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IFRS 17 – Key Issues and Interpretation

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Agenda

- **Why is interpretation required?**
- **Insurance contracts and unit of account**
- **Discount rate**
- **Risk Adjustment**
- **Transition to IFRS 17**
- **Profit profiles**

Disclaimer: Our comments and interpretations are based on implementation for life contracts; P&C and reinsurance contracts may differ. Comments should not be taken as advice, which will depend on the circumstances of the individual contracts or organisations. The views expressed are those of the authors.

References: We use extracts from the IFRS 17 standard and related publications in this presentation. The standard "IFRS 17 Insurance Contracts" and the "Basis for Conclusion" are © 2017 IASB.

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Why is interpretation required

IFRS 17 is a global standard, leaving considerable room for financial and practical interpretation

- Technical judgements and decisions will impact equity, profit emergence, implementation complexity and business strategy
- Requires new actuarial models – dealing with CSM retrospective assumptions, calculations and analysis
- Further pressure on reporting processes, requiring new systems and people TOM

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Insurance contracts and unit of account

Matthew Ford

Insurance contracts and unit of account

Scope of IFRS 17 – Insurance and some investment contracts

Scope of IFRS 17 applies to:

- Insurance and reinsurance contracts issued or held, or via acquisition
- Investment contracts with discretionary participation features

Must contain significant insurance risk, involving an uncertain future event and an adverse effect on the policyholder

Investment contracts are treated under IFRS 9

- Non distinct investment components apply IFRS 17, but excluded from insurance revenue and service
- Distinct investment components must be separated, if not highly inter-related (through measurement or policy holder benefit)
- Distinct service components and embedded derivatives are also accounted for separately

Key interpretation questions

- Identify investment contracts and components
- Do other contracts meet the significant insurance risk and other IFRS 17 requirements?

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Insurance contracts and unit of account

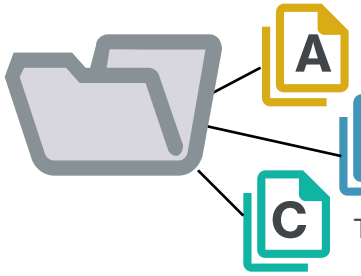
Unit of Account / Level of Aggregation

- The unit of account is highly significant
- The treatment of loss-making and profitable contracts is asymmetrical under IFRS 17; any losses on onerous contracts are recognised immediately whereas any initial gain is released to profit over the coverage period
- The unit of account is the contract "group"

1

Contracts initially to be split into "portfolios", meaning contracts that are subject to similar risks and managed together.

2 **Each portfolio is then divided into three groups:**



Contracts that at initial recognition have no significant possibility of becoming onerous subsequently

Contracts that are onerous at initial recognition

The remaining contracts in the portfolio

3 **Contracts in a group must be no more than a year apart ("annual cohorts")**

- Grouping implications
  - Typically will fall in Group C
  - Grouping only applies to CSM, not BEL or RA
  - For the transition to IFRS 17, different annual cohort requirements

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Insurance contracts and unit of account

Grouping of contracts

- Once determined at outset, groups remain fixed
- Exemption where law or regulation impacts the ability to price separately
- Requirement to perform the assessment of group at contract level, unless there is reasonable and supportable information to conclude that a set of contracts will be in the same group
- Basis for conclusions *'an entity would not be expected under normal circumstances to group separately contracts priced in the same way'*

Key interpretation questions

- Portfolio and group determination impacts complexity and the asymmetry regarding onerous and profit making contracts
- Determination of portfolio – comparison to Solvency II
- Onerous contract assessment – comparison to pricing

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Discount rate

Patrick Penzler

Discount rate

> *The discount rates applied to the estimates of future cash flows […] shall*
>
> *a) reflect the **time value** of money, the **characteristics** of the cash flows and the **liquidity** characteristics of the insurance contracts*
>
> *b) be consistent with observable current market prices (if any) for financial instruments with [similar cash flows]; and*
>
> ***c) exclude** the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance contracts*

Companies should use discount rates, for example,

- to measure fulfilment cash flows: use current discount rate
- to determine interest on the CSM and to measure changes to the CSM
- at initial recognition: may use weighted-average discount rates in cohort

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Discount rate

If, as is likely, firms are unable to find directly appropriate and observable market prices, then they need to use estimation techniques

Market based	• *maximise use of observable inputs and reflect all reasonable […] information on non-market variables available without undue cost or effort* • *…shall not contradict any available and relevant market data, and any non-market variables used shall not contradict observable market variables* • *reflect current market conditions from the perspective of a market participant*
Judgement	• exercise judgement to assess the degree of similarity between the features of the liabilities being measured and the market instrument being used and adjust to reflect the differences between them

