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IFRS 17: CSM Working Party Findings (D3)

Dublin – 21 November 2019

Wijdan Yousuf (Aon); James Thorpe (Deloitte); Clarence Er (Hymans Robertson)

on behalf of the IFoA IFRS 17 CSM Working Party

Agenda

01	**Introduction** …to the working party: background, aims, output to date, pipeline	3 minutes
02	**Coverage units** Considerations and difficulties when determining coverage units	10 minutes
03	**Loss components** Comparing various methods of loss component amortisation	10 minutes
04	**Proportionate reinsurance contracts held** Analysing the June 2019 Exposure Draft amendments	10 minutes
05	**Acknowledgements** Special thanks	1 minute
06	**Questions / comments** Over to you!	10 minutes

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Introduction

…to the working party, background, aims, output to date, pipeline

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Introduction to the working party

Antoon Pelsser

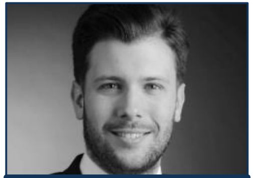
Asim Ghosh

Clarence Er

James Thorpe

Joanna Stansfield

Kruti Malde



Richard Dyble

Rob Walton

Timothy Berry

Weihe Qin

Natalia Mirin
(deputy chair)

Wijdan Yousuf
(chair)

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Introduction to the working party

Analyse and provoke

Sessional paper

Background

Aims

Outputs to date

Pipeline

Formed in summer 2018

30 LinkedIn articles*
Presentations

*https://www.actuaries.org.uk/practice-areas/life/research-working-parties/ifrs-17-contractual-service-margin-csm

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Coverage units

Considerations and difficulties when determining coverage units

James Thorpe

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Recognition of the CSM in profit or loss

Represents unearned profit

Contractual service margin

Recognition in the P&L

Companies need to calculate coverage units provided in this period and expected to be provided in future periods

Coverage units

CSM recognised as revenue as and when service is provided i.e. by allocating the CSM to coverage units

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Key requirements for coverage units

Paragraph B119

For a given contract, determined by considering the:

- **quantity of the benefits provided**
- and its **expected coverage period**

Reflect variability across periods in the level of cover provided by the contracts in the group

Reflect the likelihood of insured events occurring to the extent they affect the expected duration of contracts in the group

Do not reflect the likelihood of insured events occurring to the extent they affect the amount expected to be claimed in a period

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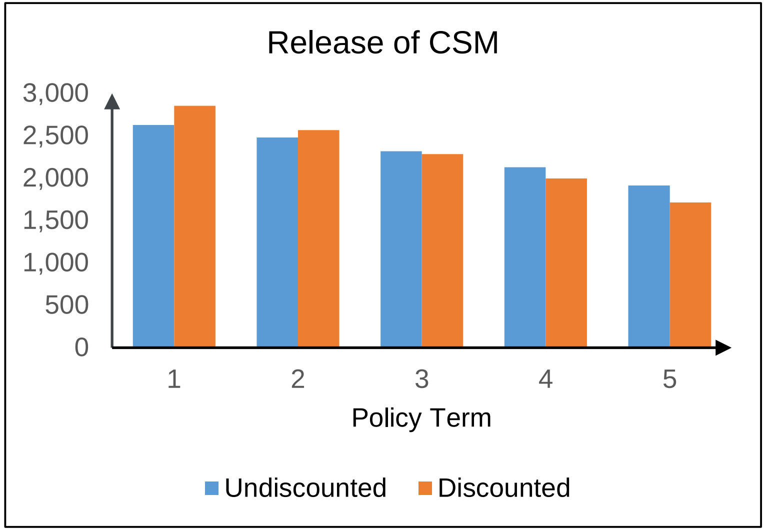
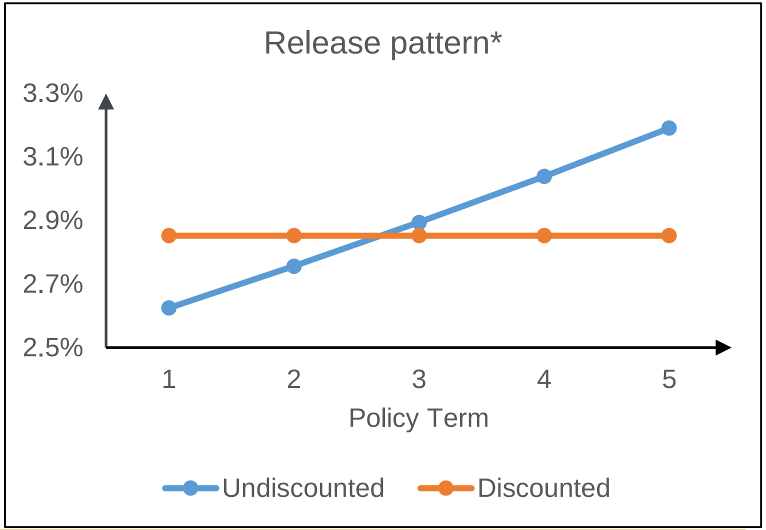
Coverage units

