Hrvatsko aktuarsko društvo
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IFRS 17 and its business implications

- What is IFRS 17 and how it is going to change the life of accountants and actuaries

Agenda

- A quick overview of the new standard
- Recognition of profit or loss under IFRS 17
- Case study for life assurance
- Practical implications

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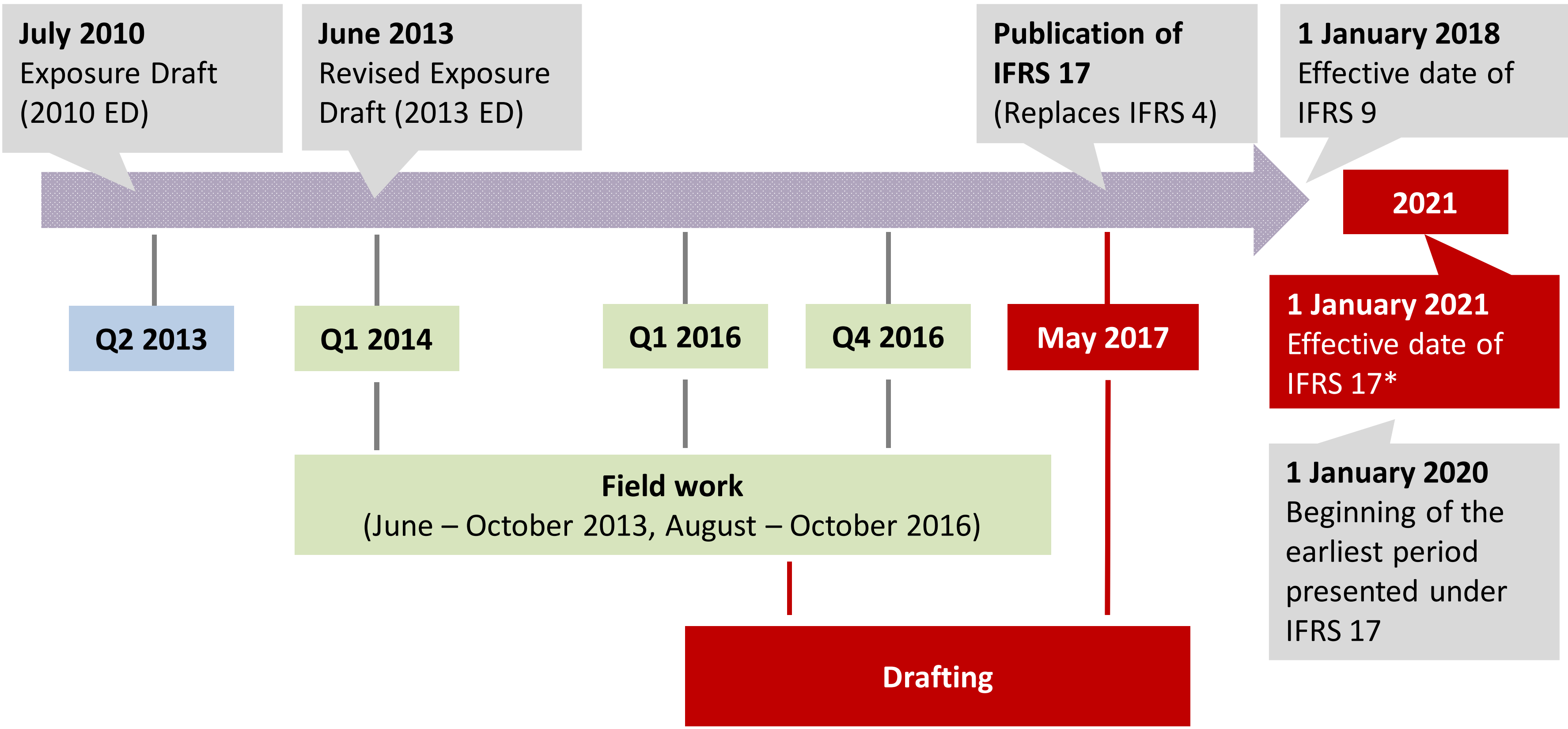
Current status of the project



** An entity may apply IFRS 17 before 1 January 2021, if it also applies IFRS9 and IFRS15 on or before the date of initial application of IFRS17*

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Definition of an insurance contract

"A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."

