CAMAR

IFRS 17

Emerging hot topics for Non-Life Insurers

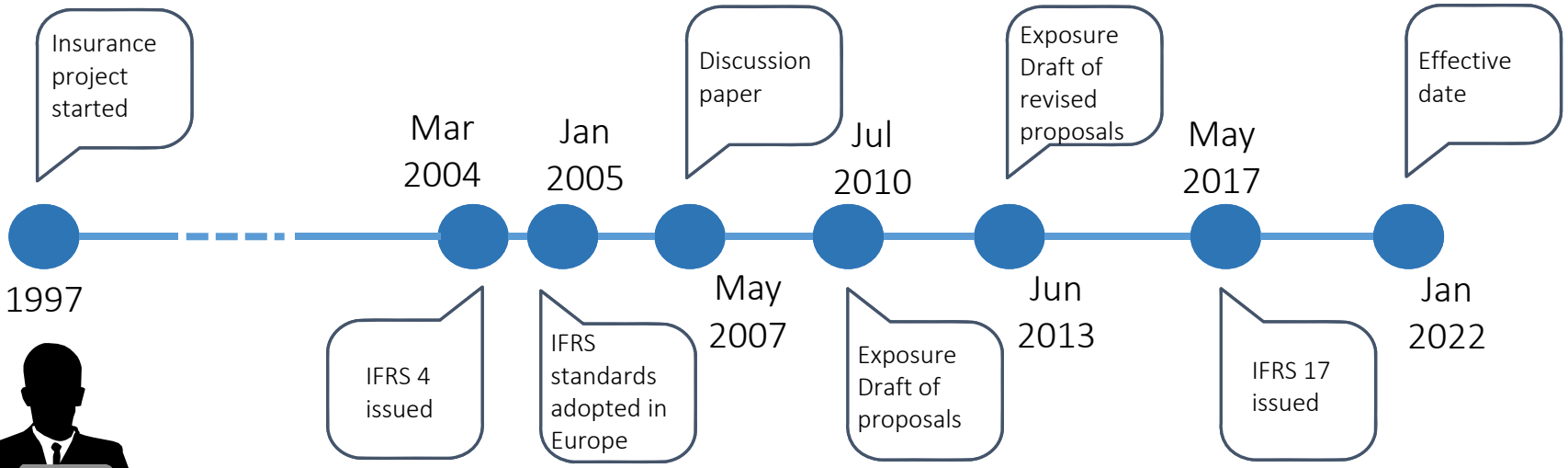
November 19, 2019

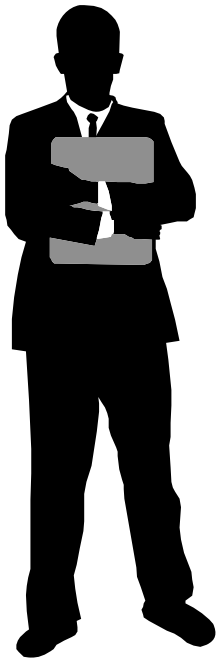
Agenda

1. Background
2. Premium Allocation Approach (PAA)
3. Level of Aggregation & Onerous Contracts
4. Discounting
5. Risk Adjustment
6. Ceded Reinsurance
7. Next Steps for IASB
8. Questions

1 – Background

Background
IASB's project on insurance contracts





- The International Accounting Standards Board (IASB) develops International Financial Reporting Standards (IFRS) – IFRS 17 covers insurance contracts and replaces IFRS 4
- The IASB Board is represented by large countries around the globe, including the US
- Most countries around the world, though there are exceptions like the US, follow IFRS either directly or with minor adjustments.

Background
IFRS 17 key points

What is IFRS 17?

- A comprehensive standard to account for insurance contracts applicable to companies that prepare financial statements under IFRS. It replaces IFRS 4, which was not a comprehensive standard

Why was IFRS 17 developed?

- To bring consistency to financial reporting around the globe for companies reporting under IFRS 17, and to better compare those insurance companies to those operating in other sectors of industry

What is the most fundamental element of change that IFRS 17 brings?