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Discount rate

Key interpretation questions

- Characteristics of the cashflows
  - nominal or real? fixed or vary based on the returns on any underlying items? subject to guarantees?
- One rate per cashflow type?
  - *"If an entity does not divide the estimated cash flows in this way, the entity shall apply discount rates appropriate for the estimated cash flows as a whole"*.
- Can a flat rate be used?
  - IFRS 17 is not explicit, but there is a requirement to reflect the timing of liability cash flows when setting discount rates, which a curve will necessarily do better than a single rate
- Negative interest rates?
  - The requirement to make maximum use of observable market inputs and not to substitute other values implies that if rates are negative then these inputs should be used when setting liability discount rates

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Discount rate

Estimation

Although *IFRS 17 does not require a particular estimation technique*, the standard suggests two approaches:

Bottom-up	Top-down
Adjusting a liquid **risk-free yield curve** to reflect **illiquidity** of the insurance contracts	Adjusting a yield curve implicit in a **reference portfolio of assets** for factors that are not relevant to the insurance contracts

The standard also mentions

- Replicating portfolio techniques
- Risk-neutral stochastic modelling

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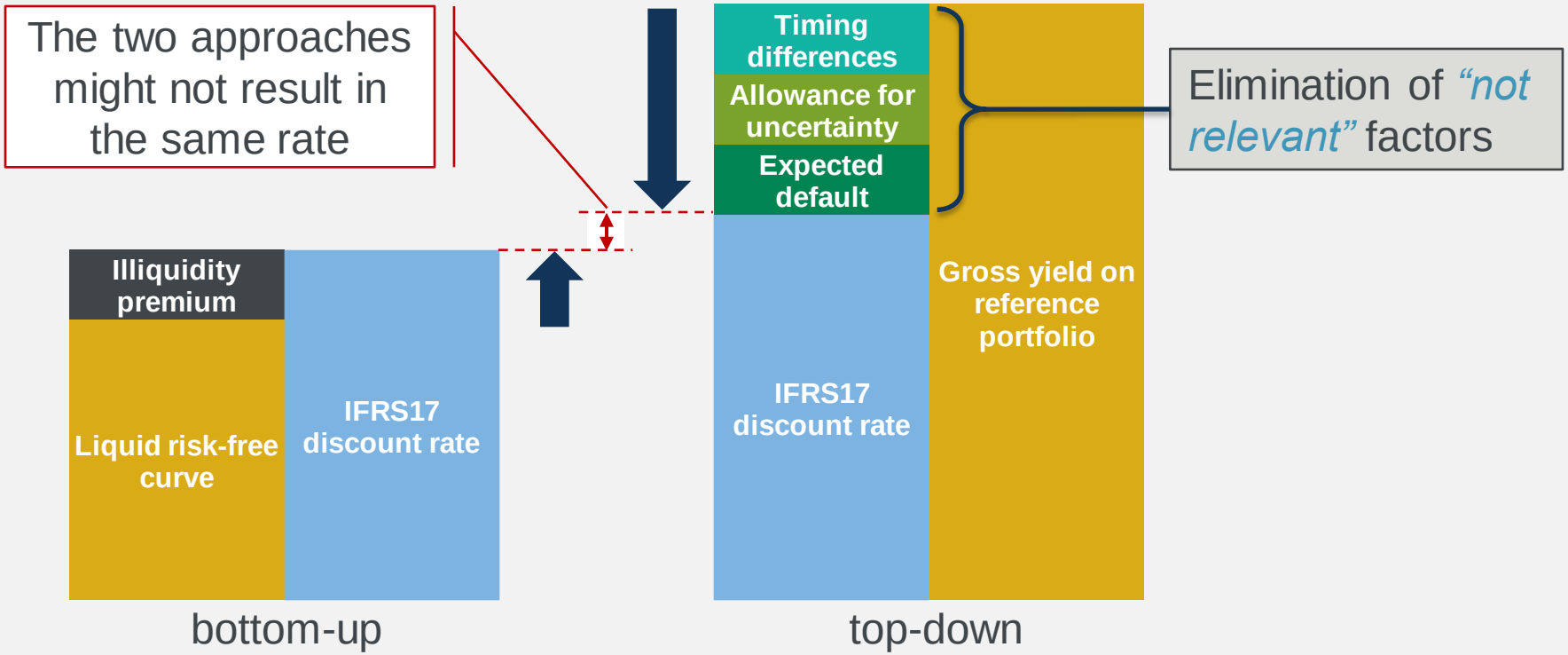
Discount rate

Bottom-up vs top-down



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Discount rate

Bottom-up approach

Key interpretation questions

Liquid risk-free rate

- Use Government bonds, Swaps, …?

Illiquidity premium

- No obvious source of current market inputs to derive an illiquidity adjustment
- Likely to involve significant qualitative judgement
- Common practice used by UK annuity writers: percentage of spread based on historic credit loss data
- BoE: structural approach (2007 paper)

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Discount rate

Top-down approach

Key interpretation questions

Adjustments for *"not relevant"* in reference portfolio

- Need to adjust for differences in amount, timing and uncertainty; fewer adjustments necessary if portfolio cash flows are matching closely
- Credit risk – IFRS standard refers to possible use of credit derivatives
  - Are they available for all bonds in reference portfolio?
  - Post the Financial Crisis, banks' appetite for writing such instruments reduced significantly; how much of the prices is down to supply vs demand?
- No need to adjust for illiquidity?
- Other (tax treatment, callable, convertible, acceptance as collateral, …)

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Discount rate

Leverage Solvency II work?

