

# IFRS 17

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Introduction to the new Insurance Accounting Standard

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# The need of a new accounting Standard

The current insurance contracts accounting under IFRS does not provide existing and potential investors, clients, creditors and other third parties with the information they need in order to:

- understand the financial statements of entities that issue insurance contracts
- make meaningful comparisons between them and with entities in other industries

The main aim of IFRS 17 is to standardize insurance accounting globally and to bring

- improved reporting quality, increased amount of information in the financial statements
- better comparability between insurers and also between insurers and firms in other industries
- more transparency in the financial statements of the insurance entities

# IFRS 17 Key Objectives

The key objectives of the standard are:

- Introduce for the first time a single IFRS accounting model for all types of insurance contracts and eliminate the numerous approaches possible under IFRS4
- Make the new accounting model highly transparent and market consistent
- Provide information on
  - The effect of the insurance contracts that an entity issues on its performance
  - The way by which entities earn profits, or incur losses, through underwriting services
  - The nature and extent of risks that companies are exposed to, as a result of issuing insurance contracts
- Split earnings by source and separate the insurance operating margin and the investment returns.

# Scope of the IFRS 17 application

IFRS 17 applies to

- Insurance contracts issued. For a contract to be classified as insurance significant insurance risk needs to be transferred to the issuer. Significance of insurance risk is defined in the standard and is assessed at policy inception
- Reinsurance contracts issued
- Investment contracts with Discretionary Participation Features but only if the entity issues also insurance contracts

IFRS 17 does NOT apply to

- Insurance contracts if the entity is the policyholder
- Other financial guarantees contracts
- Employers assets and liabilities that arise from employee benefit plans

# IFRS 17 Aggregation (1)

IFRS 17 introduces the unit of account concept. All portfolio that is subject to the standard needs to be segregated between Unit of Accounts under a three ways grouping rationale

- Risk Profile Contracts that belong into the same unit of account need to be subject to similar risks
- Profitability at Inception Contracts that belong into the same unit of account need to be of the same profitability profile at inception as in the below categories
  - Onerous
  - Non Significant probability of becoming Onerous
  - Other (if any)

## IFRS 17 Aggregation (2)

- Cohort Contracts that belong into the same unit of account can not be sold more than one year apart from each other.

The Unit of Accounts should be determined in a per contract basis unless the entity has reasonable and supportable information to conclude that a set of contracts can be in the same group.

The creation of the units of account is demanding as the entity's need to construct them for the inforce business which requires a lot of historical data, pricing information and experience that is not always available

Alternative approach for the older in force business is offered through the fair valuation

# Unbundling

An insurance contract may contain one or more components that would be within the scope of another accounting standard if they were separate contracts like an *investment component*

An entity needs to

- Separate from the host insurance contract any distinct investment component. An investment component needs to fulfill specific criteria defined in the standard to be characterized as distinct
  - Non high relation to the host insurance contract
  - Could be sold separately in the same market or same jurisdiction
  
- Identify any embedded derivatives within the insurance contract, and account for them separately

# IFRS 17 Methodology

Each of the Unit of Accounts is falling within a specific calculation methodology of recognition out of three that the IFRS 17 determines

## ➤ General Model

- Building Block Approach is the Default Approach
- Variable Fee approach will should be applied when the contract is of direct participation nature
  - Participation in a clearly identified pool of assets
  - Payout is expected to be an amount equal to a substantial share of the fair value of the underlying assets
  - Payout varies as the fair value of the underlying assets changes

## ➤ Premium Allocation Approach is a simplification, optionally applied if

- The entity expects that the measurement of the liability will not be materially different than the default approach
- The coverage period of the group of business is a year or less



# Financial Statements – Balance Sheet

IFRS 4 Balance Sheet	IFRS 17 Balance Sheet
+ Financial Assets + DAC <u>+ Other Assets</u> <b>= Total Assets</b>	+ Financial Assets  <u>+ Other Assets</u> <b>= Total Assets</b>
+ Local Stat Reserves + Liability Adequacy Provisions  <u>+ Other Liabilities</u> <b>= Total Liabilities</b>	+ Insurance Contract Liabilities 1. PVFC (Including Loss Component if any) 2. Risk Adjustment 3. CSM <u>+ Other Liabilities</u> <b>= Total Liabilities</b>
<b>Net Assets = Equity</b>	<b>Net Assets = Equity</b>

# Financial Statements – Income Statement

IFRS 4 Income Statement	IFRS 17 Income Statement
+ Gross Premiums <u>+ Investment Income</u> <b>= Total Income</b>	+ Insurance Revenue <u>- Insurance Service Expenses</u> <b>= Insurance Service Result</b>
+ Claims, Benefits & Expenses <u>+ Change in Liabilities</u> <b>= Total Expenses</b>	+ Investment Income <u>- Insurance Finance Income or Expenses</u> <b>= Net Financial Result</b>
<b>Profit Before Tax</b>	<b>Profit Before Tax</b>

IFRS 17 income statement separates insurance result and investment result making the financial statements more transparent and comparable.