- Risk is uncertainty about, at least one of the following aspects: Probability of the insured event; Amount payable under the event; Timing of the payment

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Significant insurance risk

- It is assessed based on scenarios with commercial substance and on a
  - Present value basis
  - Contract-by-contact basis
  - Before reinsurance

"Insurance risk is significant if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance"

Boundary of the contract (1/2)

"Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services"

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Boundary of the contract (2/2)

- A substantive obligation to provide services ends when:
  a) The entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; OR
  b) Both of the following criteria are satisfied:
     i) the entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio;
     ii) the pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date

Separation of components from an insurance contract

Client contract

- Insurance components
- Distinct investment components
- Embedded Derivatives
- Distinct goods or non-insurance services

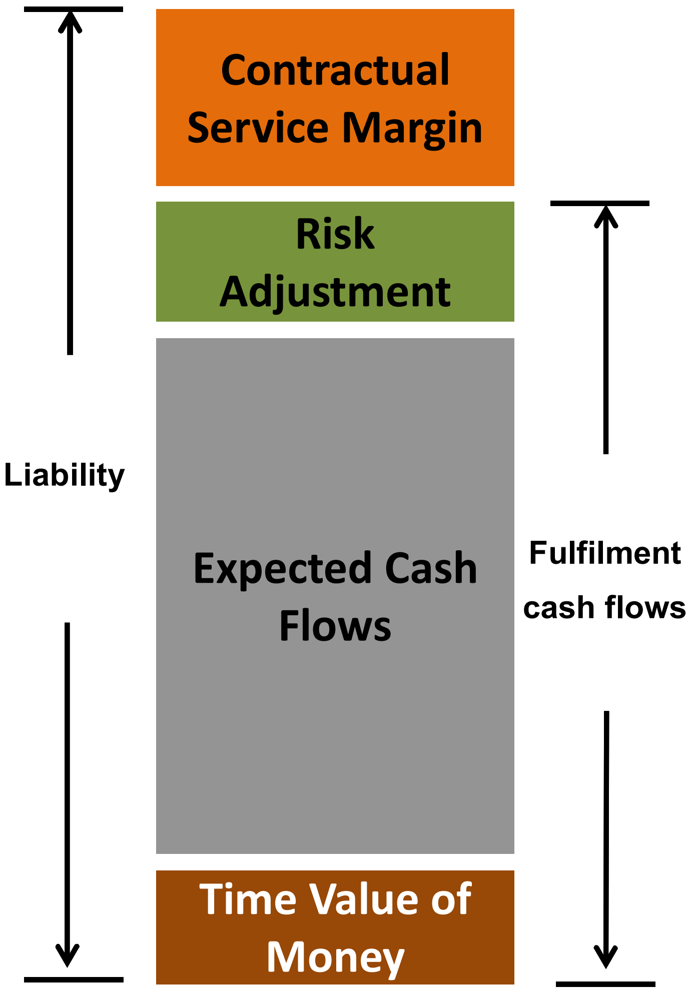
- The new Insurance Contracts Standard **IFRS17**
- Under the new Financial Instruments Standard **IFRS 9**
- Under the new Revenue Recognition Standard **IFRS 15**

Level of aggregation

"An entity shall identify portfolios of insurance contracts. A portfolio comprises contracts subject to similar risks and managed together"

Å An entity shall divide a portfolio of insurance contracts issues into a minimum of
 - ï a group of contracts that are onerous at initial recognition, if any;
 - ï a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and
 - ï a group of the remaining contracts in the portfolio, if any.

