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EY
Building a better working world

Overview of IFRS17

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Agenda

- An overview of IFRS 17
- Building Block Approach
- Premium Allocation Approach
- Contracts with participating features
- Implementation

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IFRS17 objectives

Improve comparability

1. Lack of comparability between insurers
2. Non-uniform reporting of products within groups
3. Inconsistency with other industries

→

- Worldwide objective to harmonise insurance accounting practices across jurisdictions
- New framework replaces a huge variety of accounting treatments
- Revenue reflects the services provided

Improve quality of financial information

1. Lack of useful information
2. Lack of transparency about profitability

→

- Discount rate will reflect characteristics of the insurance contract
- Additional metrics to evaluate performance will be available

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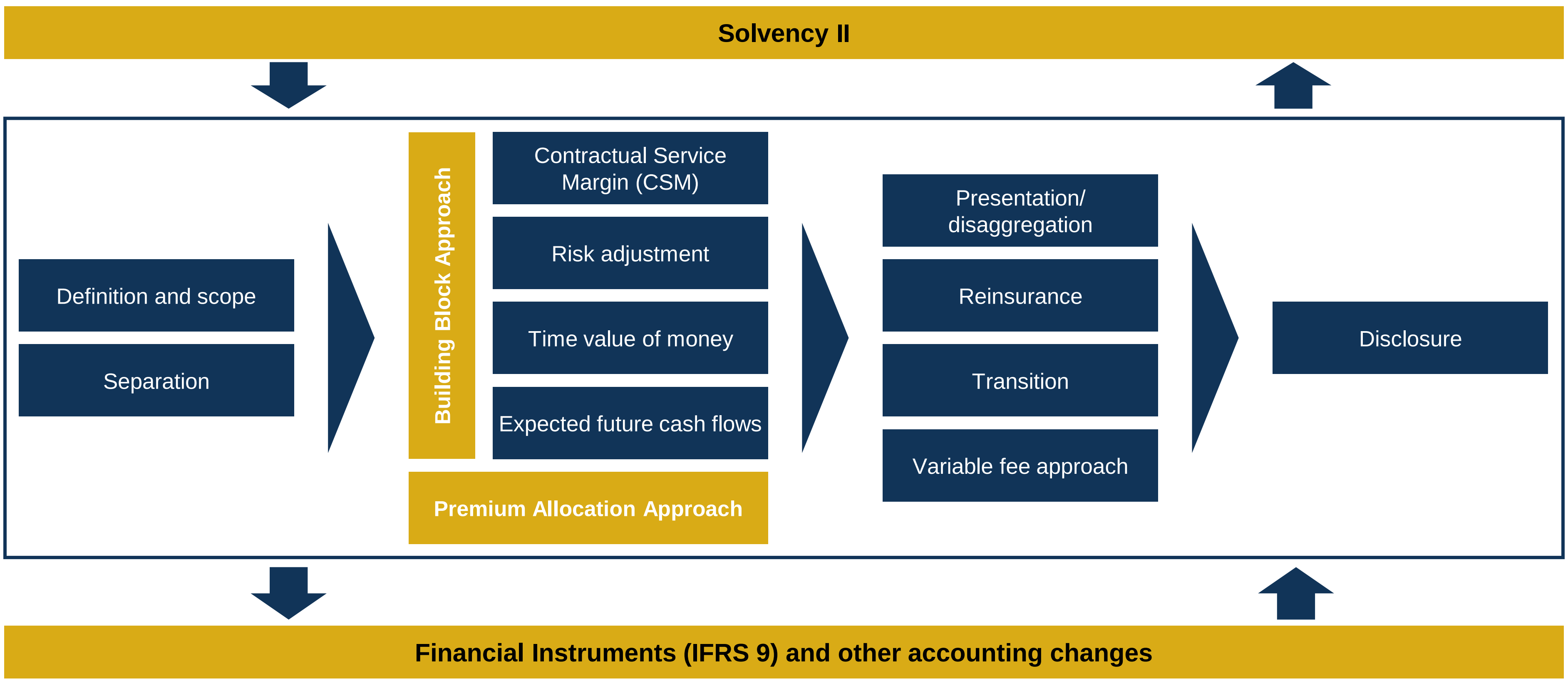
IFRS 17 – overview of the proposed model



Scope of IFRS17

Application confirmed ✓

Insurance contracts

Reinsurance contracts held by insurance companies (amended guidance)

Investment contracts with a discretionary participation feature issued by insurance companies

Excluded from application ✗

Financial guarantee contracts, unless the issuer has previously classified them as insurance contracts (status quo under IFRS 4 Phase I)

Application optional ?