Key interpretation questions

To what extent is the Solvency II risk-free rate compatible with IFRS 17?

- Before the last liquid point
- After the last liquid point (→ ultimate forward rate)

Matching Adjustment

- EIOPA's fundamental spreads are derived using historic corporate bond data
- Consistent with IFRS 17's requirement to make maximum use and be as consistent as possible to current observable market variables?

Volatility adjustment

- Reference portfolio is set by EIOPA at a country level → more adjustments?
- 65% based on market?

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Risk Adjustment

Matthew Ford

Risk Adjustment

Principles (General Model and Variable Fee)

- Risk Adjustment for non-financial risk
- Forms part of Fulfilment Cash Flow, and is separately identifiable / measured

"Adjusts the estimate of the present value of the further cash flows to reflect the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk."

Note that **financial risk** is allowed for in the discount rate or cash flows themselves

- RA and CSM offset each other at contract recognition
- Risk adjustment is released as the risk is released (CSM is released as insurance services were provided, or loss recognition for onerous contract).
- Includes insurance and for example lapse risk, but not general operational risk
- No prescription of approach, but disclosure of an equivalent confidence level
- Reflect (and allocate) own view of the level at which risk diversification is taken
- Reflect level of uncertainty (may change over time) in cash flows and own risk aversion

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Risk Adjustment

Key interpretation questions

- Is the risk adjustment (quantum and/or methodology) consistent with the entity allowance made in pricing, EV reporting or other management decisions? Are these fit for IFRS 17 purpose?
- Own allowance for diversification, and allocation of risk adjustment back to groups
- Does the risk adjustment appropriately reflect the uncertainty and entity view of risk aversion?
- How to determine the pattern of release, including as uncertainty changes
- Possible approaches, and their implications could include:
  - Cost of capital – what capital charge, correlation with Solvency II (Pillar I or II), might not reflect catastrophe events
  - Conditional tail expectation – consistency with Solvency II risk pdfs
  - Confidence level – gives direct confidence level disclosure
  - Assumption PADs - could be a pragmatic implementation of the above

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Transition to IFRS 17

Matthew Ford

Transition to IFRS 17

Key concepts

- For an effective date of IFRS 17 of the reporting period starting 1 January 2021, the 'transition date' (TD) is the start of the prior period, 1 January 2020
- IASB aim that IFRS 17 is applied retrospectively unless *'impractical'*, but the standard allows a range of approaches, subject to constraints
- Different approaches can (and may have to be) used for different cohorts or groups
- Different approach taken for past acquisitions
- The transition approach taken may significantly impact the data required, implementation complexity, initial impact and future profit emergence
- Any differences or derecognition from past balances (eg DAC) are passed through equity on transition
- Disclosures at transition and for future reporting must explain approach and approximations used

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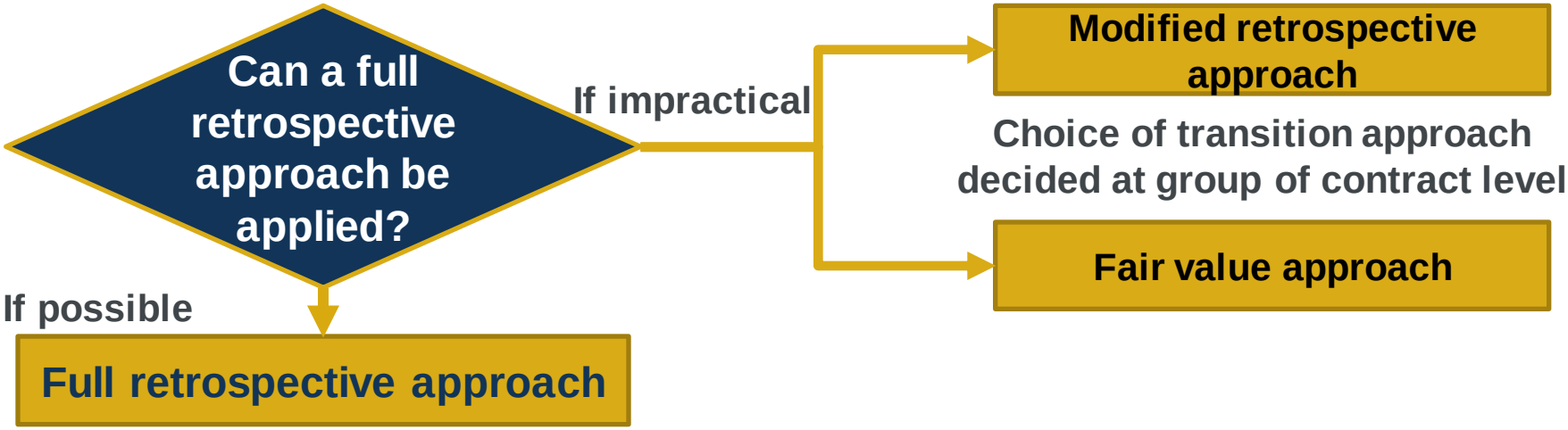
Transition to IFRS 17

