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IFRS 17

Will you be ready for 2022?

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Overview

- Objectives
- Background
- Technical Overview
- The Premium Allocation Approach (PAA)
- The Building Block Approach (BBA)
- Next Steps

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Where are we on the journey?

#1	IFRS 17 it's a bit like Solvency II right?
#2	There's a PAA model for GI insurers and a BBA model for life and that's about it...
#3	I've heard PAA eligibility may be tricky, onerous contracts difficult and reinsurance is a nightmare but can you explain why please?
#4	Actually I think I understand the problems but what can we do about them?
#5	We've finalised out IFRS 17 detailed design and are in full on build mode

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#1

Why and how?

Why:

- Current IFRS 4 Insurance Contracts Standard is only an interim Standard => diverse practice and differing treatments
- Comparisons are difficult for different products, companies and jurisdictions

How:

- Global insurance Standard
- IASB wants consistency across industry and consistent accounting for all insurance contracts by all companies
- IASB intention is to have one Building Block Approach (BBA) for all contracts
- IASB believes market-consistent approach provides best information

For General Insurance:

- Current GI model not considered 'broken'
- Request from general insurers to develop simplified model => Premium Allocation Approach (PAA)
- PAA should be an approximation of the BBA
- Can only be used under certain circumstances = > This leads to potential issues around PAA eligibility for multi-year contracts

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#1

Different bases

Basis	Features
Current IFRS	• Wide variety of methods in current accounting treatment • Unearned Premium Reserve + Claims Outstanding* (including IBNR) (+ Equalisation Provision + Additional Unexpired Risk Reserve) • Usually undiscounted • Not necessarily a best estimate basis
Solvency II	• To provide enhanced security to policyholders • …by ensuring insurance companies have a robust approach to risk management • …and hold sufficient capital (based on those risks) to reduce the probability of failure to at least 1 in 200 in a one-year timeframe across the EU • Immediate recognition of profit • Best estimate basis, discounted cashflow approach • Claims provision + premium provision + risk margin
IFRS 4 Phase II	• To ensure that the presentation of the accounts for insurance companies is consistent with the approach used for other non-insurance companies globally • …and thus to enable investors etc. to compare all types of companies on a like-for-like basis • No gain on policy inception but losses must be recognised immediately => recognition of profit deferred until earned • Best estimate basis with an allowance for risk

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#1

Why is this such a big deal?

Increased volatility in results

Metrics for performance management

Calculations and reconciliations

More detailed disclosures

New processes and systems

Consistency with regulatory messaging

Data requirements

Preparing investors for change

Technical understanding

Managing the messages to market

The actuary

New measurement basis, measurement of

Capital

Risk adjustment - what approach, confidence level?

Inputs to reserving may change, product design may be

Other actuarial roles

Management information, reporting

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#1

Technical overview

- General measurement model known as the Building Block Approach (BBA)
- Simplifications exist for eligible contracts:
  - Premium Allocation Approach (PAA) for unexpired risk component
  - PAA with undiscounted expired risk
- Recognition of contracts - earliest of start of coverage and premium receipt (plus onerous contract test)
- Applies to outwards reinsurance too
- More granularity required
- Detailed disclosure requirements

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#2

Technical Overview

	IFRS / GAAP		BBA		PAA (unexpired) *
Liability for remaining coverage = Unexpired risk	UPR less DAC	THE FUTURE	Contractual Service Margin	OR	Akin to premium (less acquisition costs) unearned
			Risk adjustment		
			Discounting		
			Best estimate of fulfilment cash flows		
Liability for incurred claims = Expired risk	Undiscounted reserves for past claims (including IBNR)		Risk adjustment		Risk adjustment
			Discounting		Discounting
			Best estimate of fulfilment cash flows		Best estimate of fulfilment cash flows

Size of boxes for illustrative purposes only. Specific conditions must be met for PAA (*)

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#2

Technical - Revenue recognition: PAA

Liability for remaining coverage

Akin to premium (less acquisition costs) unearned → Release unearned premium relating to period and exposure → Income statement (underwriting result)

Liability for incurred claims

Risk adjustment → Release of risk adjustment relating to current period → Income statement (underwriting result)

Probability weighted discounted expected present value of cash flows →
- Interest on insurance liability at inception rate (unwind of discount rate) → Income statement (investment result)
- Changes in discount rates (update current market rates) → Income statement (investment result) / Other comprehensive income (equity) (elected options)
- Changes in cash flows related to past and current services → Income statement (underwriting result)

