts is onerous

Can include individual contracts in already existing group only when issued

Building Block Approach/General Model

Contract Boundaries

Is the cash flow in the boundary of an insurance contract?



Building Block Approach/General Model

Block 1: Cashflows included and excluded in best estimate cashflows

Cash flow included:

- Premiums and cash flows that arise within the "contract boundary"
- Claims and benefits paid to policyholders, plus associated costs
- Surrender and participating benefits
- Cash flows resulting from options and guarantees
- Costs of selling, underwriting and initiating that can be directly attributable to a portfolio level
- Transaction-based taxes and levies
- Policy administration and maintenance costs
- Some overhead-type costs such as claims software, etc.

Cash flow excluded:

- Investment returns
- Payments to and from reinsurers
- Cash flows that may arise from future insurance contracts
- Acquisition costs not directly attributable to obtaining the portfolio of contracts
- Cash flows arising from abnormal amounts of wasted labor
- General overhead
- Income tax payments and receipts
- Cash flows from unbundled components

Building Block Approach/General Model

Block 2: How will discount rates be determined?

Top-Down Approach

Bottom-Up Approach

Remove factors that are not relevant to the insurance contracts (such as market risk premiums for assets included in the reference portfolio) and adjust for differences between timing of cash flows between the assets and the cash flows of insurance contracts.

Dependent on:
1. Duration
2. Liquidity
3. Currency

A "risk-free rate" **plus** a liquidity adjustment based on the characteristics of liability cash flows.

Building Block Approach/General Model

Block 3: What is a risk adjustment liability?

- Risk adjustment for non-financial risk (RA) measures the **compensation** that the entity requires for it to be **indifferent/neutral between** fulfilling a liability that:
  1. Has a **range** of possible outcomes arising from non-financial risk; and
  2. Will generate **fixed** cash flows with the same expected present value as the insurance contracts.

- Risk adjustment is the **compensation** that the entity requires for bearing **uncertainty** about the **amount and timing** of cash flows that arise from non-financial risk.

- Risk adjustment reflects:
  a) **diversification of risks** the insurer considers, and
  b) both **favourable and unfavourable outcomes** reflecting the entity's degree of risk aversion.

- Risk adjustment reflects **all non-financial risks** associated with the insurance contracts. It shall <u>not</u> reflect financial risks or risks that do <u>not</u> arise from the insurance contracts.

- The risk adjustment is an **entity specific** measurement.

Building Block Approach/General Model

Block 4: Contractual Service Margin ("CSM")

Requirement

- Eliminates gains at inception of a contract.
- The release of the CSM is over the coverage period based on coverage units.
- Measured at "group" level (units of account).
- Requirement to "unlock" CSM for changes in non-market assumptions at each reporting date.
- Negative CSM (onerous losses) needs to be tracked for potential reversal to P&L.

