Reserving Seminar 2018
IFRS 17 Overview

Alice Boreman
on behalf of the IFoA IFRS 17 for General Insurance working party

A work in progress

This presentation represents the views of the working party members and does not represent the views of the members’ respective employers.

Our thinking is still a work in progress rather than agreed consensus views.
Overview of IFRS 17

IFRS 17 is the first truly international, comprehensive accounting Standard for insurance, replacing IFRS4 – an interim Standard that results in widely divergent practices.

The IASB aimed for IFRS 17 to bring:

- Consistent accounting for all insurance contracts (health, life and general insurance sectors and with other sectors)
- Updated information about obligations, risks and performance of insurance contracts
- Increased transparency in financial information reported by insurance companies

What IFRS 17 requires:

- A measurement model for insurance contracts which is based on:
  - expected future cash flows;
  - discounted to reflect time value of money; and
  - a risk adjustment to reflect the compensation the insurer requires to bear risk
- The expected profit in a contract is measured on day one and released over the coverage period
- Early recognition of potential loss making contracts
- Increased disclosure requirements

Impact of IFRS 17 on general insurers:

- Move to a best estimate basis, no reserve margins will be permitted instead an explicit risk adjustment will be required
- Driver of profit and recognition of profit over time will change due to new best estimate valuation model, unwind of discount, release of risk adjustment and release of CSM (GM only)
- Underwriting result and finance result will have a new ’feel’ and presentation.
- New KPIs, strategy, incentives and education are required as well as system changes
- Expansion of disclosure requirements

Entities finalising implementation

Effective date of IFRS 17

18 May 2017 2018 2019 2020 2021

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Adoption of IFRS 17 across the globe

Measurement model overview

IFRS 17 introduces two measurement models:

1. “General Model” (GM) where unearned and earned coverage is all measured by considering discounted, risk-adjusted cash flows and profit is measured at inception by the Contractual Service Margin (CSM) which is earned out over the coverage period.

2. “Premium Allocation Approach” (PAA) which offers a simplified approach to measurement of unearned business.

Contracts are eligible for the simplified approach if:

- the coverage period is 12 months or less; or
- if the entity reasonably expects it would produce a liability for remaining coverage for the group that would not differ materially from the one that would be produced under GM.
Overview of key areas of the standard

Presentation and disclosure

Portfolios / onerous contracts

Central estimate cash flows

Simplified approach (PAA)

Risk adjustment

Discounting/ inflation

Contractual service margin (GM only)

Reinsurance measurement

Acquired portfolios

Transition

Unbundling

Expenses

Premium Allocation Approach

When can it apply?

<table>
<thead>
<tr>
<th>PAA Eligibility Decision</th>
<th>For each portfolio/cohort of contracts</th>
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</thead>
<tbody>
<tr>
<td>Do all contracts within the portfolio/cohort have a coverage period of 12 months or less?</td>
<td><strong>YES</strong></td>
</tr>
<tr>
<td>• The portfolio/cohort automatically applies for the PAA.</td>
<td></td>
</tr>
<tr>
<td>• No need to demonstrate eligibility.</td>
<td></td>
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<tr>
<td>• Auditors may request evidence that the portfolio/cohort fulfils the criteria.</td>
<td></td>
</tr>
<tr>
<td><strong>NO</strong></td>
<td></td>
</tr>
</tbody>
</table>

| Can it be reasonably expected that the LRC under the PAA would not differ materially from the GM? | **YES** |
| • The portfolio is likely to be eligible for the PAA. |
| • Auditors are likely however require justification. |
| • Need to define what ‘reasonably expects’ and ‘differs materially’ means for the reporting entity. |
| • May require modelling of future stresses/scenarios to demonstrate immateriality in a range of outcomes. |
| **NO** |

| Is the portfolio/cohort and associated deviation in the LRC immaterial for the reporting entity? | **YES** |
| • This consideration is outside the scope of IFRS 17. |
| • Broader accounting/materiality question – see IASB Practice Statement 2 “Making Materiality Judgements”. |
| • Will need to carefully monitor the materiality of the portfolio/cohort which are not eligible (based on the above steps) over time. |
| **NO** |

It is unlikely that the PAA will be available to the portfolio/cohort.

The period before a claim is incurred. Variability in the fulfilment cash flows increases coverage period of the group of contracts.”
IFRS 17 introduces more rigorous measuring and reporting requirements for “groups” of loss making contracts

Measurement of insurance liabilities is (performed or allocated) at the level of a “group of insurance contracts” so that favourable and unfavourable changes in estimates from the individual contracts in the group are offset within the group but not with other groups. IFRS 17 asks to consider profitability gross of reinsurance, and allowing for the effect of discounting and risk adjustment. For PAA groups, this is identified based on “facts and circumstances”.