Three approaches to transition

- Assess these on a group-by-group basis



Key interpretation questions

- In general likely to be impracticable to apply full retrospective to many groups
- Treatment of 2017-19 cohorts?
- Avoid application of hindsight

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Transition to IFRS 17

The retrospective approach-statement of financial position at TD

Fulfilment Cash Flows	Use current assumptions and data at TD
Contractual Service Margin	Perform a retrospective calculation • Identify groups as at initial recognition • Calculate CSM based on data and assumptions at initial recognition • Calculate emergence of CSM profit / loss to date, to arrive at current CSM
Other Comprehensive Income Balance	If this option is taken, accumulate this from finance income and expense (recognised against expected) since inception

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Transition to IFRS 17

Modified Retrospective Method

- *"Objective of the modified retrospective approach is to achieve the closest outcome to retrospective application possible using reasonable and supportable information available without undue cost or effort."*
  - If the information isn't available without undue cost or effort, use fair value approach
  - Maximise the use of the available information
- Permitted modifications include
  - Grouping can be based on data at inception or TD
  - No requirement to use annual cohorts
  - Observable yield curve or spread
  - Roll back of BEL and RA to t=0
  - Roll forward of CSM to TD
  - Allocation of any past losses
- For DPF contracts – slightly simpler approach

Calculation approach

FCF (BEL + RA) @ TD

↓

Adjust BEL and RA to t=0

↓

Derive CSM @ t=0

↓

Wind forward CSM to TD, based on coverage units

Allow for cash flows on exited contracts

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Transition to IFRS 17

Modified Retrospective Approach

Key interpretation questions

- What is ***'undue cost or effort'*****?**
- Assessment and verification of data sourced
- How many cohort time bands?
- Use of actual past revenue data and backward extrapolation (eg claims)
- Do you understand the **difference** between CSM and PVIF?

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Transition to IFRS 17

Fair Value Approach

CSM at TD = Fair Value – Fulfilment Cash Flows

- IFRS 13 principles apply, except that the liability does not have to meet demand payment
- No requirement to use annual cohorts (unless data is available)
- Applying IFRS 13 – fair value includes the profit margin that a **market participant** would accept

Key interpretation questions

- Assessing a fair value may be judgemental but consider
  - Market transactions
  - Embedded value
  - Impact of IFRS 17 scope
  - Discount rate determination

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Transition to IFRS 17

Key interpretation questions

- Impact on opening position and profit emergence
- Investor messaging – what's the ***'back–book'*** and ***'future–book'*** story and how do they compare?
- Data, modelling, process and disclosure requirements – for each group based on the approach taken

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Profit profiles

Patrick Penzler

Worked examples

- Simple annuity contract (single-life, single premium, fixed annuity)
- Illustrative profit profiles for IFRS 4, Solvency II and IFRS 17
- Impact of different discount rates
- Impact of non-market assumption change

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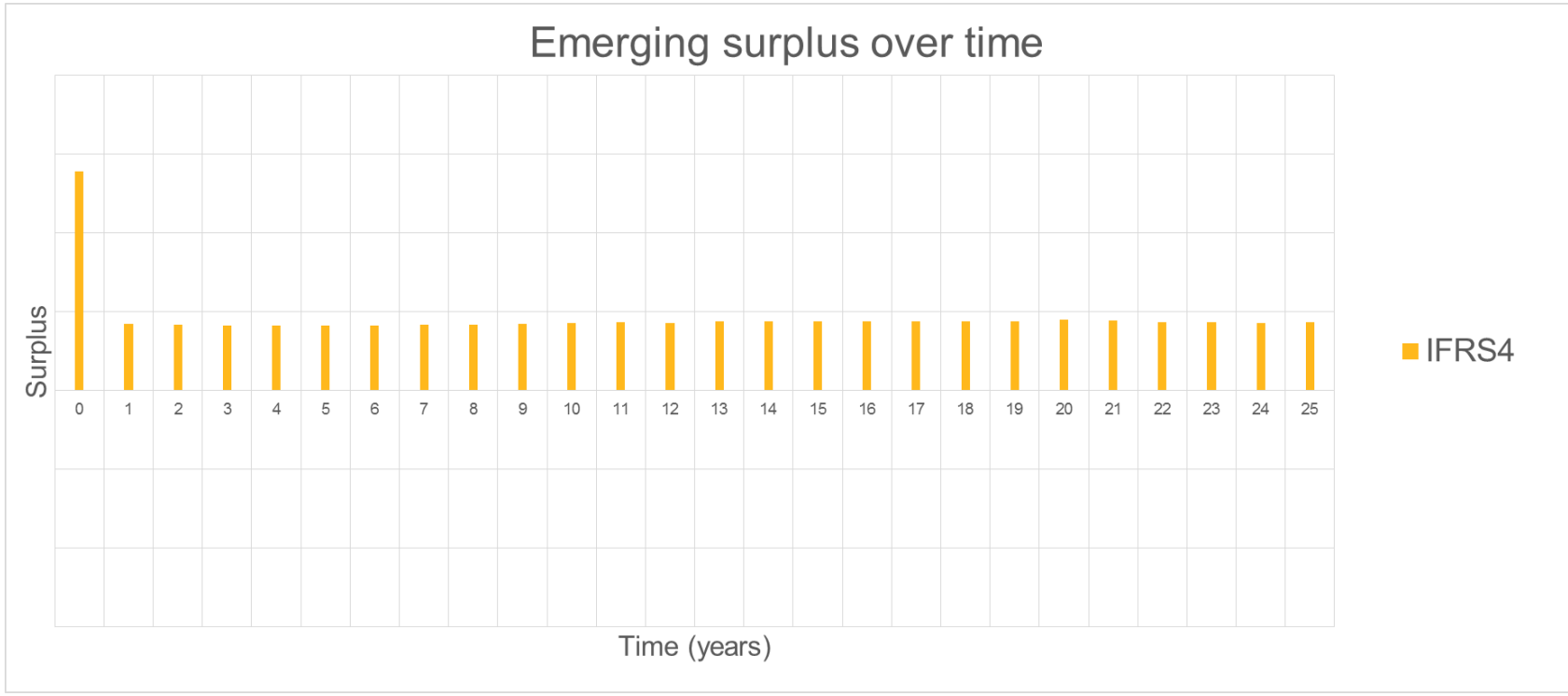
Example: Non-profit annuity projections