The Building Block Approach (BBA)



- **Expected cash flows**
  - Explicit and current
  - Entity’s perspective but not in contrast with observable market variables
- **Risk Adjustment (RA)**
  - Includes diversification benefits
  - Reflects entity’s risk aversion
- **Contractual Service Margin (CSM)**
  - Unearned profit
- **Discount rate**
  - Consistent with observable market prices
  - Excludes any factors which are not relevant to CFs of the insurance contract

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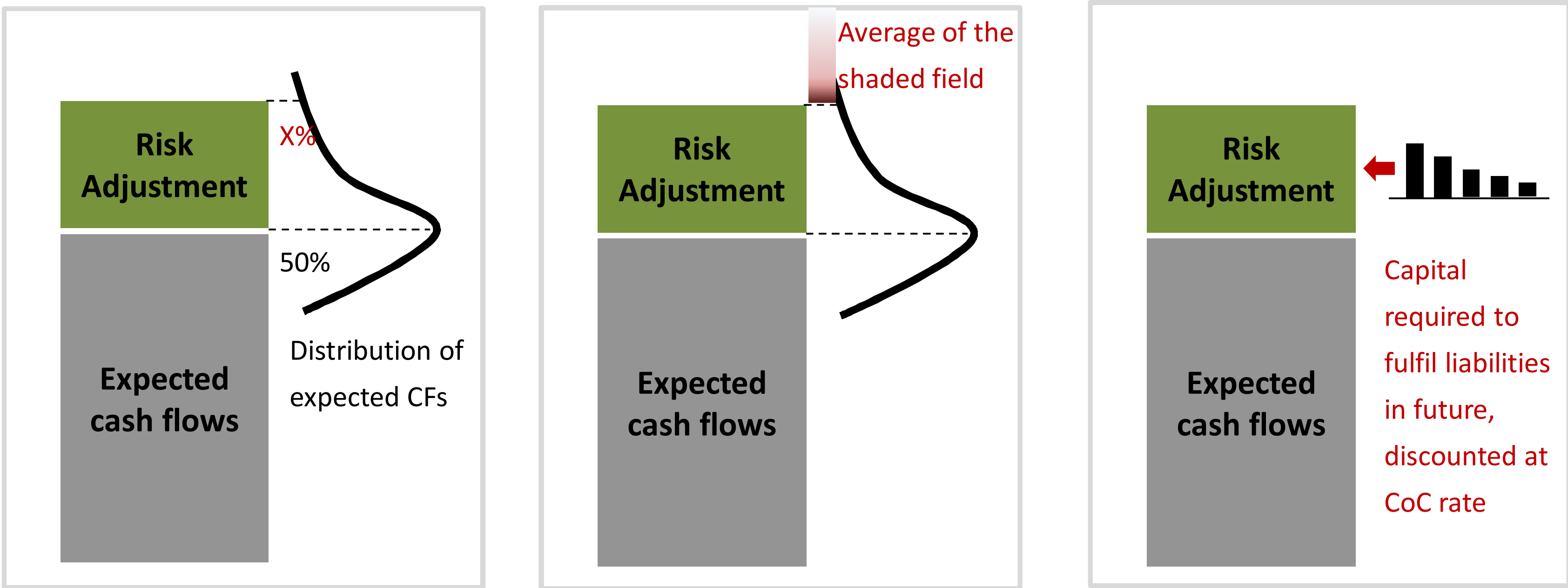
Expected cash flows

- Should include all cash inflows and cash outflows that relate to the fulfilment of the portfolio of insurance contracts
- Cash flows should
  - Be current
  - Be explicit, unbiased and probability-weighted estimates
  - Reflect the perspective of the entity (but should not contradict to observable market data)
  - Incorporate all information about the amount, timing and uncertainty
  - Comprise only CFs within the Contract Boundary

Risk Adjustment

Confidence Level **Conditional Tail** **Cost of Capital**



- An entity shall disclose the confidence level used to determine the risk adjustment for non-financial risk