Additional disclosures are required in the income statements to further detail the sources of earnings

# IFRS 17 Building Block Approach

## Building Block Approach Overview

<b>CSM</b>  <b>Fulfillment Cash Flow</b>	Block 4	<p><b><u>Contractual Service Margin</u></b>            The unearned profit that the entity recognizes as it provides services. (Is spread over period of the contract)</p>
	Block 3	<p><b><u>Risk Adjustment</u></b>            Compensation an entity requires for bearing the uncertainties about the amount and timing of the cash flows that arise as the entity fulfils the insurance contract. Measurement of the risk associated to the business</p>
	Block 2	<p><b><u>Discount Rate</u></b>            Should be selected to reflect the characteristics of the liabilities            Top down and bottom-up approaches are possible</p>
	Block 1	<p><b><u>Expected Future Cash Flows</u></b>            An explicit, unbiased and probability-weighted estimate of future net cash flows that will arise as the entity fulfils the insurance obligations</p>

# IFRS 17 Building Block Approach – Block 1

## Block 1 Expected Future Cash Flows

In order to determine the fulfilment cash flows entities shall include all cash inflows and outflows that relate directly to the fulfilment of the portfolio of contracts in a way that the cash flows:

- Are current and explicit
- Incorporate all available information in an unbiased manner
- Include all cash flows within the contract boundary
- Incorporate the entity's perspective of the business

The valuation at inception is performed on a point of sale basis

An entity shall include in the measurement of a group of insurance contracts all the future cash flows within the boundary of each contract in the group

The majority of the cash flow is common to the Solvency II with some exceptions

# IFRS 17 Building Block Approach – Block 2

## Block 2 Discount Rates – Time Value of Money

The discounting methodologies that are widely used in both the existing IFRS and the SII need to be re assessed for appropriateness. The new standard requires the discount rates to

- Reflect the characteristics of the cash flows and the liquidity characteristics of the insurance contracts
- Be market consistent
- Factors not relevant to the insurance liability needs to be excluded

Both the top down and the bottom up approaches can be utilized.

The widely used under SII concepts of the last liquid point and the ultimate forward rate do not relate to market data and can be challenged.

# IFRS 17 Building Block Approach – Block 3

## Block 3 Risk Adjustment – a new concept in the IFRS

An entity needs to adjust the estimate of the present value of the future cash flows to reflect the compensation required for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk

- It should be seen as a compensation that an entity requires for bearing the fulfilment cash flow uncertainty
- Shall be included in the measurement in an explicit way
- Should reflect both favorable and unfavorable outcomes in a way that captures the entity's degree of risk aversion and the degree of diversification benefit that is considered when determining the compensation for bearing uncertainty

# IFRS 17 Building Block Approach – Block 3

## Block 3 Risk Adjustment – a new concept in the IFRS

The Risk Adjustment is mostly principle based so there are no strictly prescribed methods for the calculation

It is a concept similar to the Risk Margin that is calculated under SII so there can be potential leveraging but there is a significant difference that under IFRS 17 the Risk Adjustment is not on entity level but on a group level

Risk Adjustment should be higher if

- Uncertainty in portfolio due to lack of actual experience
- Low frequency and high severity in the insurance event
- Little knowledge about trends of experience and policy holder behavior
- Long contract duration

# IFRS 17 Building Block Approach – Block 4

## Block 4 CSM – a new concept in the IFRS

The most important new concept in the IFRS 17 standard. It is defined as the component for a group of insurance contracts that represents the (risk adjusted) unearned profit that the entity will recognize as it provides services in the future

Its calculation is unlocking for the changes in the actuarial assumptions but locked in for the discounting rates.