Emerging surplus under IFRS 4, IFRS 17, Solvency II (net of SCR)



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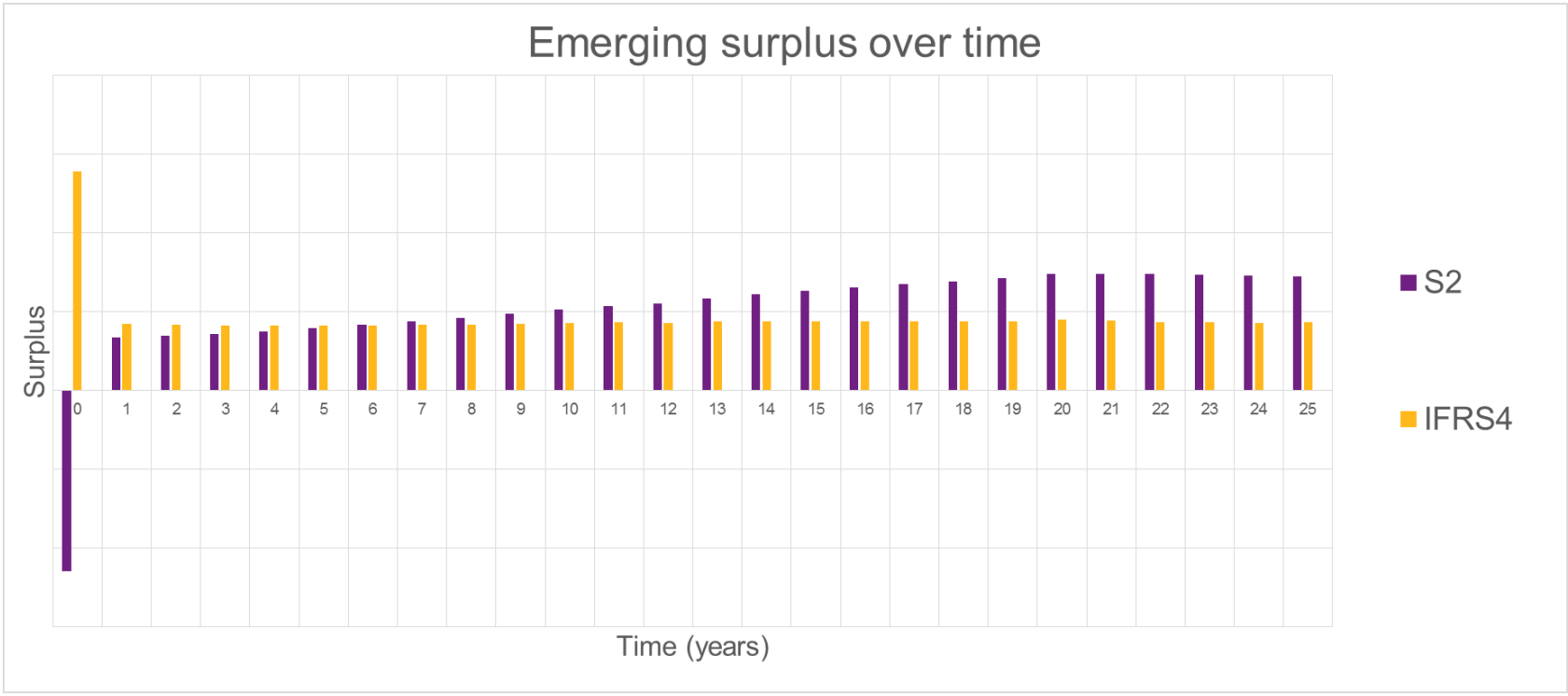