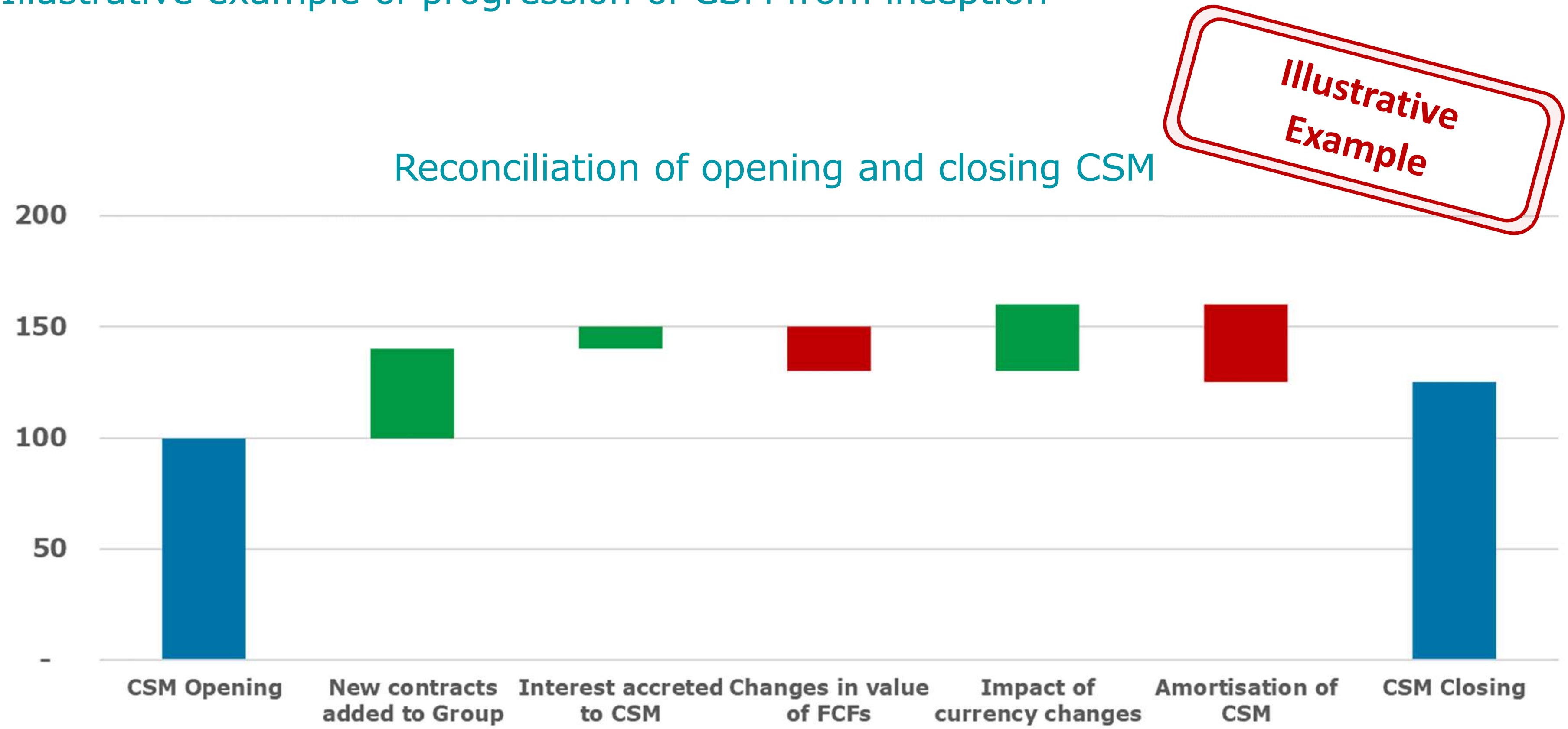
Impact

Impact (H/M/L)	
Life	**Non-Life**
H	L

- Brand new concept for IFRS – impacting the timing of profit recognition.
- Unlocking will require integration between finance and actuarial systems and introduces additional data requirements.
- Limited impact for non-life when PAA is adopted for the pre-claims liability.

Building Block Approach/General Model

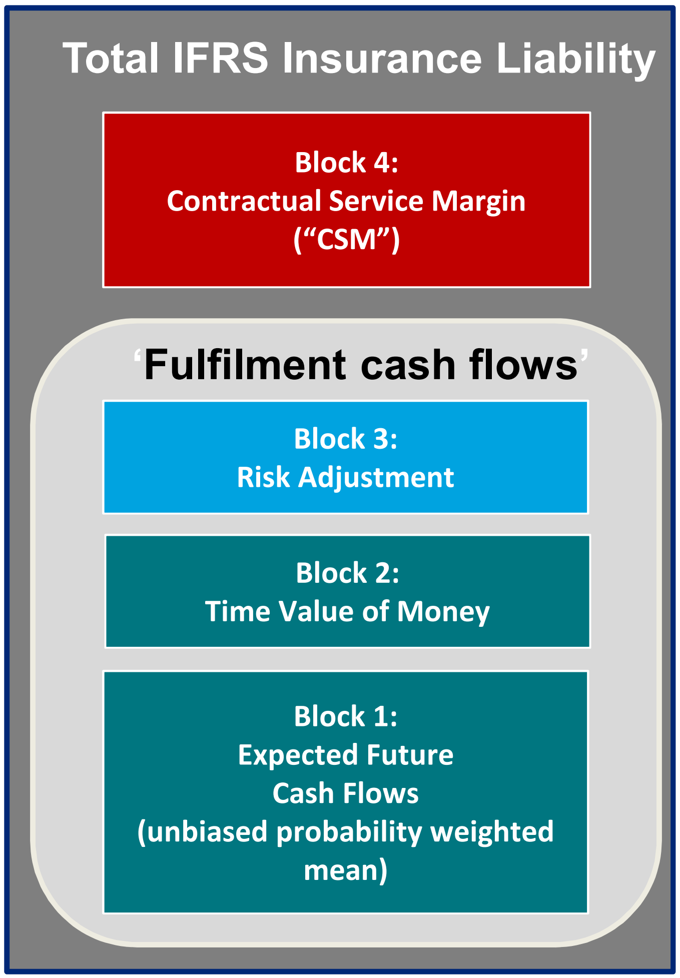
Illustrative example of progression of CSM from inception