Balance sheet measurement

Flow to income or equity

- · - · - · → Elected options

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#2

Technical - Revenue recognition: BBA

Contractual service margin

Risk adjustment

Probability weighted discounted expected present value of cash flows

Changes in estimates related to future services

Release of contractual service margin

Release of risk adjustment relating to current period

Interest on insurance liability at inception rate (unwind of discount rate)

Changes in discount rates (update current market rates)

Changes in cash flows related to past and current services

Income statement (underwriting result)

Income statement (investment result)

Other comprehensive income (equity)

Balance sheet measurement

Flow to income or equity

Elected options

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#2

IFRS 4 Phase II vs Solvency II

Topic	IFRS 4 Phase II	Solvency II
Recognition	Earliest of start of coverage and premium receipt (plus onerous contract test)	Date party to contract
Measurement model	Building Block Approach (BBA), or Premium Allocation Approach (PAA) for eligible contracts	No choice
Discount Rate	Company specific, principles based	Prescribed
Risk Allowance	Risk Adjustment - no prescribed method	Risk Margin - prescribed 6% cost of capital
Contractual Service Margin	Eliminates day-one gain (measure of unearned profit)	No similar concept
Other Comprehensive Income (optional)	Removes impact of discount rate changes from P&L	No similar concept

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#3

Key areas of the standard

- Simplified approach (PAA) ★
- Best estimate cash flows
- Discounting
- Risk adjustment ★
- Level of aggregation / onerous contracts ★
- Contractual service margin (BBA only)
- Reinsurance measurement ★
- Acquired portfolios
- Presentation and disclosure
- Transition

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#3

Simplified approach (PAA)

Objective:
Practical expedient for short-term contracts

Applies equally to insurance and reinsurance *(both inwards and outwards)* contracts, but they will need to be assessed separately

When are contracts eligible for the PAA?

If at inception the coverage period is **one year or less**

OR

If at inception, reasonably expect that measurement **would not differ materially from applying the BBA**

Not met if expect **significant variability** in the fulfilment cash flows before a claim is incurred

Variability increases with

- Length of contract coverage
- Embedded derivatives

- Expected to be adopted for the majority of general insurance contracts
- However for those contracts with a coverage period greater than 12 months;
  - Need to consider contract boundaries, and when insurer has practical ability to reassess and reprice the risk.
  - Multi year policies such as construction, retrospective reinsurances (LPTs / ADCs), risk attaching reinsurance, extended warranty etc may not be eligible.

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#4

Premium Allocation Approach
Working Party Views

- Further choices that affect the PAA result when compared to the BBA:
  - Acquisition Cost Recognition: can recognise as incurred if coverage period is 12 months or less.
  - Discounting of LFIC: can choose not to discount if all cashflows are expected to occur 12 months or less from the date a claim is incurred.

- We found little difference in the value of the LFRC between the two approaches for a range of examples where we attempted to use consistent assumptions between PAA and BBA.

- There are two features that cause differences in the measurement of the LFRC:
  - **Unwind of Discount**
    - PAA: Discount rate at initial recognition.
    - BBA: Fulfilment cashflows discounted using current rates and CSM unwound using initial rates.
  - **Pattern of release**
    - PAA: straight line or risk-adjusted earnings pattern.
    - BBA: Fulfilment cashflows - straight line or risk-adjusted earnings pattern.

      CSM – recognition of coverage units in group based on service provided in period

- PAA LFRC based on premiums received only, balance sheet exposure will appear low where there is significant amounts of premium receivable.

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#4

Premium Allocation Approach

Discussion

- Is the PAA really a practical alternative?
  - Need to regularly demonstrate the results are not materially different from the BBA (for auditors)
  - Potential cost of implementing and running two different models.
  - Explanations may be required to key stakeholders – Board, Investors, Rating Agencies…

  So is the PAA really only useful if intending to apply it to the entire business?

- How do you interpret the “materiality” and “reasonably expects” phrases from paragraph 53?
  - What will be the impact of the “materiality” condition on the level of grouping for entities that wish to use PAA

    (Is there an incentive to use larger groups in order to give a greater chance of passing this test)?

- If the two approaches given similar answers do we need to consider paragraph 54 at all?
  - I.e. if an “entity expects significant variability” in the cashflows that would affect the liability for remaining coverage before a claim is incurred, but the effect is expected to be (materially) the same under the PAA and BBA, then can we just apply paragraph 53?
  - Does the contract coverage period therefore really only impact and relate to the approach to discounting?

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#3

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#3

Risk Adjustment

Objective:
Compensation the insurer requires to make it indifferent between the present value of the uncertain cash flows and the present value of certain cash flows

Possible methods...?

