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IFRS 17: The key questions (and answers) for general insurers

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The key questions

- When to use BBA and when to use PAA
- What level of aggregation to use?
- What is different in the model for outwards reinsurance?
- How to calculate the risk adjustment?
- How to determine the discount rate?
- What are the key data and IT systems issues to consider?
- Can we leverage the work done for Solvency II?

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BBA vs PAA

	Current IFRS/GAAP	BBA	PAA
Liability for remaining coverage = Unexpired risk	UPR less DAC	Contractual Service Margin	Akin to premium (less acquisition costs) unearned
		Risk adjustment	
		Discounting	
		Best estimate of fulfilment cash flows	
Liability for incurred claims = Expired risk	Undiscounted reserves for past claims (including IBNR)	Risk adjustment	Risk adjustment
		Discounting	Discounting
		Best estimate of fulfilment cash flows	Best estimate of fulfilment cash flows

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The options

BBA throughout

✓ Only one model

✓ Future-proof

× More complex for one year policies

× Requires more resources to build

× Requires more resources to run

PPA throughout

✓ Only one model

✓ Closer to current practice

✓ Requires fewer resources to build and run

× Data and IT challenges around actual cash flows

× Some longer term policies and outwards reinsurance may not qualify

× Not future-proof

Mixture

✓ Can accommodate all elements of business

✓ Future-proof

× Have to build and maintain two models

× Requires most resources to build

× Requires most resources to run

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Level of aggregation and onerous contracts

Portfolio (similar risks, managed together):

Onerous at initial recognition

Annual cohorts

Y1
Y2
Y3

No significant possibility at initial recognition of becoming onerous

Annual cohorts

Y1
Y2
Y3

Remaining contracts

Annual cohorts

Y1
Y2
Y3

Level of assessment for onerous contracts:

Individual contracts

***Set of contracts**

*If reasonable and supportable information exists

Once the groups are established at initial recognition, their composition should not be reassessed subsequently

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The challenges with aggregation

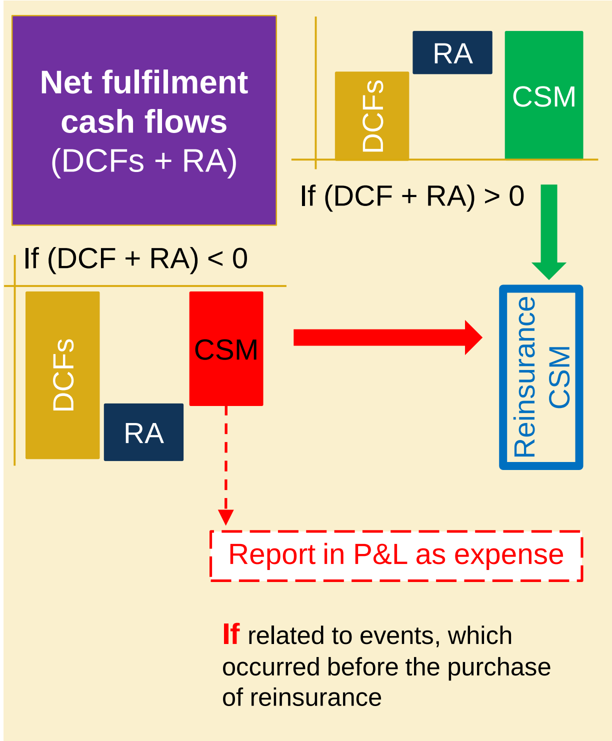
Aggregation

- How granular for calculations and for reporting?
- How closely can you match the classes you use to run the business?
- How closely can you match your Solvency II classes?

Onerous contracts

- At what level of granularity do you need to identify onerous contracts?
- How do you identify what is onerous at inception?
- How do you decide which contracts have ‘no significant possibility of becoming onerous’?

The treatment of outwards reinsurance



Legend:

Net gain on purchasing reinsurance

Net cost on purchasing reinsurance

- Assumptions consistent with ceded contracts. No ‘netting down’
- No immediate recognition of a loss on reinsurance held
- Risk adjustment only for risks transferred to the reinsurer
- Changes to reinsurer default risk go to P&L
- Reinsurance contracts held cannot be onerous

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The treatment of outwards reinsurance…or painting by numbers?