- CSM is subject to a floor of zero.
- Given the loss component is zero, subsequent reductions in FCF (i.e. improvements in profitability) should be allocated to the loss component until the CSM is reduced to zero. Only the excess is allocated to CSM.

Building Block Approach/General Model

Subsequent Measurement under the BBA – Recognition of changes in estimates and assumptions



CSM is adjusted by changes in estimates and is allocated to profit or loss on basis of passage of time.

In each reporting period, an entity re-measures the **fulfilment cash flows** using updated assumptions about cash flows, discount rate and risk.

Variable Fee Approach

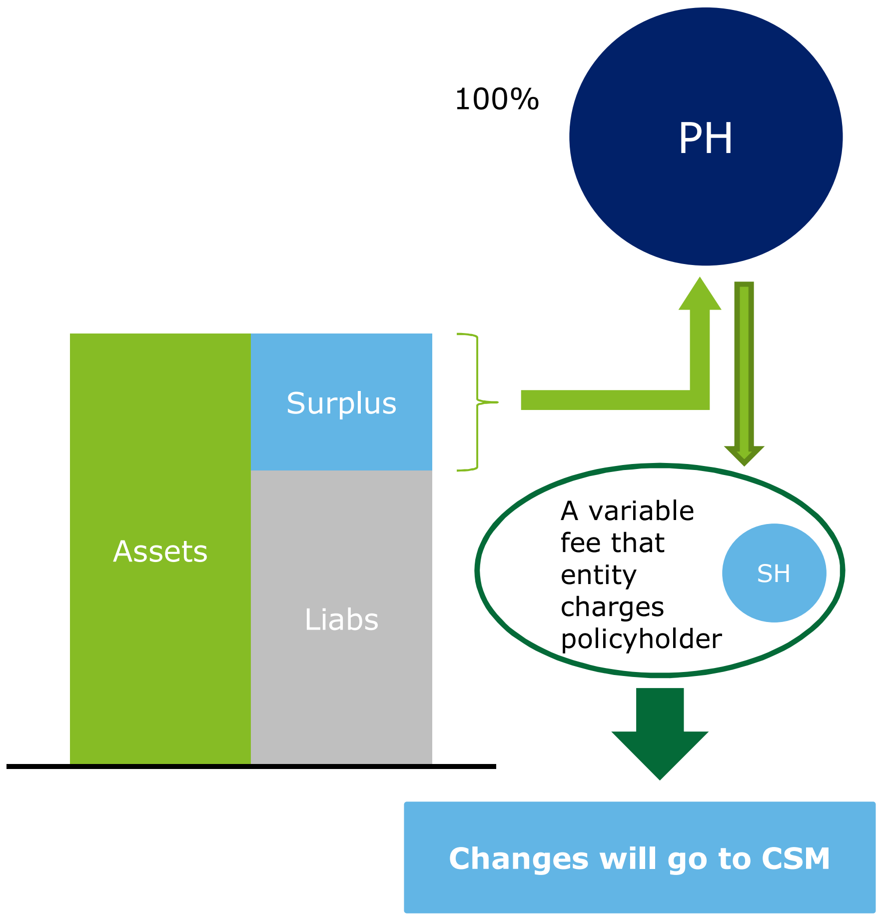
- Modification to the general approach for valuing insurance contracts with payments that vary with return on underlying items, e.g.
  - Unit-linked (with <u>insurance</u> risk)
  - With-profits