Expansion of the guidance for certain fixed-fee service contracts
(Choice between application of IFRS 17 or IFRS 15)

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Measurement approaches

Standard approach to measurement

Building Block Approach (BBA)

Contracts with participating features	Variable fee approach, for certain types of participating contracts
Premium Allocation Approach (PAA)	Option for contracts with coverage period of one year or less
Reinsurance contracts	Supplementary requirements for specific topics
Investment contracts with discretionary participation feature	Supplementary requirements for specific topics
Portfolio transfers and business combinations	Supplementary requirements for specific topics

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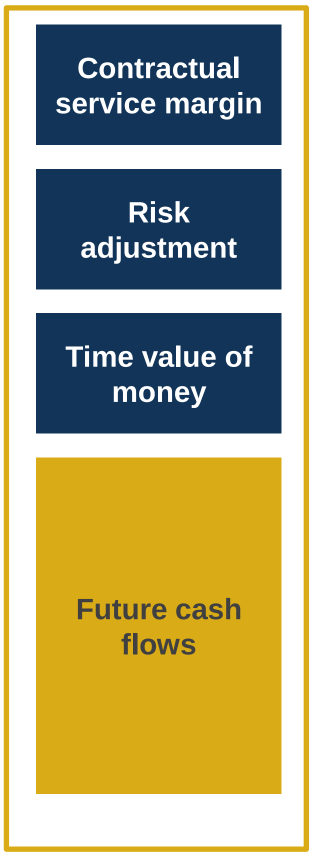
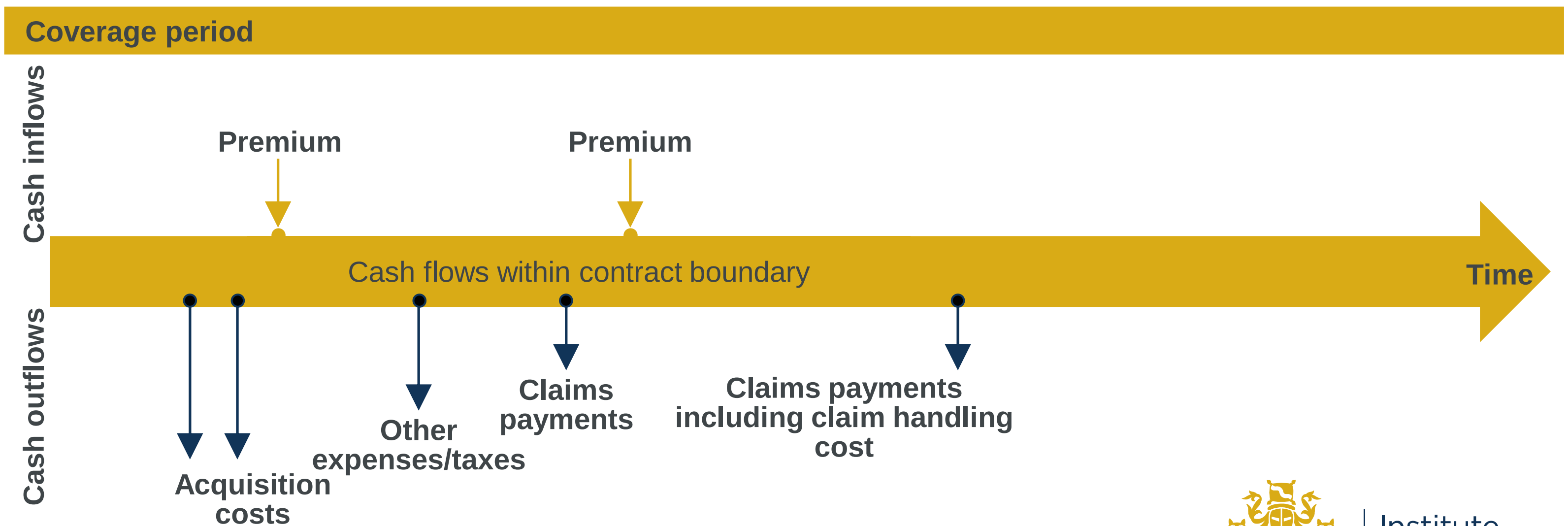
BBA – Measurement on initial recognition – Cash flows and contract boundary