- **Value at Risk (VaR)**
- **Tail Value at Risk (VaR)**
- **Cost of Capital (CoC)**

- No prescribed approach
- Risk adjustment required on a gross and reinsurance basis separately
- Re-measured at each reporting period
- Allows for effect of diversification between portfolios within a reporting entity
- Regardless of the method chosen, a confidence level equivalent must be calculated and disclosed (i.e. VaR percentile)
- Harder questions
  - Treatment of diversification across products and across legal entities?
  - Treatment of gross risk margin in presence of significant RI

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#3

Level of aggregation / onerous contracts

Objective:
Separate profitable and loss making contracts
No CSM at end of coverage period

Step 1: Identify portfolios
= insurance contracts subject to similar risks and managed together as a single pool

Contracts in different products lines would be in different portfolios.

- *contracts issued within the same 12-month period*
- *information about the contracts' resilience (considered on a gross basis)*
- *consistent with internal reporting*
- *exemption for regulatory pricing*

Profitable contracts		Contracts that at inception have no significant possibility of becoming onerous subsequently, if any	Unearned profit is recognised as liability and is released as insurance services are provided
		Other profitable contracts, if any	
Onerous contracts		Contracts that are onerous at inception, if any	A loss is recognised in P/L

Fulfilment cash flows may be estimated at a **higher level of aggregation** than the group or portfolio => then need to **allocate estimates to groups of contracts**

PAA:
At inception:
Assume no contracts in the portfolio are onerous, unless **facts and circumstances** indicate otherwise

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#4

One approach

Unit of account

Groupings

Onerous

No significant possibility

Other profitable

P1 P2 P3

Portfolios

Period issued/held

Under PAA: What are facts and circumstances?

Broadly similar risks managed together

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#3&4

Reinsurance: aggregation and measurement

- Measurement of liabilities is done for groups of contracts
  - Net to gross ratios calculate a total recoverable but do not value individual reinsurance recoverables
- Requirement to disclose portfolios in asset and liability position
- Measurement is determined by the CASH positions
- Treatment of commissions and RIPs is different to current and will take some getting used to!

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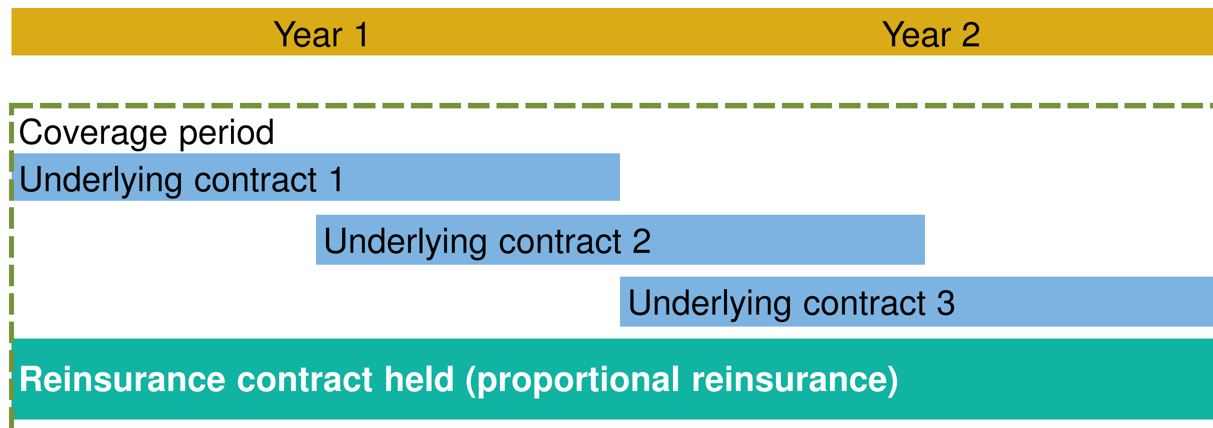
#3&4

Reinsurance: PAA eligibility

- ▶ The period during which the holder of the reinsurance contract receives services
  - For example, a proportional reinsurance treaty that protects an entity for claims arising from contracts it issues in a year
  - Reinsurance contract held may have a coverage period that is longer than the individual underlying contracts an entity issues



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#3&4

Reinsurance: Some good news

- There ‘was’ a wholesale mismatch between treatment of onerous inwards contracts and outwards recoveries
- TRG has tenatively proposed to extend p66 (c)(ii) to allow RI offset of onerous contracts (whether or not the RI contract is profitable or not) where:
  - RI provides ‘proportionate’ coverage to claims incurred
  - RI is already entered into before or at same time as contract

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Questions

Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.

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