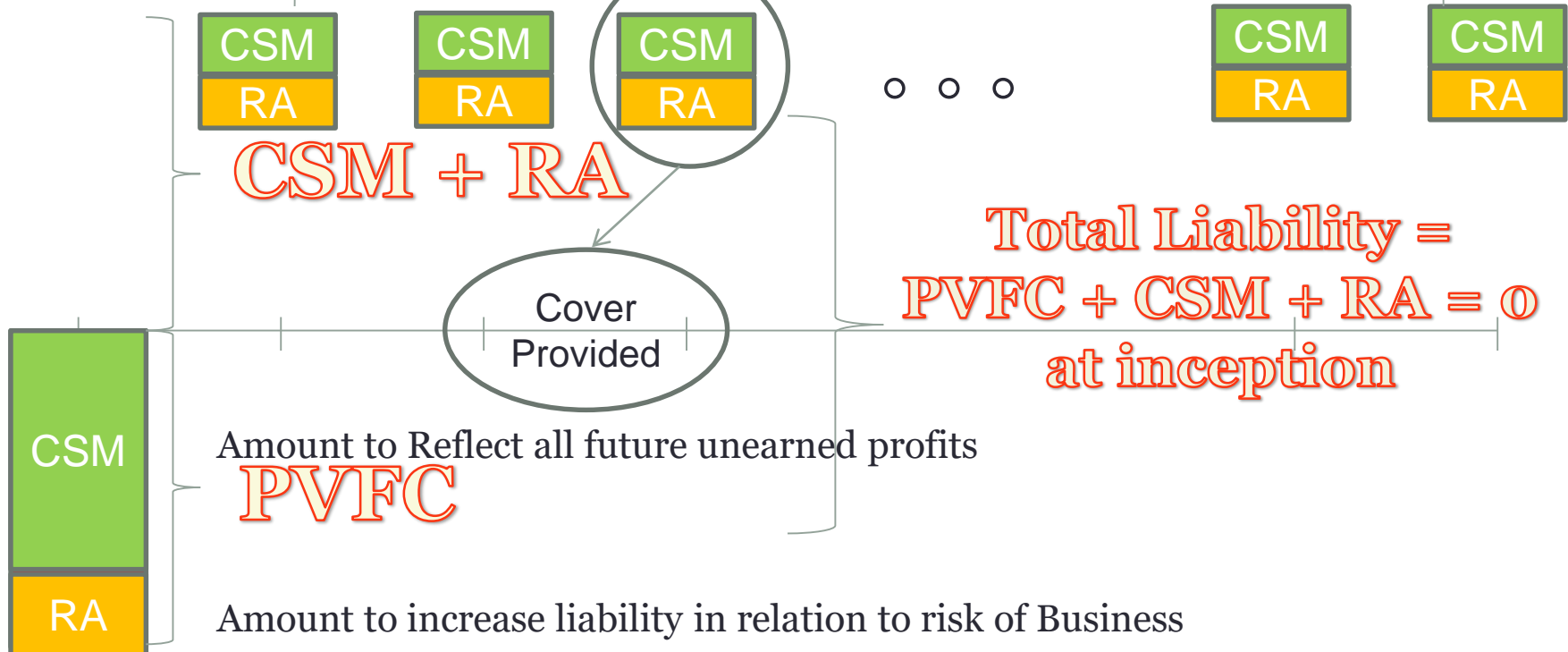
- CSM can not be negative – if a negative value arises then this charged immediately to profit or loss – referred to as a loss component.
- CSM is being amortized over the remaining coverage period based on the service provided on a per unit of account basis
- In determining the CSM or loss component (at initial recognition) onerous portfolios should not be combined with profit-making portfolios