The estimates of CFs used to determine the fulfilment CFs shall include all cash inflows and outflows that relate directly to the fulfilment of the portfolio of contracts:

- Current and explicit (separate from discount rate and risk adjustment)
- Incorporate all available information in an unbiased manner (including trends)
- Include all CFs within contract boundary
- Perspective of the entity (provided that market variables are consistent with observable prices)



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BBA – Measurement on initial recognition – Fulfilment Cash flows – Examples

Included ✓

- Premiums including premium adjustments
- Incurred, reported and future claims and benefits, including claim-handling costs
- Fixed and variable overheads that are directly attributable at the portfolio level
- Cash flows from options and guarantees embedded in the contract to the extent that these options and guarantees are not separated
- Acquisition costs that are directly attributable to the portfolio
- Policy administration and maintenance costs, including commissions
- Transaction-based taxes and levies that arise directly from the contract
- Payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder
- Profit participation

Excluded ✗

- Investment returns on underlying items (unless variable fee approach applies)
- Cash flows that arise from components that are separated from the insurance contract
- Cash flows between different components of the reporting entity
- Cash flows (payments or receipts) that arise under reinsurance contracts
- acquisition costs not directly attributable to the portfolio that may arise at sale, underwriting or contract introduction
- Cash flows that arise from abnormal amounts of wasted labour or other resources that are used to fulfil the contract
- Product-development costs
- Training costs
- Income tax payments and receipts

BBA – Measurement on initial recognition – Time value of money

Contractual service margin

Risk adjustment

Time value of money

Future cash flows

- Adjust the estimates of future cash flows for the time value of money using discount rates that:
  - Reflects characteristics of fulfilment cash flows
  - Consistent with observable market prices for instruments with cash flows that have consistent characteristics with insurance contract, e.g., with respect to timing, currency and liquidity
  - Adjust observed market prices to reflect the characteristics of the liability/the factors that are relevant for the contracts, e.g., exclude irrelevant risks, estimate the rate beyond the period of observable data
  - Consistent with other estimates used to measure the insurance contract (e.g., inflation, discount rate for participating contracts)
- No particular method prescribed to determine discount rates:
  - Top-down approach or bottom-up approach – starting from market yields, or from risk free curve
- When applying PAA: no need to discount cash flows which are expected to be paid or received in one year or less

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BBA: Measurement on initial recognition – Risk adjustment

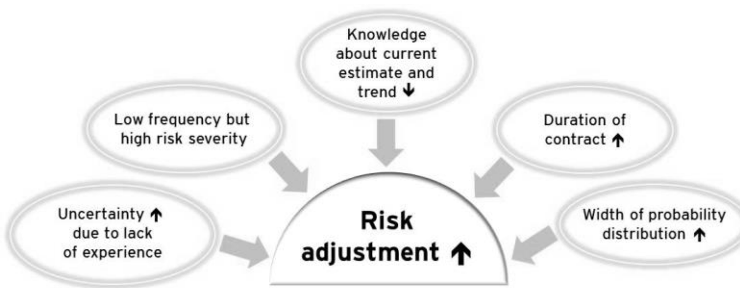
Contractual service margin

Risk adjustment

Time value of money

Future cash flows

- Compensation that an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arise as the entity fulfils the insurance contract
- RA shall be included in the measurement in an explicit way (i.e., uncertainty should not be included in the future cash flows)
- Reflects both favourable and unfavourable outcomes in a way that reflects the entity's degree of risk aversion
- Conveys the degree of diversification benefit that is considered when determining the compensation for bearing uncertainty
- No prescribed technique so different companies may use different techniques
- Disclosure on the confidence-level is required if the entity uses a technique other than the confidence level



BBA: Measurement on initial recognition – Contractual service margin – Key features