Discount rates

- An entity should determine the fulfilment cash flows by adjusting the estimates of future cash flows for the time value of the money, using discount rates that reflect the characteristics of those cash flows
- Discount rates should
  - Be consistent with observable current market prices for instruments whose characteristics reflect the insurance liability (e.g. timing, currency and liquidity) AND
  - Exclude the effect of any factors that influence the observable market prices but that are not relevant to the cash flows of the insurance contract

Contractual Service Margin (1/2)

- The Contractual Service Margin (CSM) is initially set to eliminate gains at inception whereas losses are to be recognized immediately
- At initial recognition, an entity should recognize the CSM at an amount that is equal to the opposite sum of
  - The fulfilment cash flows for the contract at initial recognition; AND
  - Any pre-coverage cash flows

Contractual Service Margin (2/2)

- The initially recognized CSM should be released over time during the coverage period or period of provision of the insurance services
- Interest should be accrued at locked-in rate on the remaining balance of the CSM and the CSM should be released over passage of time and expected number of in-force policies

Statement of financial performance

Å An entity shall disaggregate the amounts recognised in the statement(s) of profit or loss and other comprehensive income (hereafter referred to as the statement(s) of financial performance) into:

 ï Insurance service result, comprising insurance revenue and insurance service expenses;
 ï Insurance finance income or expenses

Insurance service result (1/2)

- (83) An entity shall present in profit or loss insurance revenue arising from the groups of insurance contracts issued. Insurance revenue shall depict the provision of coverage and other services arising from the group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services.
- (84) An entity shall present in profit or loss insurance service expenses arising from a group of insurance contracts issued, comprising incurred claims (excluding repayments of investment components), other incurred insurance service expenses and other amounts as described in paragraph 103(b)
- (85) Insurance revenue and insurance service expenses presented in profit or loss shall exclude any investment components. An entity shall not present premium information in profit or loss if that information is inconsistent with paragraph 83.

Insurance service result (2/2)

- (B121) The total consideration for a group of contracts covers the following amounts:
  - (a) Amounts related to the provision of services, comprising:
    - i) Insurance service expenses, excluding any amounts allocated to the loss component of the liability for remaining coverage;
    - ii) The risk adjustment for non-financial risk, excluding any amounts allocated to the loss component of the liability for remaining coverage; and
    - iii) The contractual service margin.
  - b) Amounts related to insurance acquisition cash flows

Insurance finance income or expenses

- An entity should include in insurance finance income or expenses the effect of changes in assumptions that relate to financial risk
- An entity should make an accounting policy choice as to whether to disaggregate insurance finance income or expenses for the period between profit or loss and other comprehensive income. An entity shall apply its choice of accounting policy to portfolios of insurance contracts