- Treats returns on the assets underlying these contracts as part of the fee that the entity charges the policyholder for the services provided

- CSM at inception is the same as general model. CSM subsequently differs from general model:
  - CSM adjusted for financial assumption changes
  - Includes changes to the value of risk mitigation for guarantees, unless these are 'formalised'
  - CSM has interest accretion at current rates

- The CSM under VFA <u>cannot</u> be calculated prospectively

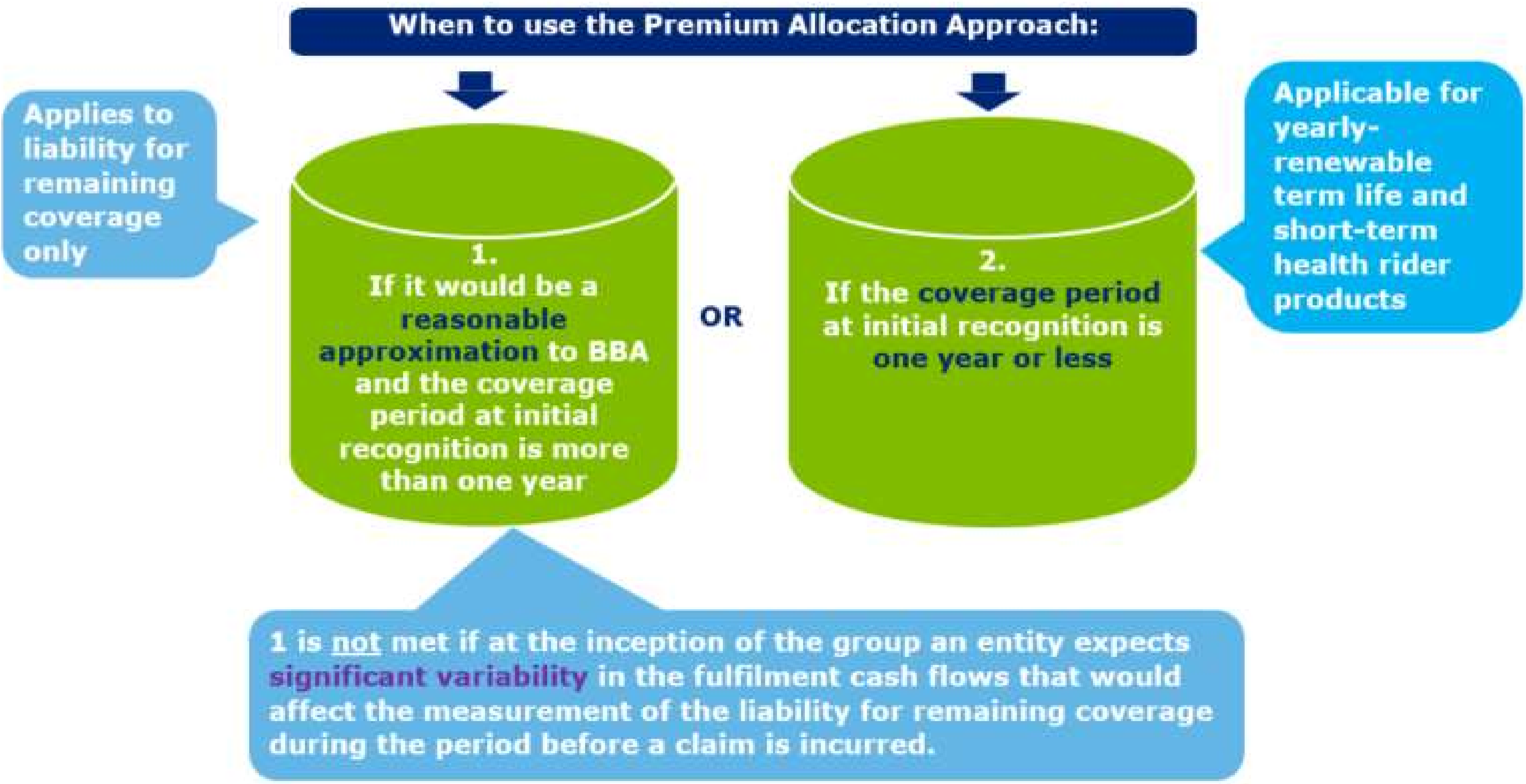
- Benefit of VFA is that it eliminates artificial volatility in the Profit & Loss