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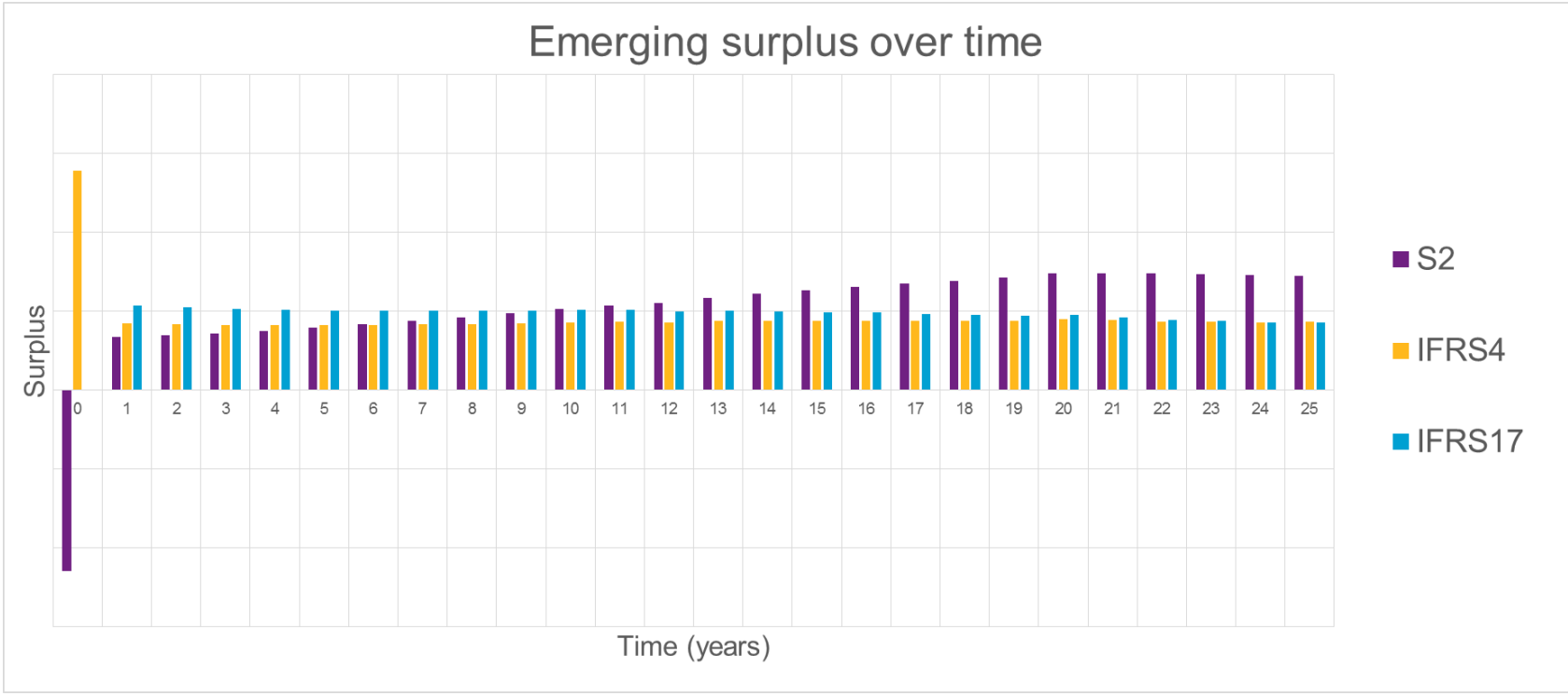

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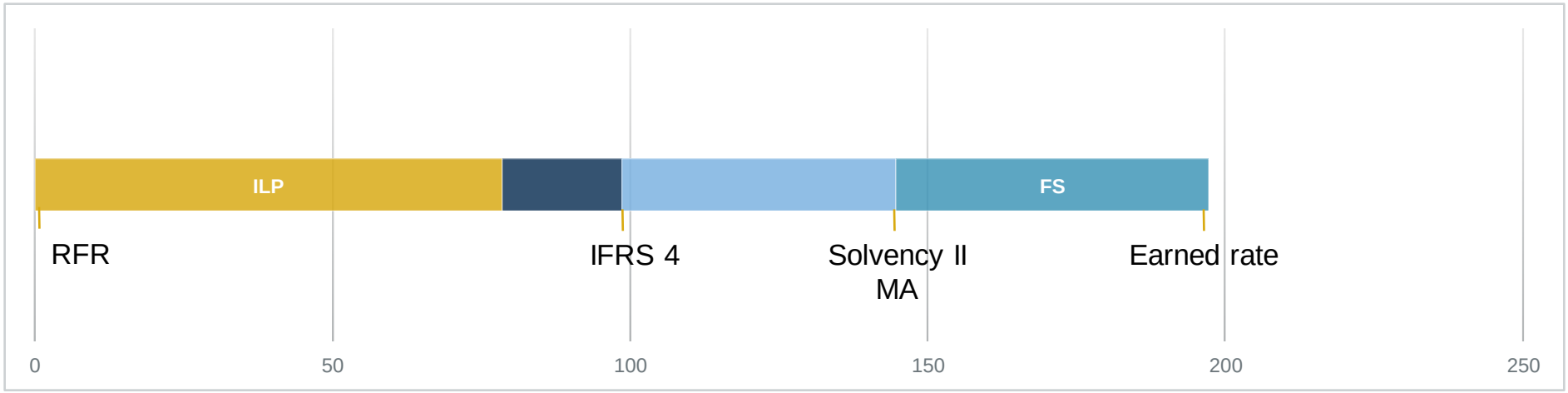
Modelling with different IFRS 17 discount rates

