IFRS 17 implementation

Practical issues and challenges so far

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Baltic Actuarial Summer Days 2018

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Brief overview of IFRS17

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- Major change in accounting rules for insurance contracts
- IFRS 17 will not be applied to investment contracts although unbundling rules will change.
- Effective from 1 January 2021
- Insurance contract liabilities will be more similar to Solvency II technical provisions, but not the same
- Complex transition rules
- The impact on financial results and equity still needs to be assessed (depends on the accounting model/ transitional options selected)
- Major impact on systems (data, valuation, reporting)

Accounting/ measurement models

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	General model	Premium allocation approach	Variable fee approach
Why is it needed?	Default model for all insurance contracts	Simplified measurement for short-term contracts with little pre-claim variability	Model for direct participating business
Mandatory?	Mandatory	Optional	Mandatory

Source: PwC, In depth, A look at current financial reporting issues, IFRS 17 marks a new epoch for insurance contract accounting

Direct participation feature/ VFA

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- VFA reduces the volatility of results compared to BBA s
- Participating contracts are products where pool of policyholders has the legal right to the pre-defined share of surplus
- . . . however the rules for individual contract may not be fixed
- Criteria to determine whether VFA approach can be applied (“direct participation”)
- Insurers share in profit is accounted as CSM
- Changes in the estimates of future fees adjusted against CSM.
- In calculations of liabilities for different groups of policies will be possible to move expected bonuses between groups without affecting the PL or CSM

Obligation to policyholder

Benefits based on underlying assets

Minus “variable fee” i.e. charge of the company

Challenge No 1. Decide on the portfolios and measurement models

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- Review classification to insurance and investment contracts
- Discretionary participation feature
- Direct participation feature
- Separation of components
- Grouping of contracts

IFRS17 classification tree

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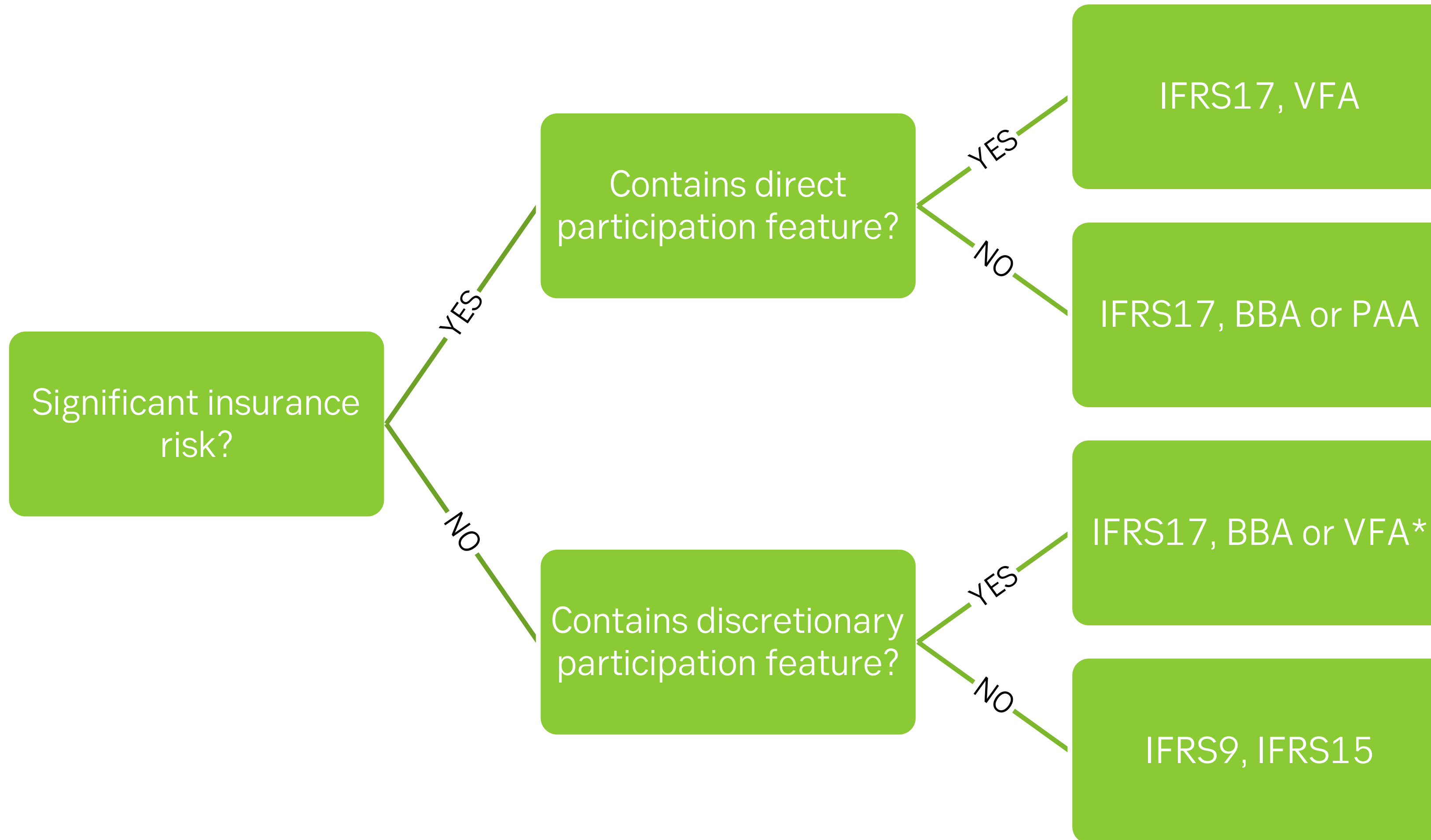