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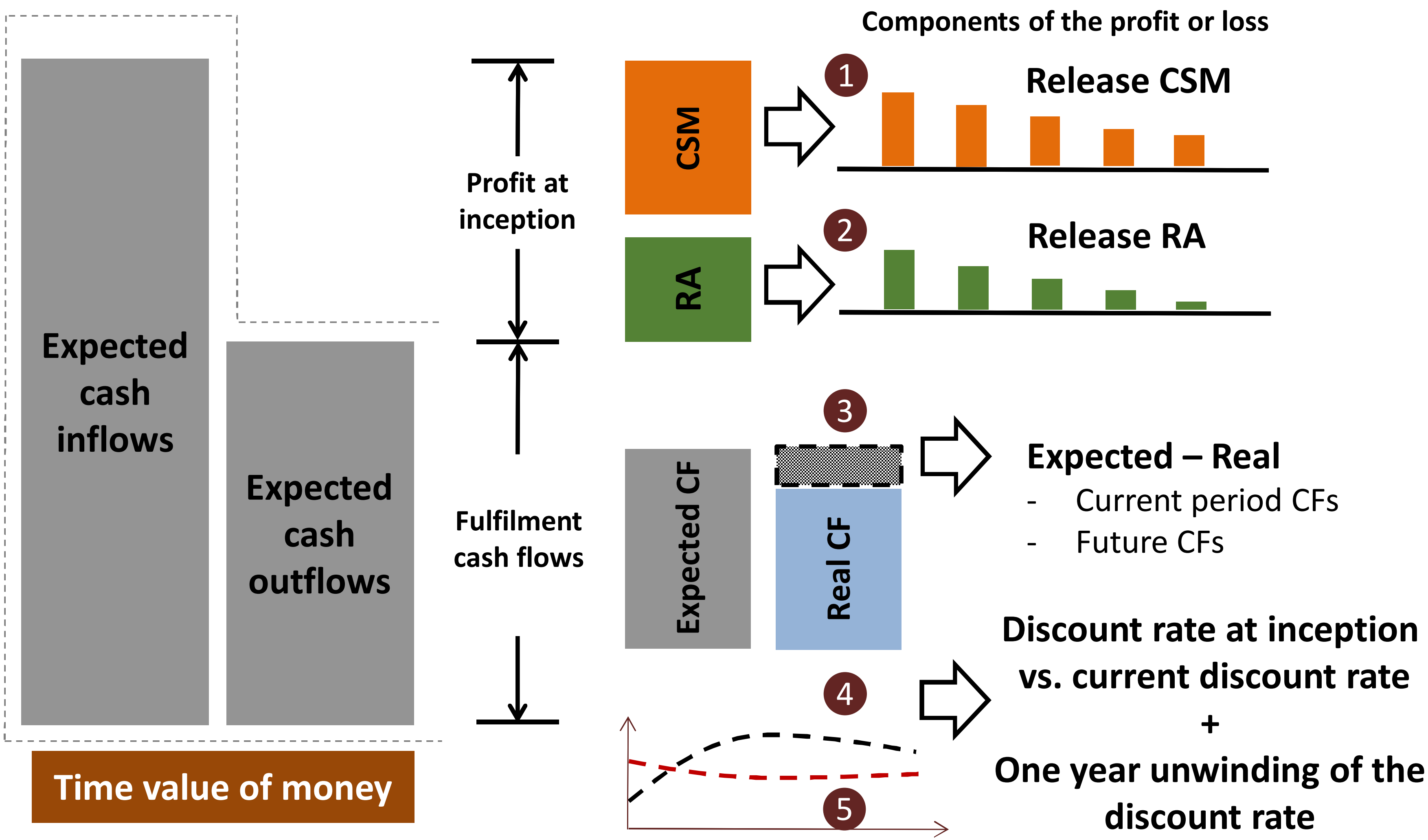
Components of the profit or loss (1/2)



Components of the profit or loss (2/2)

	Insurance contract revenue	x
3	Incurred claims and expenses	(x)
	Insurance service result	X
	Investment income on assets	X
5	Insurance investment expense on insurance liability	(x)
	Insurance finance income or expenses	X
	Profit or Loss	X
4	Discount rate changes on insurance liability	X
	Comprehensive income	X

Release of Contractual Service Margin	(x)	1
Release of Risk Adjustment	X	2
Expected claims and expenses	x	3
Insurance Contract Revenue	X	

- **Revenue and expense** are recognised as earned or incurred
- **Insurance investment expense** is current or 'cost view', depending on accounting policy
- If insurance investment expense is 'cost view', **difference between current and cost basis is presented in OCI**

Transition (1/2)

- (C3) An entity shall apply IFRS 17 retrospectively unless impracticable
- (C4) To apply IFRS 17 retrospectively, an entity shall at the transition date
  - identify, recognise and measure each group of insurance contracts as if IFRS 17 had always applied
  - derecognise any existing balances that would not exist had IFRS 17 always applied; and
  - recognise any resulting net difference in equity

Transition (2/2)

Å (C5) If, and only if, it is impracticable for an entity to apply paragraph C3, an entity shall apply the following approaches instead of the retrospective approach

ï The modified retrospective approach

ï The Fair Value approach

A case study for life assurance (1/4)