Spread (bps) over EIOPA RFR



- IFRS 4: 50% of spread
- Solvency II with Matching Adjustment: Earned rate minus fundamental spread

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Modelling with different IFRS 17 discount rates

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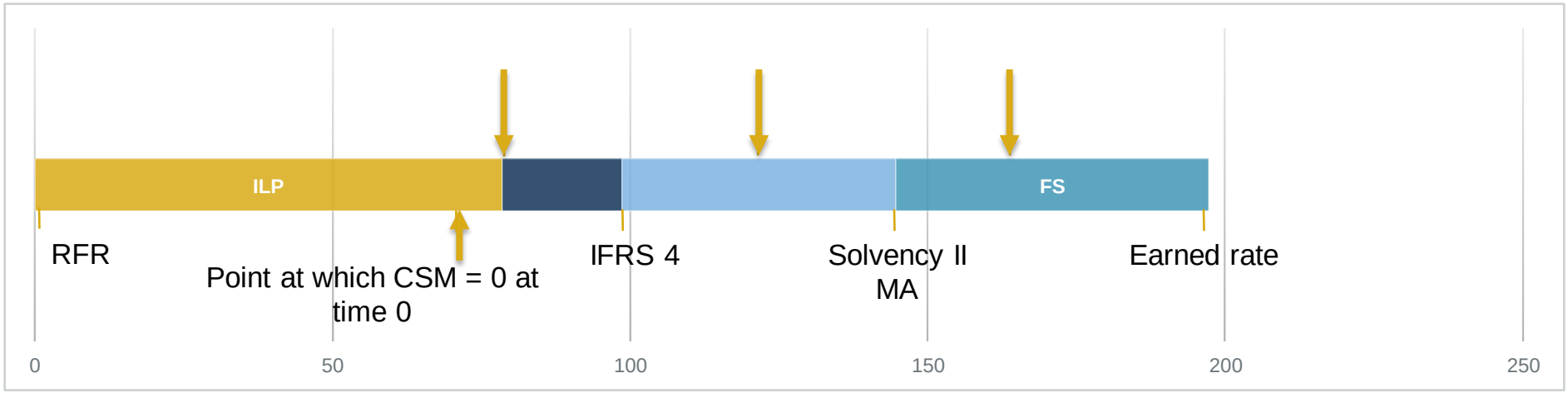

- IFRS 4: 50% of spread
- Solvency II with Matching Adjustment: Earned rate minus fundamental spread

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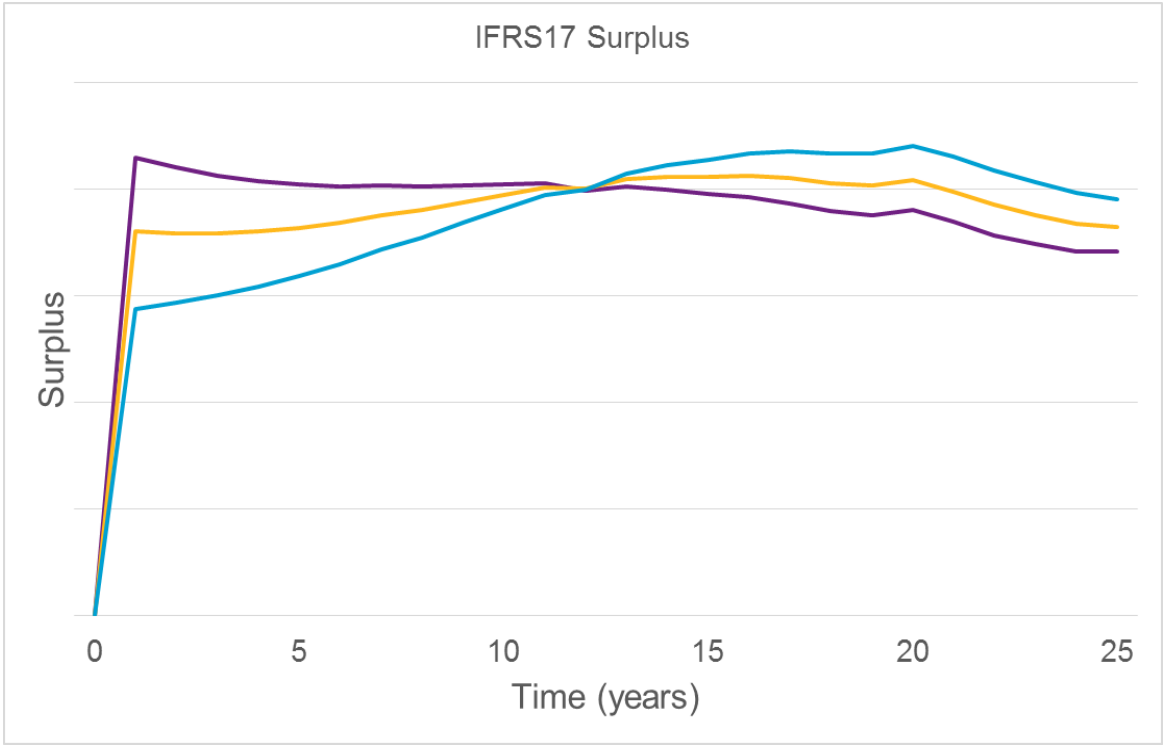
Sensitivity in assumptions