*if the company also issues insurance contracts

PAA eligibility criteria

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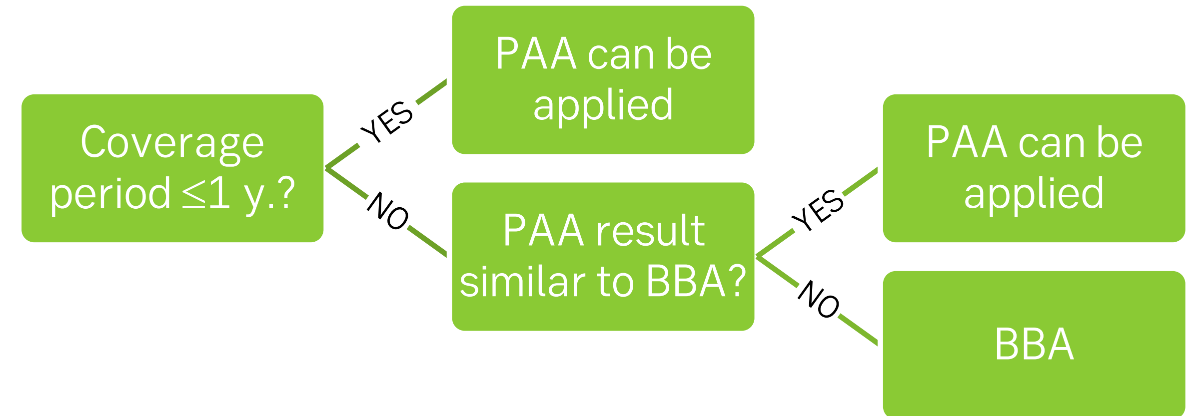
- Basis for PAA – premiums received less acquisition costs
- Option to expense acquisition costs for groups of contracts with coverage period ≤1 year
- Adjustment for discounting if there is a significant financing element
- Losses for onerous groups should be recognized immediately
- Incurred claims provisions still under BBA, but discounting is not mandatory if CF≤1 year.



Open questions to consider

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- Will the previous benchmarks for significance of insurance risk will hold?
- What about products with profit sharing, where policy conditions do not specify the profit sharing proportions? Is the link to FV returns enforceable? Can such product meet the definition of DPF or DiPF?
- Can long term pure risk life insurance qualify for PAA? If yes, what supporting analysis should be performed?