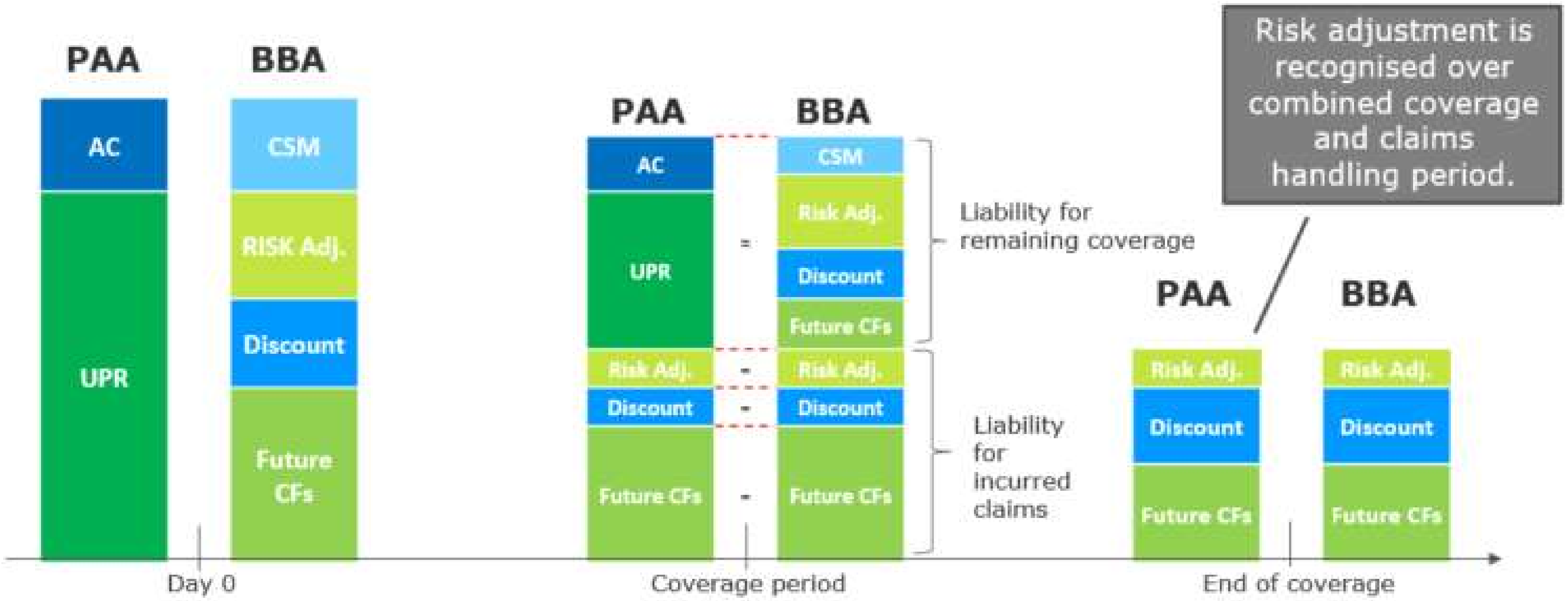
Introduction to the Premium Allocation Approach

- Premium Allocation Approach (PAA) is a **simplified approach** to measuring the **Liability for Remaining Coverage (LRC) only**.
- The key simplification is to **exempt** the insurer from calculating and explicitly **accounting for the CSM**, the main component of the liability for remaining coverage.
- It does not apply to the **Liability for Incurred Claims (LIC)** for which the general measurement model/**Building Block Approach (BBA) always applies**.
- The primary impact of the PAA is that it allows **non-life insurers** to continue to use their process and systems for calculating **unearned premiums amounts**.