- Closer alignment of the accounting to the underlying economics of insurance

Background
Overview of the guidance

IFRS 17 is the proposed new international accounting standard for insurance contracts which replaces the existing IFRS 4 standard. The new standard provides a single global accounting standard for insurance contracts.

What is changing?

Balance Sheet

- IFRS 17 requires a current measurement model for life contracts as well as P&C, where estimates are re-measured in each reporting period.
- The measurement is based on the building blocks of discounted, expected value cash flows, a risk adjustment, and a contractual service margin ('CSM') to prevent an accounting gain at the inception of the contract.

Income Statement

- Requirements in IFRS 17 align the presentation of revenue with other industries. Investment components are excluded from revenue, and ceded reinsurance is treated as a separate expense (i.e., does not net revenue)
- Under IFRS 17, entities have an accounting policy choice to recognize the impact of changes in discount rates in profit or loss or in other comprehensive income ('OCI') to reduce some volatility in profit or loss.

Disclosures

- IFRS 17 disclosures will be more detailed than required under current reporting frameworks.
- Disclosures are intended to provide additional insight into key judgements and profit emergence.
- Disclosures are designed to allow greater comparability across entities.

Background
Overview of the measurement models

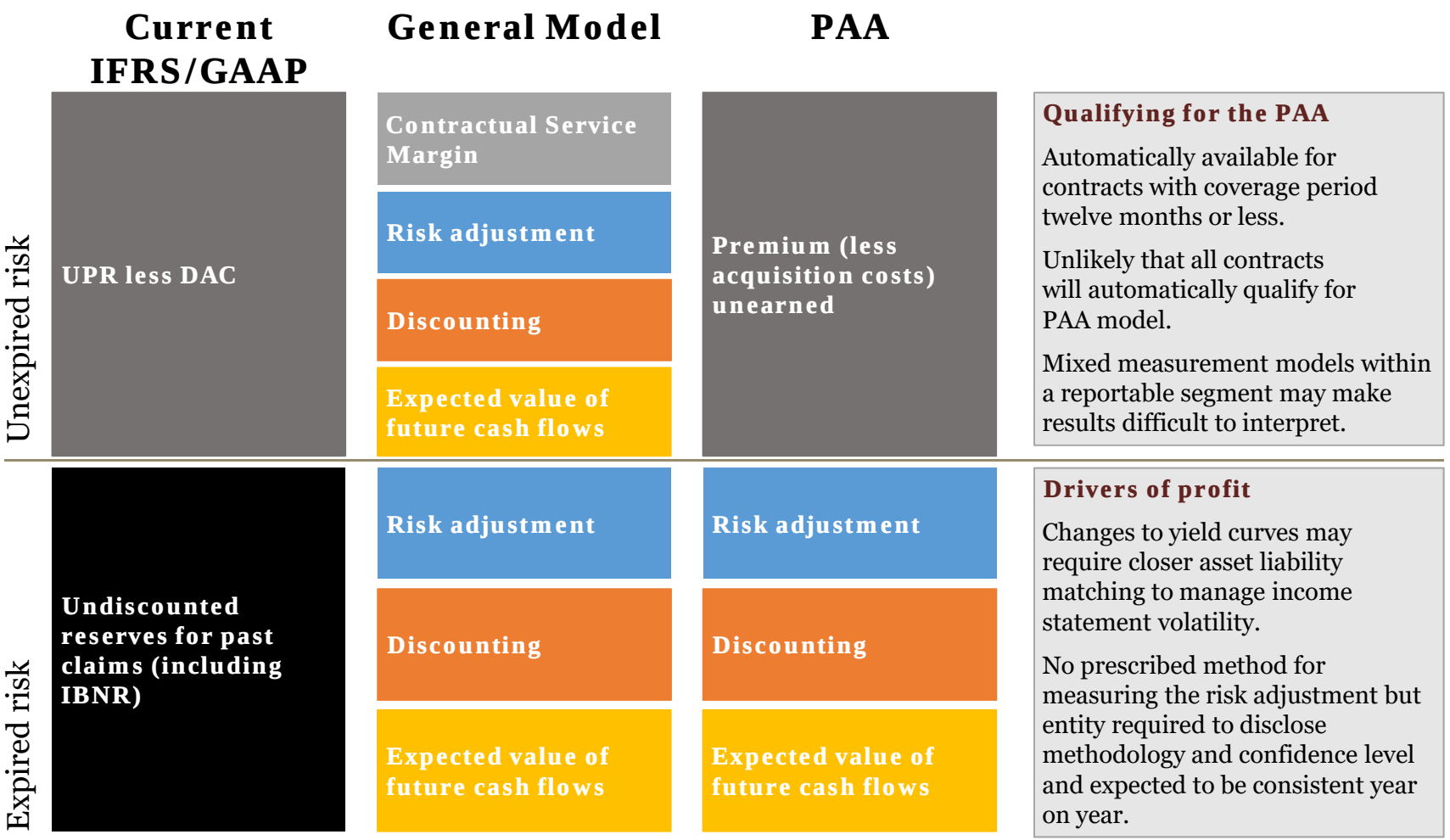
	General model	Premium allocation approach (PAA)	Variable fee approach
Why is it needed?	Default model for all insurance contracts	To simplify for short term contracts with little variability	To deal with participating business where payments to policyholders are linked to underlying items like assets
Types of contract	• Long-term and whole life insurance, protection business • Certain annuities • US style universal life • Certain reinsurance written • Some P&C insurance contracts	• Most P&C insurance and some reinsurance contracts • Short-term life and certain group contracts	• Unit-linked contracts, US variable annuities, and equity index-linked contracts • Continental European 90/10 contract • UK with profits contracts
Mandatory?	Mandatory	Optional	Mandatory