Liabilities at transition	PVCF	RA	CSM	Total
IFRS 4 Liability	7 167			7 167
IFRS 17 Liability	6 868	69	127	7 064
Transition adjustment				**104**

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A case study for life assurance (2/4)

A

IFRS 17 reserve	7 064	5 869	4 865	4 271	3 914
Premiums		642	562	491	429
Investment income		5	17	24	30
Change in reserves	B	1 195	1 004	594	356
Claims paid		-1 746	-1 488	-1 023	-736
Investment expenses		-5	-5	-5	-4
Acquisition costs		6	1	0	0
Fulfilment expenses		-56	-52	-47	-43
IFRS 17 profit excl. other exp.		**41**	**39**	**35**	**32**
Other expenses		-14	-13	-12	-11
Total IFRS 17 profit		**28**	**26**	**23**	**21**

A case study for life assurance (3/4)

B

Revenue	Insurance service expenses		1 185	1 008	611	381
	Release RA		12	10	6	4
	Release CSM		3	3	3	3
	Incurred claims and expenses	A	-1 159	-982	-584	-354
	Other expenses		-14	-13	-12	-11
	Insurance service result		**28**	**27**	**24**	**23**
	Investment income		5	17	24	30
	Insurance investment expense		-5	-18	-25	-31
	Insurance finance income or exp.		**0**	**0**	**-1**	**-1**
	Total IFRS 17 profit		**28**	**26**	**23**	**21**

** Premiums and repayments of investment components will not part of the revenue. Included are here only for illustrative purposes.*

A case study for life assurance (4/4)

Movements in In-Force Business	PV CF	RA	CSM	Total
Opening balance IFRS 17 liability	**6 868**	**69**	**127**	**7 064**
Premiums received	642			642
Claims paid	-1 746			-1 746
Experience adjustments claims	-13			-13
Acquisition costs paid	6			6
Other fulfilment expenses paid	-61			-61
Experience adjustments expenses	-4			-4
Insurance investment expense	5	0	0	5
Changes in expected future cash flows against the CSM				
Changes in expected future cash flows recognized in PnL				
CSM recognized in period for prov. Services			-3	-3
Changes to the RA recognized in PnL		-12		-12
Impact of changes in discount rates and other mkt. var.	-10	0		-10
Closing balance IFRS 17 liability	**5 687**	**57**	**124**	**5 869**

Practical implications (1/4)

Å We have 3,5 years for implementation …

Å Product classification

ï Not all contract components may classify as insurance contracts

ï Need deep knowledge of other IFRS's (IFRS 9, IFRS 15, …)

Å Portfolios of insurance contracts

ï IFRS 17 definition may not be fully consistent with business view

ï Disclosure requirements at portfolio level

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Practical implications (2/4)

Å Transition

- ï Do we have information for the retrospective approaches? (Need to determine remaining CSM from inception of the contracts)
- ï Transition adjustments vs. tax legislation
- ï Deferred tax implications

Å Actuarial models and data

- ï (Full) stochastic modelling (Need to disclose the level of confidence for Risk Adjustment)

Practical implications (3/4)

Å Data collection and IT

ï Collection of very granular data

ï Probability-weighted estimates of cash flows

ï Suitability of existing IT systems/programs

ï Analysing historical costs

Å Product design

ï Definition of significant insurance risk

ï Different contract components may change due to accounting implications

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Practical implications (4/4)

Å Market share

- ï How do we measure this without premiums?

Å Solvency II vs. IFRS 17

- ï Do we have the systems and time to run two completely separate calculations?
- ï Do we understand the links between these two standards
- ï Solvency II is about balance sheet but IFRS 17 is about the PnL

References

- S. Otzen: Understanding IFRS 4.2 (European Actuarial Academy, 2016)
- Floris van Diest –Tim Schilders: Knowledge Sharing - IFRS 17 (www.zanders.eu)
- IFRS 17 Insurance Contracts, May 2017
- http://www.ifrs.org/Current+Projects/IASB+Projects/Insurance+Contracts/Insurance+Contracts.htm

Thank You!

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