Divide a portfolio of insurance contracts into a minimum of the following (ie. consider each of the three groups below):

<table>
<thead>
<tr>
<th>Onerous group</th>
<th>Other</th>
<th>No significant possibility of becoming onerous</th>
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</thead>
<tbody>
<tr>
<td>Groups that are onerous (loss making), ie. fulfilment cash flows is a net outflow</td>
<td>Groups that could potentially turn onerous under very stressed conditions</td>
<td>Resilient group: Some characteristics of resilience include low sensitivity to risk drivers, “thick” margin</td>
</tr>
<tr>
<td>For PAA, assume that there are no onerous contracts unless “facts and circumstances” indicate otherwise.</td>
<td>Assess whether non onerous contracts have no significant possibility of becoming onerous subsequently based on likelihood of changes in facts and circumstances</td>
<td>Example of “Other” may be groups of contracts on a ‘watch list’ (such as where historic COR &gt;95%) or which are particularly sensitive to changes in assumptions (volatile)</td>
</tr>
<tr>
<td>Where senior management would be aware of selling loss making business</td>
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Identifying “groups” of insurance contracts

What the standard requires

IFRS 17 expects you to identify portfolios of insurance contracts which comprise contracts that have similar risks and are managed together. These portfolios are then divided into a minimum of three groups: a group of contracts that are onerous at initial recognition, a group of contracts that have no significant possibility of becoming onerous and a group of remaining contracts. In addition, within these groups there will be underwriting cohorts as a group cannot contain contracts that are issued more than one year apart.

Data at each intersection is then needed to calculate the carrying amount of the group of contracts.

Contracts issued in 20X1

Contracts issued in 20X2

By annual cohorts - UW year

By group – at a minimum of those below

Expected to be onerous at initial recognition

No significant possibility of being onerous as at initial recognition

Other at initial recognition

By portfolio – similar risks managed together

By portfolio A

Portfolio B

Portfolio C

Portfolio A
**Risk Adjustment**

The purpose of the risk adjustment for non-financial risk is to **measure the effect of uncertainty in the cash flows that arise from insurance contracts, other than uncertainty arising from financial risk.** [IFRS 17.B89]

The level at which the target CL and hence the risk adjustment is set for each entity could have a material impact on the number of contracts being classified as onerous and will be important factors in the tests for onerous contracts.

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**Reinsurance**

- IFRS 17 uses ‘reinsurance contracts issued’ to describe inwards reinsurance contracts
- IFRS 17 describes outwards reinsurance contracts as ‘reinsurance contracts held’
- Requirements in respect of reinsurance contracts issued are the same as the requirements applicable to insurance contracts issued
- These requirements are modified for reinsurance contracts held to reflect the specific features of reinsurance contracts held

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**PAA eligibility**

Reinsurance contracts with coverage periods of a year or less are automatically eligible for the (simplified) premium allocation approach [PAA]

**Coverage units**

The amount of CSM recognised in the P&L in each period is determined based on “coverage units”. Coverage units are determined by considering the quantity of benefits provided under a contract and its expected coverage duration

**Treatment of net gains and losses on reinsurance held**

- Net expense/loss on initial recognition
  - On initial recognition, a debit CSM would typically be recognised which represents the net expense of purchasing reinsurance
  - If a net gain/credit CSM arises, i.e. amount paid for RI < expected PV of cash inflows plus risk adjustment

- Net gain on initial recognition
  - Recognise over coverage period as services are received

- Exception: If reinsurance held covers events that have already occurred (e.g. ADC), recognise the whole net expense in P&L on initial recognition

- Coverage units for contracts applying the general model (GM)
  - The amount of CSM recognised in the P&L in each period is determined based on “coverage units”. Coverage units are determined by considering the quantity of benefits provided under a contract and its expected coverage duration

**Embedded derivatives**

There may be derivatives embedded in insurance (or reinsurance) contracts that need to be accounted for separately under IFRS 9 Financial Instruments

* For proportional reinsurance held, the measurement on initial recognition should include all rights and obligations relating to future coverage, including in relation to underlying contracts not yet written

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**Diversification benefits**

Diversification benefits should be reflected and should be considered from the reporting entity’s perspective.

**May TRG (Agenda Paper 2) conclusions**

1. Individual financial statements of an entity (subsidiary) that is part of a Group
   - Diversification benefit is only reflected to the extent it is considered by the subsidiary when determining the risk adjustment related to insurance contracts issued by the entity.

2. Consolidated financial statements of the Group of entities
   - The risk adjustment at the consolidated level is the same as the risk adjustment at the individual entity level.
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Questions

Comments