Contractual service margin

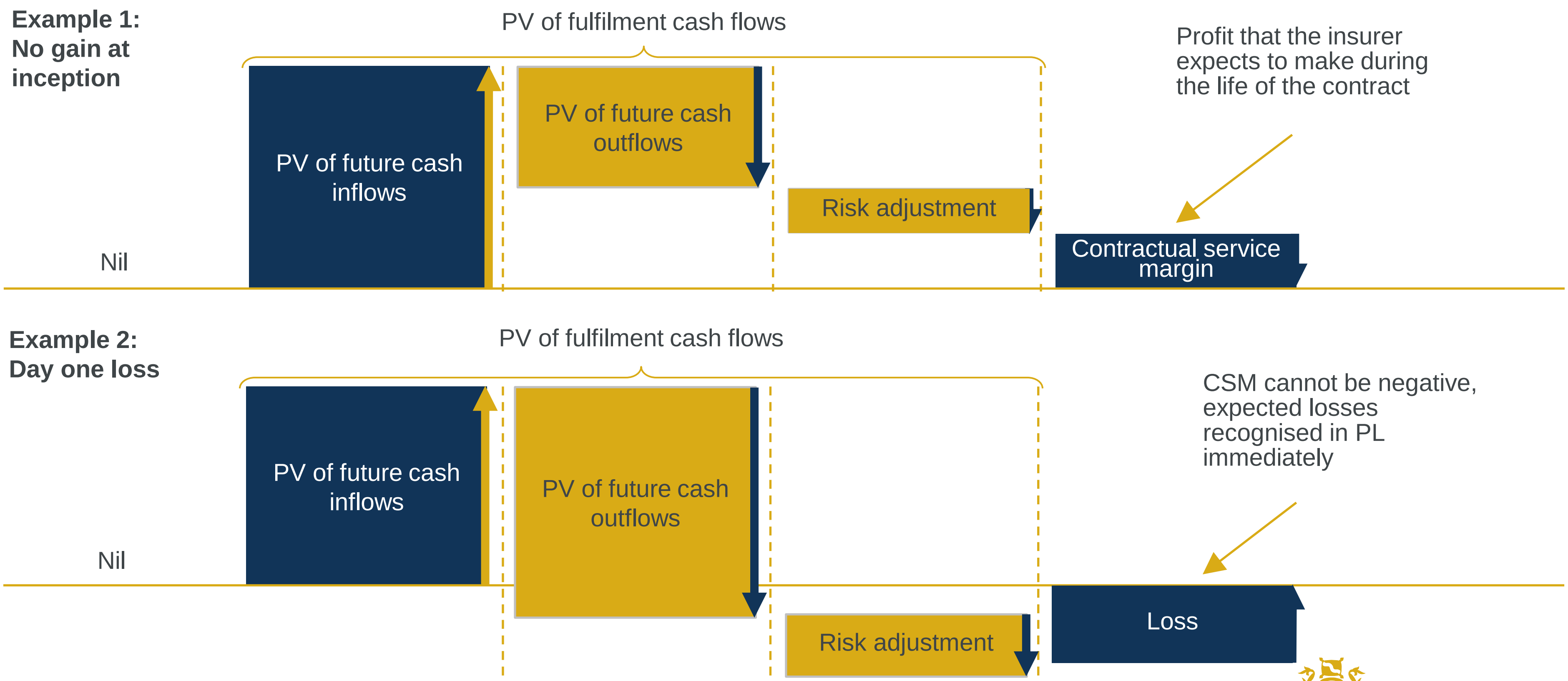
Risk adjustment

Time value of money

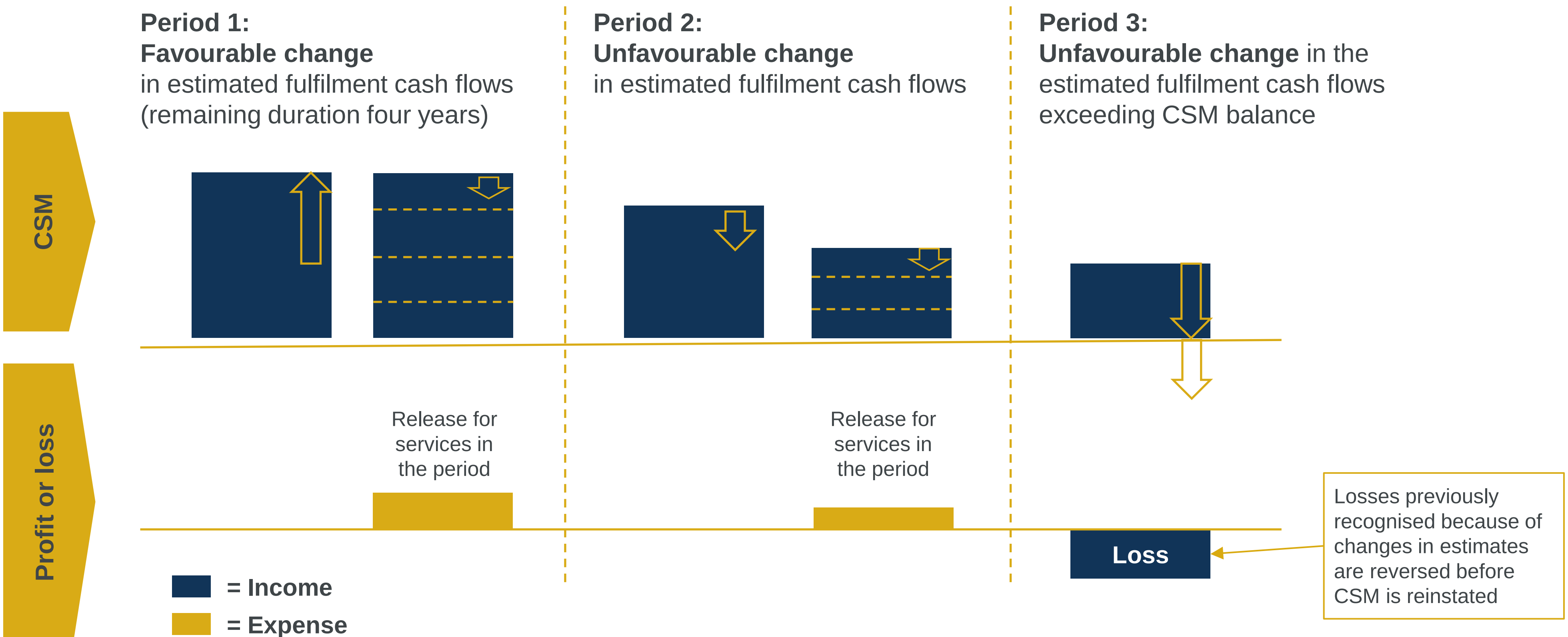
Future cash flows

- At initial recognition, the CSM is defined as the net difference between the fulfilment cash inflows and outflows, floored by zero (i.e., cannot be negative)
- Purpose of recognising a positive initial CSM: Objective is to report expected profitability from the contract over time (thus eliminating any day-one gain)
- If CSM is floored by zero at inception, the insurance contract is onerous. Losses should be recognised in P&L immediately
- Interest applied to CSM is calculated with initial discount rates (locked-in)
- Objective for allocation to recognise the contractual service margin for an individual contract, or groups of homogeneous contracts, in profit and loss over the coverage period of the contract in a way that best reflects the service to be provided