Premium Allocation Approach - Eligibility



Premium Allocation Approach – BBA vs PAA



Acronym key	
AC	Acquisition cash flows
UPR	Unearned premium reserve
BBA	Building block approach
PAA	Premium allocation approach
CFs	Cash flows

Reinsurance under IFRS 17

Inwards reinsurance contracts		Outwards reinsurance contracts
• Two potential measurement models: BBA or PAA	**Measurement**	• Two potential measurement models: BBA or PAA • Measured separately to underlying insurance contracts
• Explicit, unbiased and probability weighted estimate of fulfilment cash flows	**Cash flows and Recognition**	• Use assumptions consistent with underlying contracts • Cashflows adjusted to reflect credit risk of reinsurer • Different recognition criteria

Different recognition criteria compared to underlying insurance contract

- **Proportional reinsurance** – later of:
  1) beginning of coverage period of group of RI contracts or
  2) initial recognition of underlying insurance contract.
- **All other cases** – beginning of coverage period of group of RI contracts

Reinsurance under IFRS 17

Inwards reinsurance contracts

- CSM can only be positive at initial recognition
- Contracts aggregated into profitable, onerous or no significant possibility of becoming onerous

Contractual Service Margin

Outwards reinsurance contracts

- CSM can be positive or negative at initial recognition
- Contracts aggregated according to whether they produce a net cost or gain on initial recognition

Key Reinsurance Issues to consider:

- Unit of account
- Data Issues
- Retrospective reinsurance
- Restructuring of reinsurance programmes

Transition

- Effective date is 1 January 2021. One year of comparative numbers required (at least).
- Entities will be required to apply the new standard retrospectively; that means "as if the standard was in place since the inception of your insurance and reinsurance contracts" unless it is impracticable.
- Transition is aimed at determining the CSM on the transition date.
- Impact of transition is recognized in opening equity.

Approach:

Full retrospective approach
When historical data exists and hindsight is not required

If impracticable

Modified retrospective approach
When not all historical information is available but information about historical cash flows is available or can be constructed

Measurement at fair value
When no historical information about cash flows is available to determine the CSM

If impracticable

Impracticable:

(a) Amounts are not determinable

(b) Requires assumptions about past management's intent (hindsight)

(c) Requires significant past estimates (hindsight)

Presentation and disclosures

Balance sheet

- IFRS 17 estimates are **re-measured** in each reporting period
- **Separate lines for:**
  - Insurance contract assets and insurance contract liabilities
  - Reinsurance contract assets and reinsurance contract liabilities
  - No separate lines for insurance payables / receivables, policy loans, etc.

Income statement

- IFRS 17 tries to align the **presentation of revenue** with other industries.
- **Investment components and net investment income** are excluded from the underwriting result and presented as a separate line item.
- Investment result includes investment income and the discounting of the insurance liabilities
- IFRS 17 provides an **accounting policy choice** to recognize the impact of changes in discount rates in profit or loss or in other comprehensive income ('OCI')

Disclosures

- IFRS 17 **disclosures** are more detailed than required under current reporting frameworks, providing additional insight into key judgements and profit emergence and thus allowing for greater comparability across entities.
- Significantly expanded granular reconciliations of changes in each component of insurance contract assets and liabilities, including margins
- Confidence level of insurance liabilities

Insurance contract revenue

Insurance contract revenue replaces premiums

Calculated as the sum of:

- Expected change in cash flows from claims and expenses (as at the beginning of the year).
- Change in risk adjustment
- Amortization of contractual service margin
- Amortization of acquisition costs