Separation of components

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- Distinct investment components
- Distinct service component
- Embedded derivatives
- Separation of different insurance covers?? (currently under discussion in TRG)

Distinct investment component

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- Entity should separate from a host insurance contract an investment component if, and only if, that investment component is **distinct**
- Investment component is distinct if:
  - Not highly unrelated with insurance component:
    - can be measured separately,
    - policyholder is unable to benefit form one component unless other is present
  - Contract with equivalent terms is sold or could be sold in the market
- No more unbundling option, which was often applied in the Baltics

Example

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- Question:

Does unit linked contract with risk riders contain distinct investment component?

- Answer:

No, as highly interrelated. Normally in case of termination of insurance part, investment part is also terminated (and vice versa). See Illustrative Example No 4.

Grouping at initial recognition

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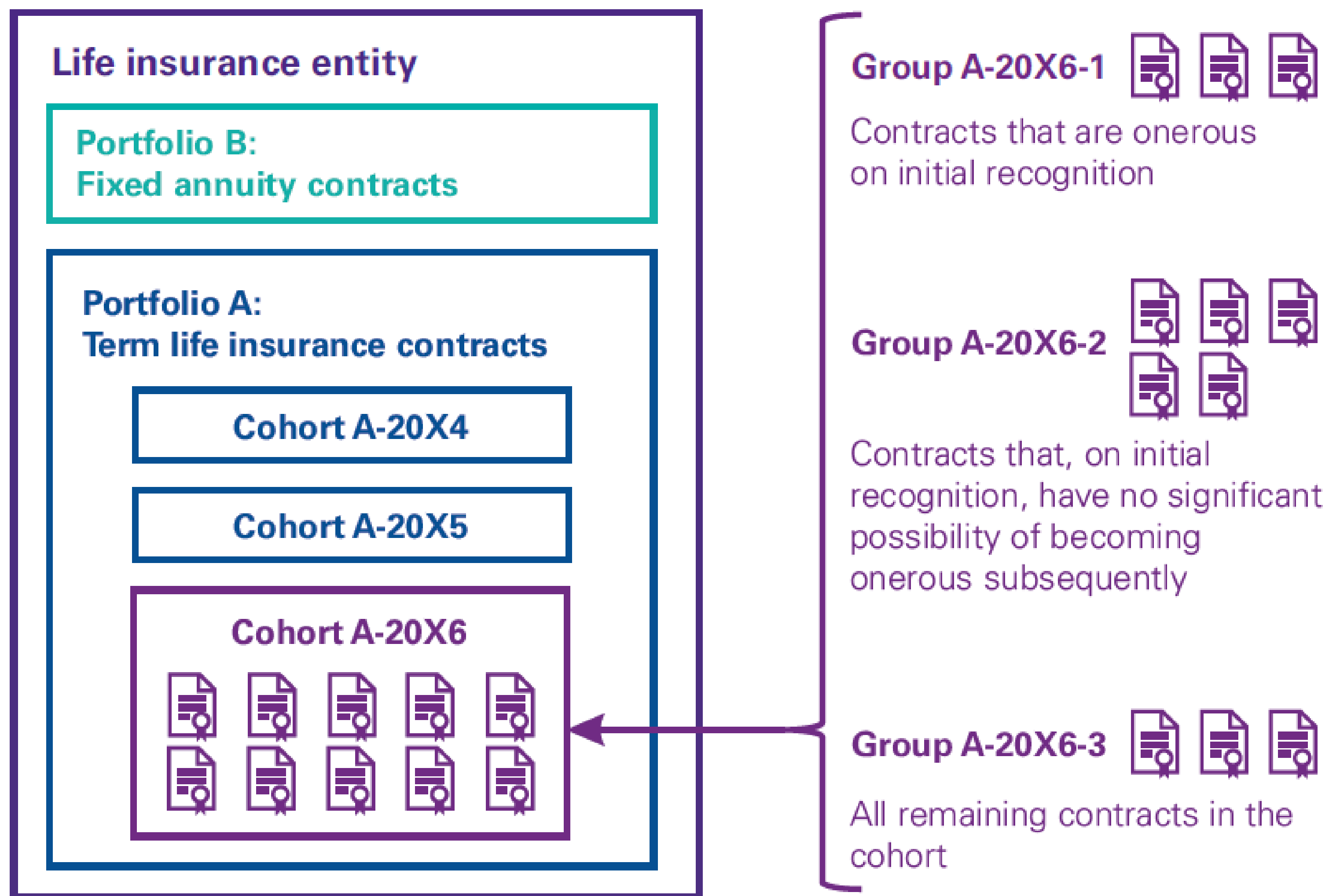