Undiscounted versus discounted coverage units



- No prescribed approach so firms need to form their own decision
- Undiscounted coverage units lead to more CSM in the later years
- Discounted coverage units lead to a more uniform release of CSM

- This effect is more emphasised the higher the level of interest rates -> should consider impact of rising rates on release of CSM
- Impact on transition CSM -> undiscounted coverage unit would lead to a greater CSM on transition versus discounted coverage unit



*Calculated as Release of CSM (t) / Expected Coverage Units (t); see https://www.linkedin.com/pulse/discounted-vs-undiscounted-coverage-units-rebecca-sardar/ for fuller discussion

Technical challenges

Weightings for multiple benefits

- Multiple benefits e.g. CI with excess life
- Riders e.g. TPD or WoC
- Benefits for second life? Children's CI?

Estimating quantity of benefits when not available

- If a suitable measure of coverage units is not available a proxy will be required e.g. non-seriatim reinsurance business

Converting different currencies

- Groupings with different currencies for underlying benefits need to be converted

Weightings between insurance and investment-return service

- Impact of approach could be significant
- Higher of unit reserve and sum assured?
- Deferred annuities?

Measuring investment-return service

- Exposure Draft now allows investment-return service to be considered
- Unit reserve?

Decrements during the year

- The coverage units could be calculated as the end-of-period coverage units or using the average between two reporting dates.

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Loss components

Comparing various methods of loss component amortisation

Clarence Er

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Introduction

Paragraph 47 (paraphrased)
A contract is ***onerous*** if at the date of initial recognition the ***total fulfilment cash flows are a net outflow.*** Groups of onerous contracts result in a ***loss component being established.*** This loss is ***immediately recognised in the profit and loss.***

Paragraph 48 (paraphrased)	Paragraph 49 (paraphrased)	Paragraph 50-52 (paraphrased)
*Any **subsequent** loss component that arises to be **recognised in the profit and loss***	*The **reversal of losses** on onerous contracts to be **excluded from insurance revenue***	*Loss component is required to be **run down to zero by the end of the coverage period***

Why do we need to amortise the loss component?

Without amortisation, both insurance revenue and insurance service expenses would be ***overstated***.

Expected cash flows	t_0	t_1	t_2	**Total**
Premiums	£5	£5	-	**£10**
Claims	-	-£50	-£50	**-£100**
Loss component of…				**£90**

Illustrative P&L with no LC amortisation	Inception	End of year 1	Year 2	**Total**
Revenue	**-**	**£50**	**£50**	**£100**
…Expected claims	-	£50	£50	£100
Service expense	**-£90**	**-£50**	**-£50**	**-£190**
…Establishment of LC	-£90	-	-	-£90
…Actual claims	-	-£50	-£50	-£100
Service result	**-£90**	**£0**	**£0**	**-£90**

total premiums ≠ total revenue

total service expenses ≠ total claims

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Why do we need to amortise the loss component?

Illustrative P&L with LC amortisation	Inception	End of year 1	Year 2	**Total**
Revenue	**£0**	**£5**	**£5**	**£10**
…Expected claims	-	£50	£50	£100
…Less amount allocated to LC	-	-£45	-£45	-£90
Service expense	**-£90**	**-£5**	**-£5**	**-£100**
…Establishment of LC	-£90	-	-	-£90
…Amortisation of LC	-	£45	£45	£90
…Actual claims	-	-£50	-£50	-£100
Service result	**-£90**	**£0**	**£0**	**-£90**

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Potential methods for amortising loss components

A systematic allocation ratio ("SAR") is applied to certain changes in fulfilment cash flows in order to determine how much to amortise the loss component by.