Background
Liability components of the General Model

Key components

Contractual service margin	Contractual service margin to prevent gain on policy inception, recognized over coverage period.
Risk adjustment	Reflect compensation entity requires for uncertainty inherent in the cash flows. Quantifies the value difference between certain and uncertain liability.
Discounting	Discount future cash flows using rates to reflect the characteristics of the liabilities in terms of timing, currency, and liquidity.
Probability weighted expected future cash flows	Expected value (explicit, **unbiased**, probability weighted estimate) of the future cash flows that will arise as the insurer "**fulfils**" the insurance contract.

Background
Comparison of the measurement models



* Size of blocks are for illustrative purposes only

2 – Premium Allocation Approach (PAA)

PAA
What IFRS 17 means for most P&C contracts

- The "Premium Allocation Approach" (PAA) option is expected to be applicable to and elected for most property/casualty (P&C) contracts – the IASB views the PAA as a simplification of the General Model for the Liability for Remaining Coverage (LFRC)
- For most P&C contracts, IFRS 17 using the PAA for LFRC is similar to common accounting frameworks in place today, but with several key differences:
  - Use of "mean" rather than undefined "best estimate" for incurred claims
  - Discounting of incurred claims through finance
    - At statement date rates for balance sheet
    - Option to use rates at incurred loss date for the income statement (OCI Option)
  - A "risk adjustment" reflecting uncertainty in amount/timing of unpaid claims
  - Earned revenue pattern based on timing of expected incurred losses, if the expected pattern of release of risk (i.e., decrease of expected incurred losses) during the coverage period differs significantly from the passage of time
  - Other key differences include (1) exclude deposit component from revenue and claims incurred expense, (2) ceding commissions netted against reinsurance premiums, (3) present DAC net against LFRC, and (4) more granular level of onerous contract testing (akin to UPR deficiency test)