Source: KPMG, Insurance Contracts, First Impressions IFRS 17

Grouping open questions

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- Determining the factors to use in determining the profitability groups, e.g.:
  - Non standard pricing
  - Client segment
  - Distribution channel
  - Etc.
- Exemption where law or regulation impact the ability to price separately (e.g. EU unisex pricing requirements).
- Is internal reporting always available to determine the profitability groups? How the companies should proceed if this is not the case?
- How to set a threshold for profitable/ highly profitable groups?

Challenge No 2. Update the measurement model

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- Contract boundaries and CF projections
- Discount rates
- Risk adjustment
- CSM

Initial recognition - BBA

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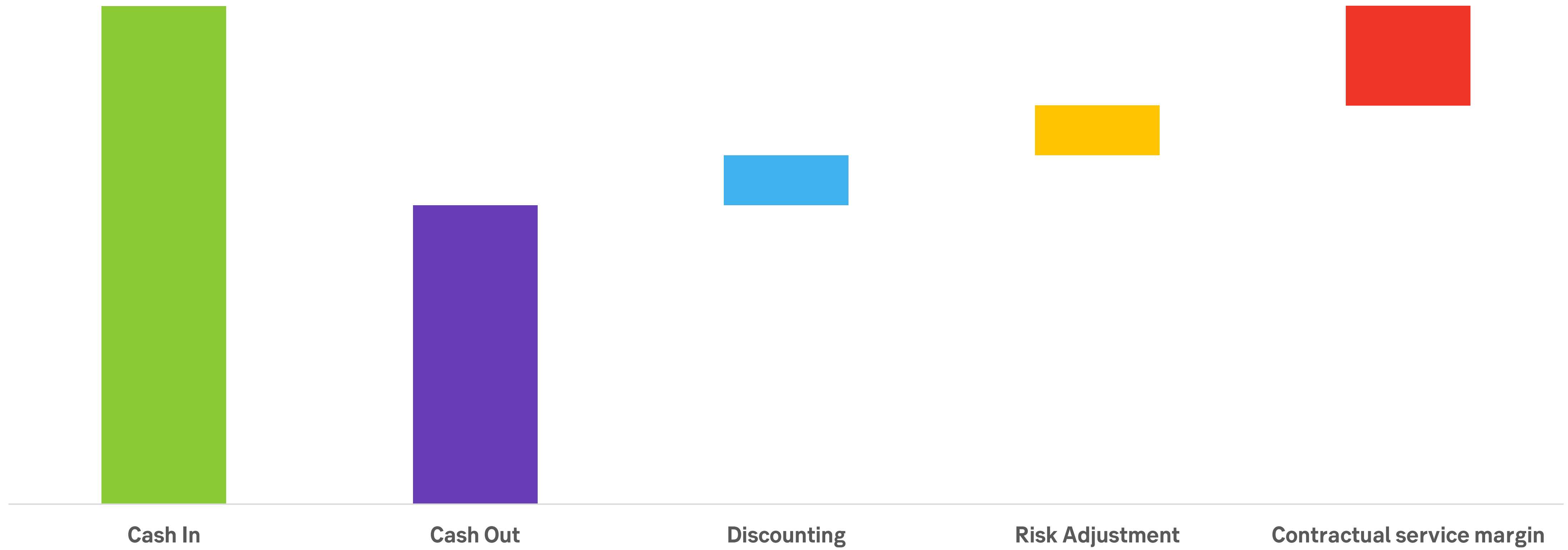