Possible approaches for determining the SAR

1. IFRS 17 Illustrative Example 8 → $$SAR = \frac{LC\ at\ \text{start of}\ period}{PVFCF(outgo\ only) + RA\ balance}$$

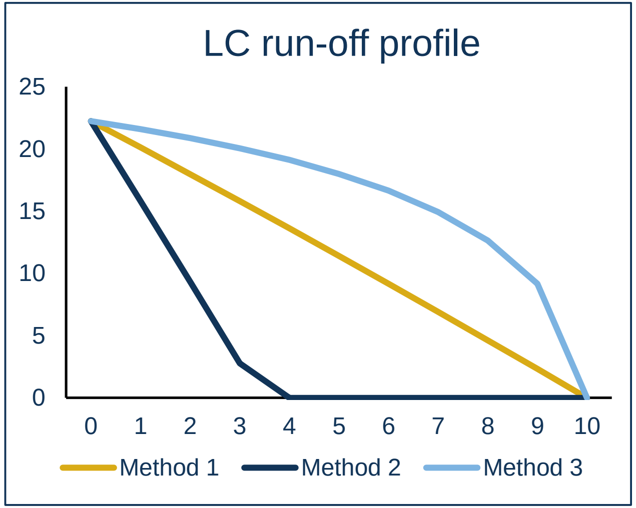
2. "Maximum run off" → $$SAR = 100\%$$ $$(with\ exceptions\ in\ certain\ periods)$$

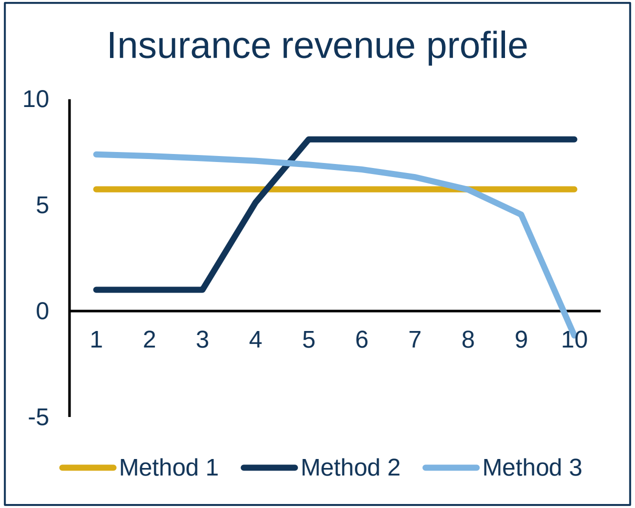
3. Based on coverage units → $$SAR = CSM\ amortisation\ rate$$ $$(with\ exceptions\ in\ certain\ periods)$$

Illustrations

Example contract

10-year policy
Single premium: £55
Acquisition expense: £10
Expected claims: £5 p.a.
Maintenance expense: £2 p.a.
Flat discount rate: 1%
Risk adjustment: 2% of claims





Observations

Method 1

- Near-linear LC run-off
- Stable profile for the revenue account
- Operationally complex

Method 2

- Quickest LC run-off
- Near-zero revenue until LC has fully run-off
- Reduced operational complexity

Method 3

- May produce slowest run off (depends on coverage units)
- Possible negative revenue (if SAR is above 100%)
- Potentially reduced operational complexity

Implications for KPI

Please refer to the following article for further details on the approaches set out above
"IFRS 17: Loss components – Part 2 of 3: Comparing various methods of amortising loss components"

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Proportionate reinsurance contracts held