1 …may have a shorter accounting boundary different from the legal term of the contract

2 …may result in a group / series of accounting contracts arising under a single legal contract

3 …accounting may be that of a single contract or require separating of the different risks

4 …may affect the classification of a contract as insurance or as a financial instrument

5 …will require careful analysis to assess if an investment components arise and how to be presented

6 …commission drivers will determine accounting and may affect KPIs

7 …will require careful analysis by cedents to conclude if they result in a contract modification or a new contract

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The calculation of the risk adjustment

The compensation the entity requires for bearing the uncertainty

Makes entity indifferent between fulfilling a liability that:

- has a range of possible outcomes; and
- will generate fixed cash flows with the same expected present value

Entity specific measure – should reflect:

- The entity's level of risk aversion
- The degree of diversification benefit the entity considers appropriate

Options for calculating the risk adjustment

Possible methods…?		
Value at Risk (VaR)	Tail Value at Risk (tVaR)	Cost of Capital (CoC)

- No prescribed approach
- But must explain chosen method
- Calculated on a gross and reinsurance basis separately
- Regardless of the method chosen, a confidence level equivalent must be calculated and disclosed (i.e. VaR percentile)

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The determination of the discount rate

Discount rate should reflect the characteristics of the liability cash flows

If observable rates are available:

- Consistent with observable market instruments (cash flows consistent with the insurance contract)
- Can be calculated using either:
  - a **bottom-up** approach, or
  - a **top-down** approach
- Must explain method and disclose reference data

If observable rates are not available:

The same principle applies but judgement is needed to:

- adjust observable inputs for differences with the contract cash flows
- use best information available
- ensure unobservable inputs do not contradict market data

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Adapting data and IT systems

Data
- Policy level data
- Need to track data by cohort
- Actual cash flow data
- Data storage and retrieval
- Leverage Solvency II?

IT and Systems
- Impact on actuarial models (AoC)
- For BBA, need CSM calculation tool
- Integration with accounting and Solvency II systems
- New posting logic and CoA

Financial Reporting
- Fundamentally different income statement
- Significant changes to Balance Sheet
- More granular information
- Prescribed reconciliation formats

Leveraging the work done for Solvency II

Many insurers have spent a lot on Solvency II and want to leverage this spend on IFRS 17

Discount Rate	• IFRS 17 allows a “top-down” or “bottom-up” approach, reflecting the characteristics of the liability cash flows • Solvency II rules are more prescriptive	• Do you use the Solvency II discount rate? • Can you justify its appropriateness?
Risk Adjustment	• IFRS 17 Risk Adjustment should reflect entity’s own view on risk diversification and risk appetite • Calculation of Solvency II Risk Margin is more prescriptive	• Do you use the Solvency II Risk Margin? • Can you justify its appropriateness?
Systems	• Many insurers have spent heavily on systems for Solvency II implementation. • IFRS 17 will require a significant amount of historical data, storage capability and modelling.	• Can existing Solvency II systems and Pillar 3 capability may be leveraged? • How can this best be achieved?
Experience	• Insurers and consultancies devoted huge amounts of time and resources to the implementation of Solvency II	• What are the technical lessons learned? • What are the operational lessons learned?

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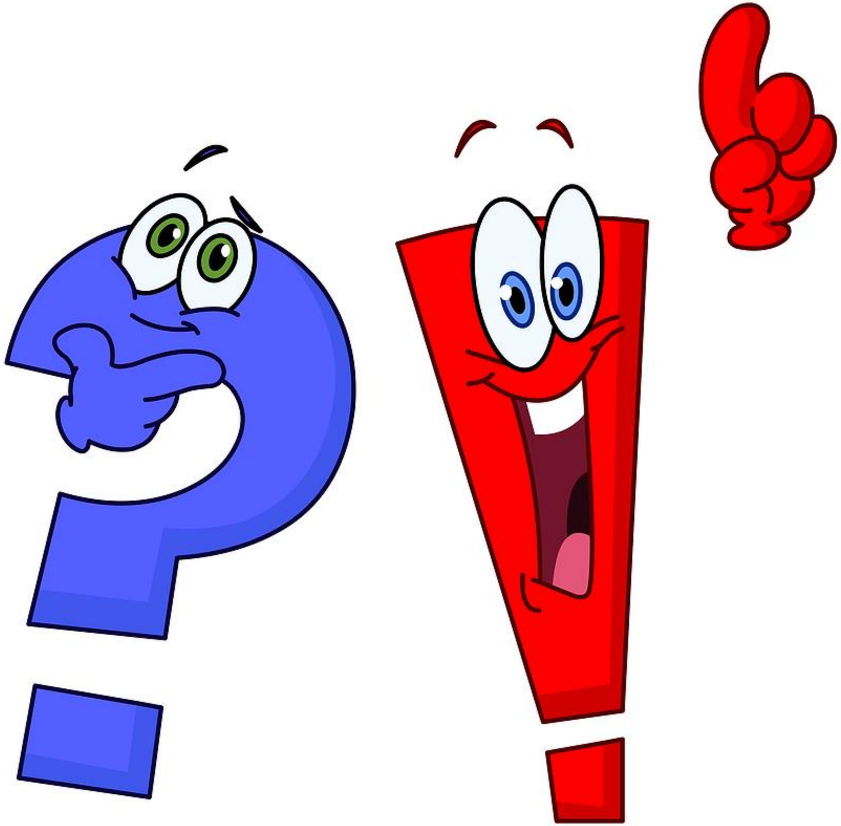
Q&A



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