Contract boundaries

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Cash flows are within the contract boundary if

- Entity can compel the policyholder to pay premiums or
- Has a substantive obligation to provide the policyholder with services

This substantive obligation ends when:

- Entity has the „practical ability“ to reassess the risks of the **particular policyholder** and can set the price that fully reflects these risks or
- Both conditions are met:
  - Entity has the „practical ability“ to reassess the risks of the **portfolio that contains the contract** and can set the price that fully reflects these risks
  - The pricing of the premiums for coverage up to the reassessment date does not take into account risk that relate to periods after the reassessment date

CF projections

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- Similar to Solvency II, however, there are exceptions:
  - Boundaries of cash flows
  - Acquisition costs
  - General overheads
  - Contracts with profit sharing (“Mutualisation”)
  - Other?

Open questions

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- One boundary approach. Still discussed in TRG. Could have major implications for direct business and reinsurance contracts held
- Determining directly attributable expenses to be included in CF projections

Valuation interest rate

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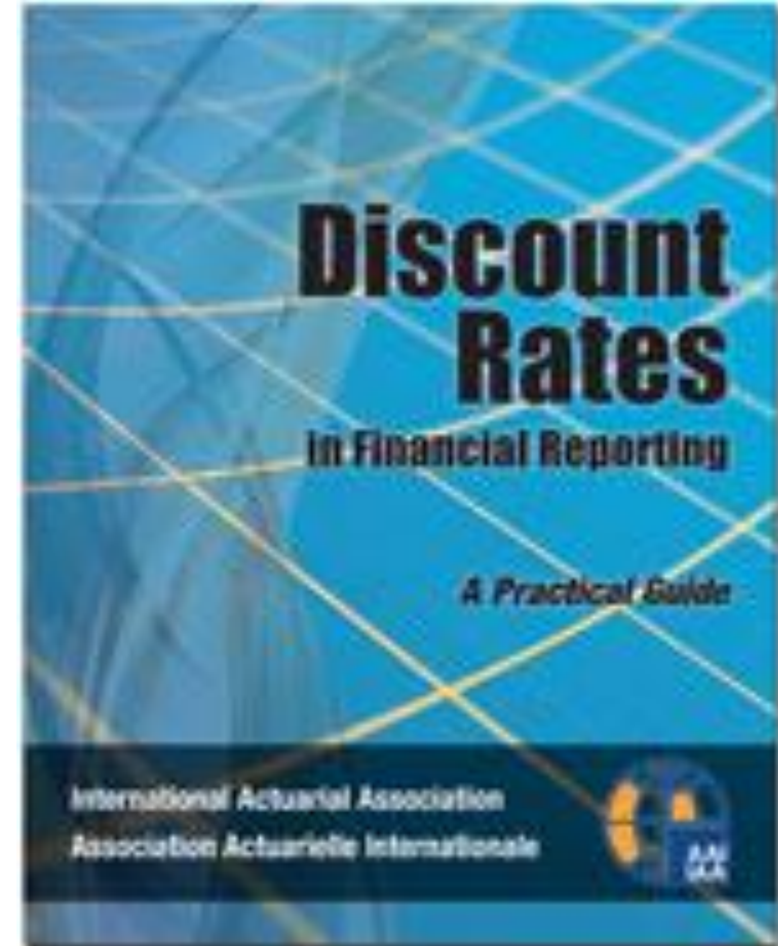
- Discount rates should reflect the nature of cash flows
- Illiquidity premium should be included in the discount rate
- „Top-down“ or „bottom-up“ approach.
- Can EIOPA risk free interest rate be used as the basis?
- What would be a practical approach to derive illiquidity premium?



Risk adjustment

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- No prescribed method, examples:
  - Confidence level
  - Cost of capital

- Cost of capital method might be considered, however:
  - Confidence level should be disclosed
  - How to derive/ justify cost of capital rate?