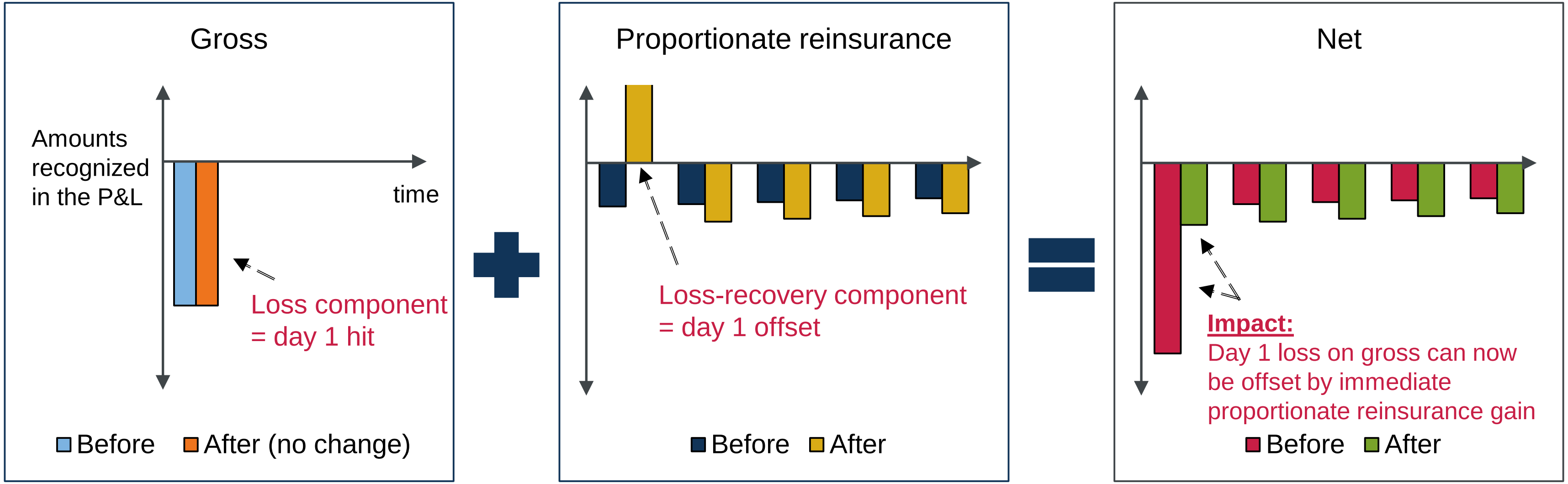
Analysing the June 2019 Exposure Draft amendments

Wijdan Yousuf

21 November 2019

Proportionate reinsurance contracts held

Impact of the June amendments (in a nutshell)



Notes for the example

- The gross contract is loss-making at initial recognition
- Reinsurance held is a ‘plain vanilla’ quota share that is ‘net cost’
- Risk adjustment and interest rates assumed to be zero

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Loss-recovery component – basic calculations

B95B and B119D

$$\begin{aligned}&\text{underlying loss component}\\ &\times \text{fixed proportion of recoverable claims}\\ &= \text{loss} - \text{recovery component}\end{aligned}$$

$\underbrace{}_{}$

how to calculate it

66A

$$\begin{aligned}&\text{reinsurance CSM}\\ &- \text{loss} - \text{recovery component}\\ &= \text{"adjusted reinsurance CSM"}\end{aligned}$$

how it gets used

Observations
No allowance for the risk of reinsurer default! Deliberate? Sensible?
The loss component might be determined using yield curve A. But the reinsurance CSM might be determined using yield curve B! Deliberate? Sensible?
The loss-recovery component always ends up ‘worsening’ the subsequent P&Ls irrespective of net cost or net gain -> theoretically possible for the loss-recovery component to ‘flip’ the reinsurance CSM from net-gain to net-cost!

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Loss-recovery component – amortisation

Relevant paragraphs

B119F (paraphrased)
The loss-recovery component needs to be adjusted to zero based on the amortisation of the loss component.

BC74 (paraphrased)
The loss-recovery component needs to be "treated similarly" to the loss component.

Interpretive issues

Does this mean a simple sum?
But what if the size of loss component ≠ size of the loss-recovery component? Even if the loss component is fully amortised, the loss-recovery component will not.

Maybe scale the amounts based on the fixed proportion of recoverable claims?
This is consistent with how the loss-recovery component was set up. But is it appropriate to allocate expected underlying expenses? Why?

Does this mean 'similar methodologies' as loss components?
Technically superior but more operational complexity!

Loss-recovery component – unintended consequence

IASB conclusion (BC79)

"Reasonable practical assumption…that the loss on underlying contracts…is caused by claims…(*to the extent that the loss does not exceed the claims cash flows …)*

Recognition that claims are not always to blame

But the proposed treatment is the same anyway

Unintended consequence:
Deferral of losses not related to reinsurance (i.e. expenses and risk adjustment)
Implications?
Further amendments?

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Acknowledgements

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Acknowledgements

Rebecca Sardar, the previous Chair, who laid the groundwork and set the direction of the working party

Miria Whittle who set out the original structure of the sessional paper and authored material on several technical issues

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Questions

Comments

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