BBA – Measurement on initial recognition



CSM – illustration of unlocking



Simplified example, no discounting applied

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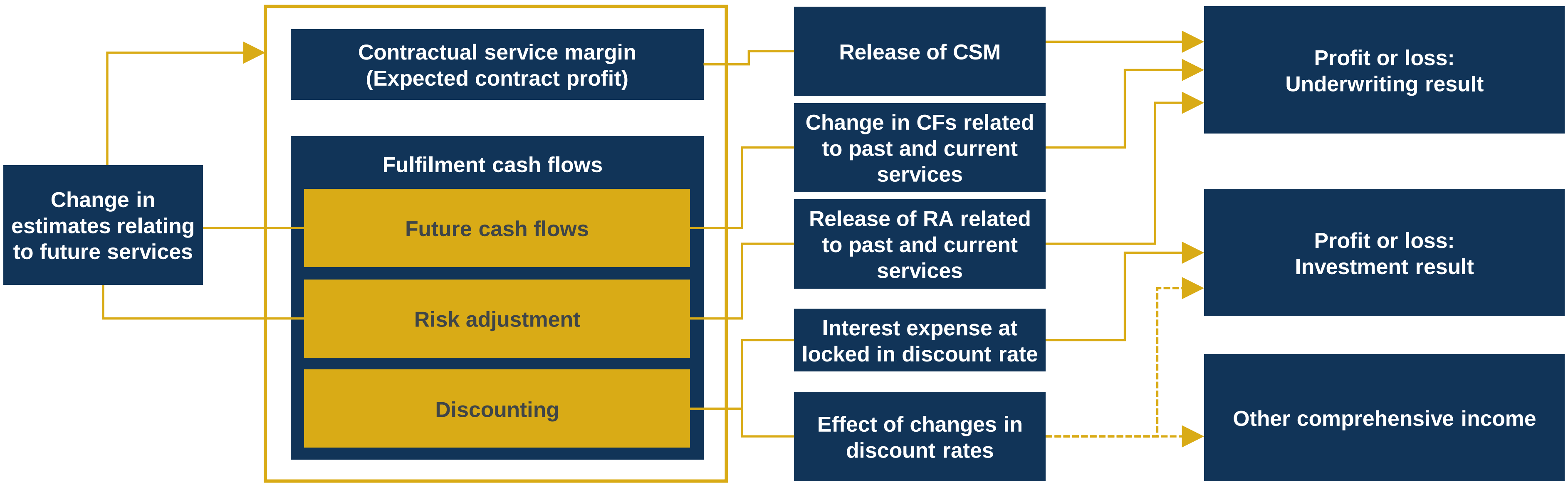
Building block approach (BBA) – subsequent measurement

Presentation of changes overview

The IASB proposed to disaggregate changes in the measurement of the insurance contracts in different line items of the financial statements, depending on the sources of the changes.



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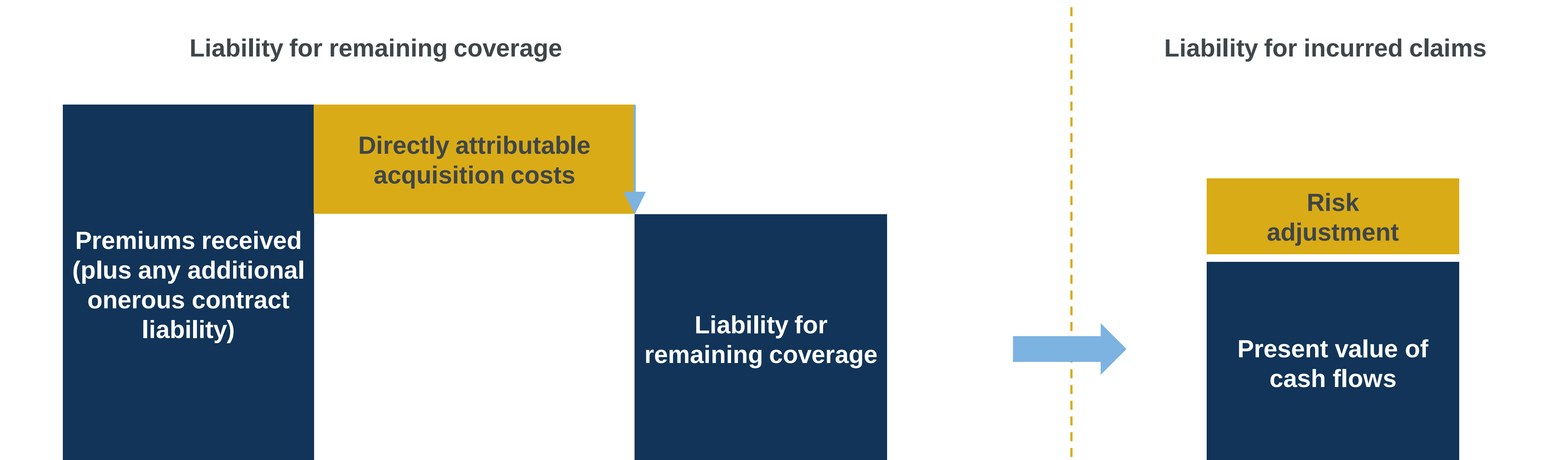
Premium Allocation Approach

Insurance contract liability can be split into:

- Liability for the remaining coverage – simplified approach based on allocation of premium (analogous to existing UPR)
- Liability for incurred claims – Building Block Approach (analogous to existing claim reserves)



Premium Allocation Approach (cont'd)

The PAA may be used if:

- Contract coverage period is one year or less, or
- PAA produces a reasonable approximation of the building block approach, e.g.,
  - Premium allocation to coverage periods does not require significant judgement **and**
  - Claims expectations are not likely to change significantly during coverage period
- Onerous contracts: an additional (onerous contracts) liability is recorded
- To reflect time value of money if a significant financing component is included and the start of coverage is more than 1 year after premium payment

Premium allocation approach | **Building block approach**

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What is a participating contract?