CSM calculations

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- The key implementation question is how to determine coverage units of a group of contracts for the purpose of release of CSM.
  - BC rejected the pattern of expected CF as the basis for allocation of CSM to reporting periods
  - Ongoing discussion at TRG on this matter
- CSM calculation will require separate tool and data storing capacity
- In BBA historic discount rates are use for interest accretion - additional data storing requirement.

Other challenges

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- Assessment of financial impact and available options
- Changes in financial reporting systems and processes
- Align new KPI, KRIs, management reporting
- Data availability and storing
- Disclosures
- Transitional calculations
- Training and employees and management

Thank you for the attention!
We'll have a lot of materials to read in the next 2 years...

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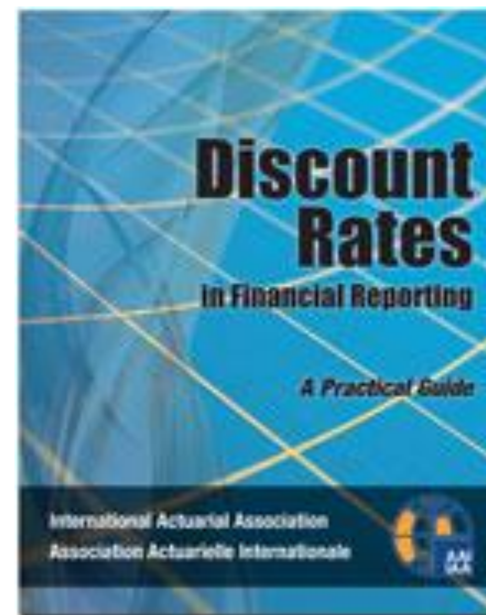
May 2017

IFRS® Standards

IFRS 17 Insurance Contracts



In depth
A look at current financial reporting issues

30 June 2017

No. INT2017-04

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IFRS 17 marks a new epoch for insurance contract accounting

At a glance

In May 2017, the International Accounting Standards Board (IASB) issued IFRS 17, 'Insurance Contracts', and thereby started a new epoch of accounting for insurers. Whereas the current standard, IFRS 4, allows insurers to use their local GAAP, IFRS 17 defines clear and consistent rules that will significantly increase the comparability of financial statements. For insurers, the transition to IFRS 17 will have an impact on financial statements and on key performance indicators.

Under IFRS 17, the *general model* requires entities to measure an insurance contract at initial recognition at the total of the fulfilment cash flows (comprising the estimated future cash flows, an adjustment to reflect the time value of money and an explicit risk adjustment for non-financial risk) and the contractual service margin. The fulfilment cash flows are remeasured on a current basis each reporting period. The unearned profit (contractual service margin) is recognised over the coverage period.

Aside from this general model, the standard provides, as a simplification, the premium allocation approach. This simplified approach is applicable for certain types of contract, including those with a coverage period of one year or less.

For insurance contracts with direct participation features, the variable fee approach applies. The variable fee approach is a variation on the general model. When applying the variable fee approach, the entity's share of the fair value changes of the underlying items is included in the contractual service margin. As a consequence, the fair value changes are not recognised in profit or loss in the period in which they occur but over the remaining life of the contract.

The new standard is applicable for annual periods beginning on or after 1 January 2021. Early application is permitted for entities that apply IFRS 9, 'Financial Instruments', and IFRS 15, 'Revenue from Contracts with Customers', at or before the date of initial application of IFRS 17. The standard can be applied retrospectively in accordance with IAS 8, but it also contains a 'modified retrospective approach' and a 'fair value approach' for transition depending on the availability of data.

Appendix C provides a table of content for this publication.

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https://www.ifrs.org/news-and-events/calendar/2018/may/ifrs-17-transition-resource-group/

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This content is for educational/ general information purposes only and cannot replace a professional advice.
Most of the IFRS17 rules are still discussed and subject to further interpretation and possible changes.