Example of the impact of the choice of discount rate



IFRS 17 discount rates:

+ 79bps
+ 122bps
+ 165bps

All with respect to the swaps less credit risk rate

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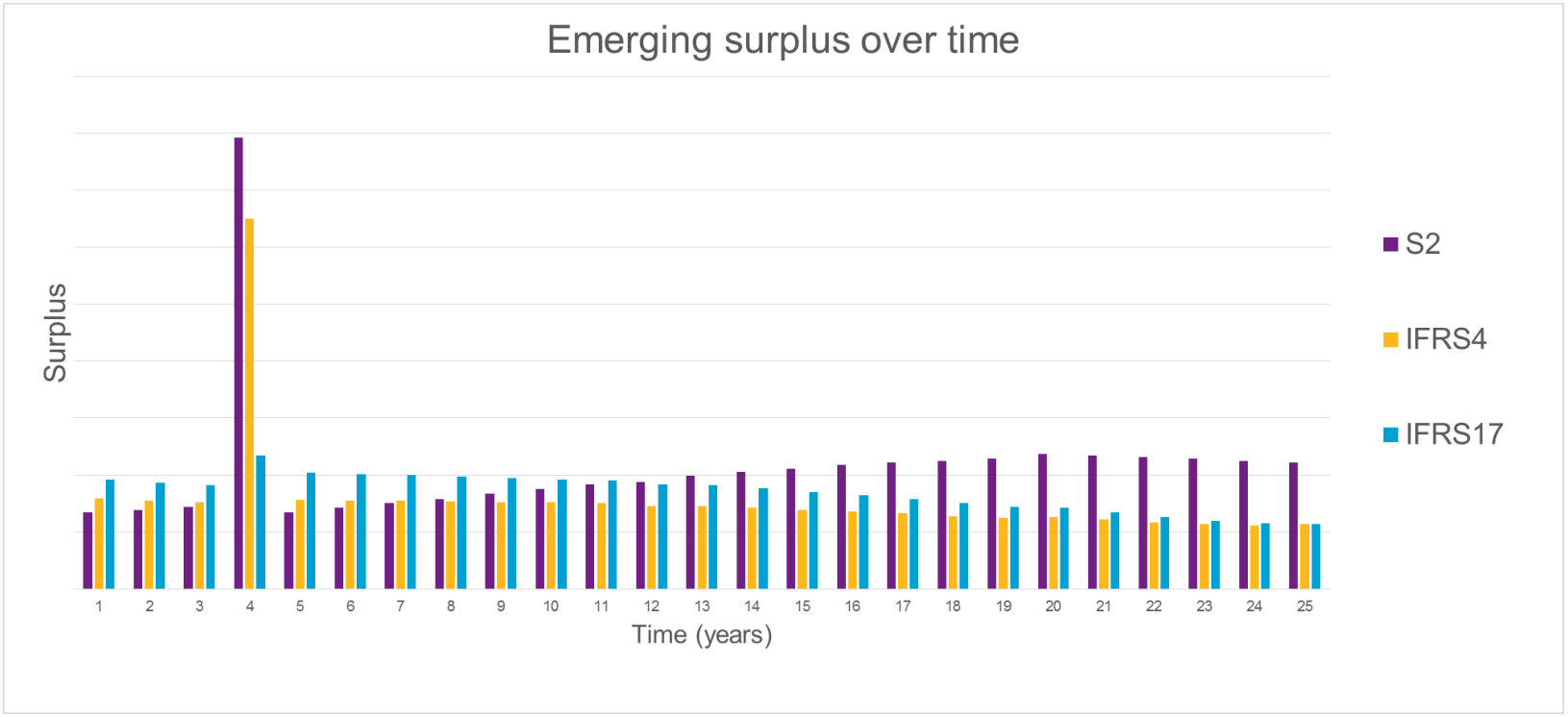
Example: Non-profit annuity projections

Positive mortality experience variance (+10%) in year 4



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