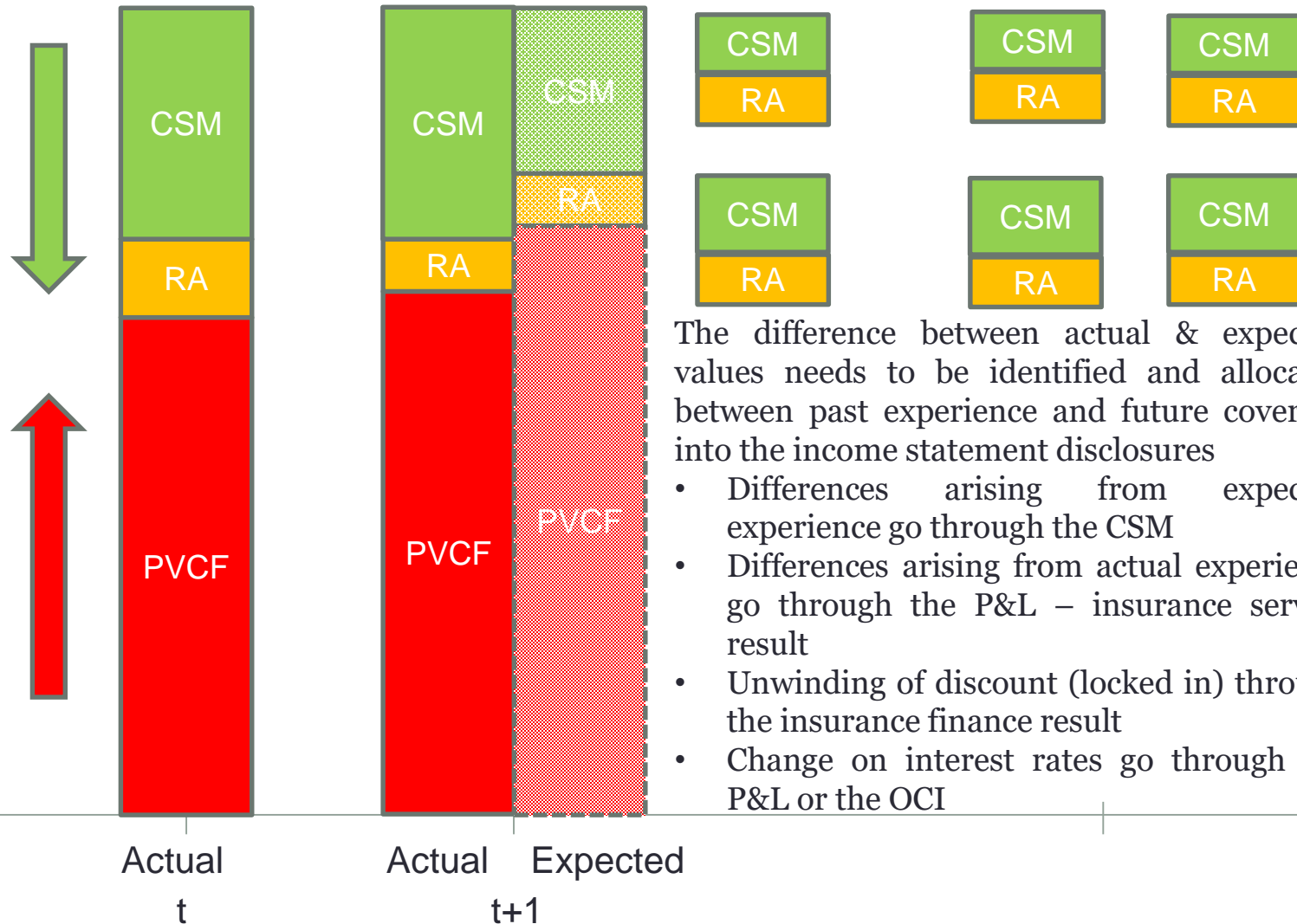
# IFRS 17 Example CSM at inception

INSURANCE REVENUE

This calculation needs to be performed per Unit of Account and the results to be maintained separately



# IFRS 17 Example CSM at re measurement



The difference between actual & expected values needs to be identified and allocated between past experience and future coverage into the income statement disclosures

- Differences arising from expected experience go through the CSM
- Differences arising from actual experience go through the P&L – insurance service result
- Unwinding of discount (locked in) through the insurance finance result
- Change on interest rates go through the P&L or the OCI

# IFRS 17 PAA

## Premium Allocation Approach Overview

Insurance Contract Liability simplified and split into two parts

Liability for Incurred Claims	Liability for remaining Cover
In Line with the current approach for the existing claims reserves – Best Estimates of discounted and probability weighted outgo.	Simplified approach based on allocation of premium (in line to the current UPR, URR and premium receivables)

### **The PAA may be used if:**

- Contract coverage period is one year or less, or
- PAA expected to produce measurement of the liability for the group that will not differ materially from one that would be produced by applying the BBA
  - Criterion not met if significant variability of the fulfilment cash flows is expected

Risk Adjustment should be calculated and included

Time value of money to be reflected if a significant financing component is included and coverage is provided more than one year after premium payment

# IFRS 17 VFA

## Variable Fee Approach

The VFA approach is related to direct participating contracts

The returns to the entity arising from participating contracts is viewed as part of the compensation that the entity charges the policyholder for service provided by the insurance contract, rather than as a share of returns from a standalone investment

The entity's interest in the investment portfolio is not the equivalent of a direct holding in assets, but is equivalent to a variable fee that the entity charges the policyholder

CSM is changed for change in FCF due to underlying items

CSM is changed for change in discount rate

Interest on CSM is accreted using the current interest rate and not the locked in rate at inception

# Major Impacts on Insurers

- Operational
  - Data, Assumptions, Systems
  - Training and models
  - Actual monitoring
  - Pricing and business decisions
  
- Financial
  - Insurance contract liability closer to the SII BEL
  - Results and profits recognition – immediate recognition of losses
  - One off adoption – impact on the balance sheet
  - Risk adjustments through the income statement
  
- Taxation
  - Adoption one off hit on results
  - Amortization of one off impact
  
- Valuation
  - Embedded Value

Thank you for your attention