Contracts that have a feature by which the entity shares additional risks and rewards with the policyholder, in some contracts subject to discretion of the entity

- Profit sharing may be based on specific assets, groups of assets and liabilities, the profit made by a fund or company or an index
- These are referred to as 'underlying items'

Examples of contracts that typically are participating contracts:

- Unit linked contracts
- With-profit contracts
- Continental European participating contracts
- Universal life contracts
- Variable annuity contracts

Why does the BBA not work for these contracts?

Problem is not with BEL measurement but with how the movements are reported in P&L/OCI and CSM.

Unwarranted profit volatility for long term business:

- Shareholder’s share of underlying items
- Time value of options and guarantees
- Mismatches between P&L recognition of investment income on underlying assets (backing the participating contracts) and investment expense relating to those contracts

Participating contracts include significant investment related services – they ‘spread out’ market fluctuations for policyholders. The BBA approach requires all changes resulting from market movements to be recognised in P&L/OCI. As these movements fluctuate over time and relate to the provision of service it makes more sense to include them in the measurement of the CSM in the same way as changes in expected cash flows and risk adjustment

Participating contracts

IASB views the shareholder's share in underlying items as a Variable fee for investment-related services.

Obligation under the contract to pay the policyholder an amount equal to the value of underlying items less a variable fee

Variable fee = shareholder's share less any expected cash flows that do not vary directly with the underlying items (e.g., expenses, Options & Guarantees)

Variable fee approach:

- Changes in the variable fee are not recognised immediately in other comprehensive income but included in CSM unlocking
- CSM updated for current interest rates and released on the basis of passage of time
- Risk mitigation: option to report changes in embedded guarantees in PL if certain criteria and documentation requirements are met
- If the insurer holds underlying items and uses OCI for reporting changes in market interest rates the P&L interest charge is equal to the P&L investment income on the underlying items.

Participating contracts (cont'd)

- Variable fee approach can be used if three criteria are met:

	Criterion		Questions
1	The contract specifies a share in a clearly identifiable pool of underlying items (assets or other profit sources)	→	What does 'specifies' mean, when is a pool 'clearly identifiable'?
2	The entity expects to pay an amount equal to a substantial share of the returns from the underlying items	→	When is a share 'substantial', how to apply an entity's expectations?
3	A substantial proportion of the expected payment should be expected to vary with the underlying items		What is a 'substantial portion', how to evaluate the role of guarantees?

- Contracts meeting these requirements are called Direct participating contracts. Those failing are called Indirect participating contracts
- Assessment to be performed at inception, no re-assessment

Accounting for participating contracts vs. non participating contracts

	Continuum of insurance contracts		
Type of contract	Non-participating	Indirect participating	Direct participating
Measurement	General model		Variable fee model
Interest expense	General model – Effective yield		Current period book yield

Differences	General model	Variable fee model
Subsequent measurement – Market variables	PL or OCI, following the general model	CSM (PL if risk-mitigated)
Accretion of interest on CSM	Locked-in rate	Current rate
Insurance investment expense	Effective yield-based	Current period book yield (if investments are held)

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IFRS 17 – what does that mean to the business?

- ✓ Reporting on new basis – need to understand performance drivers
- ✓ Disaggregating changes – need to explain it to stakeholders

- ✓ New processes required to calculate CSM
- ✓ CSM roll forward will need to be understood and explained
- ✓ Estimating CSM on transition will be a critical element impacting future profit

- ✓ Moving to best estimates may make results more volatile
- ✓ Increased chances of showing a loss during a year

- ✓ Question on whether to align with Solvency II
- ✓ Additional process work to determine time value of money
- ✓ Need to explain to stakeholders (More significant for long tailed liability insurers)

- ✓ Significantly more information needs to be provided
- ✓ Additional processes and data are required to gather the disclosure information

- ✓ New processes and information to be recorded will involve substantial system updates
- ✓ For multinational groups may help with consistency

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Questions

Comments

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