Statement of comprehensive income

IFRS 4

Income statement (Currently)
Revenue
Premiums gross
Less ceded
Net premiums
Net investment income (loss)
Interest and other investment income
Fair value and foreign currency changes on assets and liabilities
Net gains (losses) on available-for-sale assets
Fee income
Total revenue
Benefits and expenses
Gross claims and benefits paid
Increase (decrease) in insurance contract liabilities, reinsurance assets and investment contract liabilities
Reinsurance expenses (recoveries)
Commissions
Operating expenses
Premium taxes
Interest expense
Total benefits and expenses
Income tax expense
Net income (loss) attributable to participating policyholders
Preferred shareholders dividend
Common shareholders' net income (loss)

= no changes to presentation

IFRS 17

Income statement (New)*
Insurance revenue
Insurance service expenses
Income or expenses from reinsurance contracts held
Insurance service result
Insurance finance income or expense
Investment income
Investment result
Profit or loss
Other comprehensive income (if elected)
Insurance finance income or expense
Changes in FVOCI assets
Total other comprehensive income

Disclosures

Under IFRS 17 more disclosures will be required compared to IFRS 4

Amounts	Judgements	Risks

Balance sheet
Reconciliations
• *Present value of probability-weighted estimated value of future cash flows*
• *Risk adjustment*
• *Contractual service margin for general model and VFA*
• *Liability for the remaining coverage (PAA)*
Income statement
• Underwriting revenue
• Underwriting expense
• Finance income/ expense
	• Measurement methods
	• Processes for estimating the inputs
	• Changes in methods and processes
	• *Methods used to calculate finance income/ expense if OCI option is used*
	• *Confidence level for risk adjustment measurement*
	• *Yield curves*
		• Nature and extent of risks
		• Exposure
		• Procedures used to manage risks
		• Concentration of risks
		• Insurance risk: sensitivity analysis, claims development
		• Credit risk
		• Liquidity risk: maturity analysis by estimated timing of cash flows
		• Market risks:
		  • Interest rate risk
		  • Foreign currency risk
		  • Prices risk

New disclosures compared to IFRS 4 are highlighted in red.

IFRS 17 – wide ranging impacts

Adoption will have wide-ranging, significant impacts on investor education, underlying processes, systems, internal controls, valuation models, and other fundamental aspects of the insurance business.

Business

- Investor education, including the need for revised non-GAAP measures
- Timing and volatility of profit emergence, and its impact on distributable earnings
- Reconsider product design
- Overhaul planning, budgeting and forecasting functions
- Business combination and acquisition activity

Operational

- Increased risk of incorrect, inaccurate or incomplete financial information
- New financial reporting, impacts on Integrated Reporting. IT and actuarial controls and processes
- Education and people strategy

Systems

- Record, process and report a greater volume of data with an increased level of complexity
- Enhance actuarial models
- Redesign or replace source, feeder and reporting systems
- Additional load on infrastructure (processing and storage capacity)
- Implications for 3rd party arrangements

Example steps to expected adoption date

Get organized

Understand the impact and plan the project

Transition to the new standard

- **Project setup, governance and resources**
- Assess impact
- Project planning
- Gather and validate data
- Implement systems and processes – design, build, test, deploy
- Dry run and compara-tives
- 2021 Adoption

Key activities in an impact assessment:

1. Vision, principles and requirements
2. Training
3. Gap analysis
4. Systems impact assessment
5. Financial impact
6. Roadmap, detailed planning and budget

Fundamental change!

Summary

- **IFRS 17 is a fundamental change for (re)insurance contract accounting**
- **Effective from 1 January 2021 (with prior year comparatives)…..but there may be a delay (or not!)**
- **Complex standard with accounting policy options and interpretations to be made**
  - **interpretations are evolving and subject to ongoing debate**
  - **working assumptions may be required**
  - **leverage group guidance, where applicable**
- **Can be significant accounting mismatches, e.g. reinsurance**
- **Scope to leverage Solvency II but significant differences**
- **It's not just actuarial and accounting – potential wide-ranging operational and commercial impacts, e.g. systems, processes, KPIs, products, reinsurance, tax…**

Don't delay!!

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Questions?