PAA

Profit emergence example: PAA vs. Unearned Premium Reserve (UPR) model

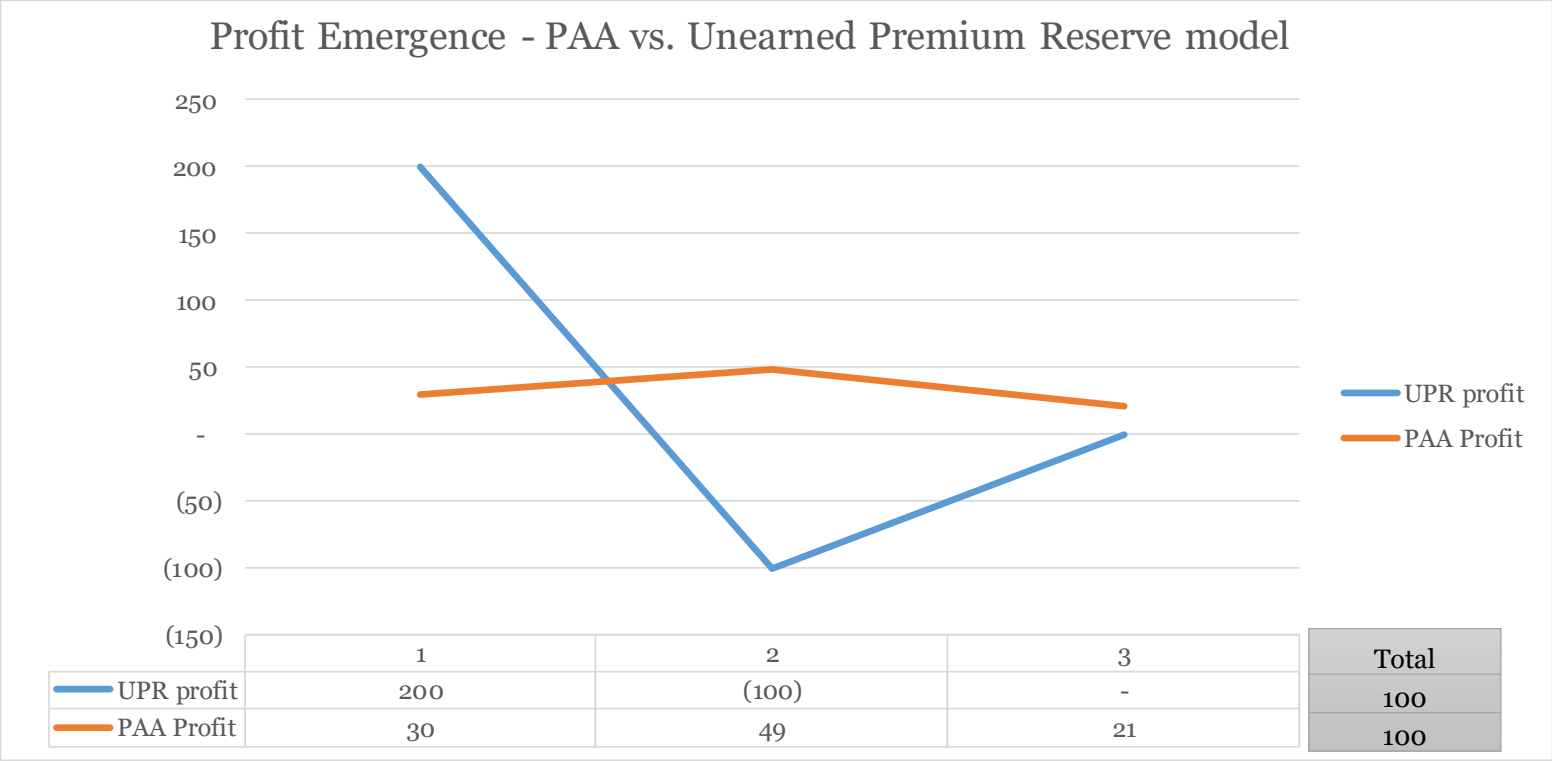
Assumptions:

- Example is for one unit of account – e.g. Underwriting Year 2017 Auto Liability
- Premium equals 1,000 currency units (CU)
- Initial expected/unbiased mean loss ratio on policy = 80%; additional 100 CU of claims are incurred during year 2. Thus, total profit = 100 CU.
- 20% of claims are paid in the year they are incurred; remainder paid in the subsequent year after being incurred.
- Flat 5.5% discount rate applied.
- Risk adjustment equals 30% of outstanding liability for incurred claims at each reporting period; the risk adjustment is released as claims are paid.

PAA			
Year --->	**1**	**2**	**3**
(1) Insurance Revenue Earned	1,000	-	-
(2) Disc. Incurred Claims	(746)	(93)	-
(3) Disc. Risk Adjustment	(224)	(28)	-
(4) Risk Adjustment Release	37	192	23
(5) Accretion of Interest	(37)	(21)	(2)
(6) Claims subtotal = Sum (2) to (5)	(970)	49	21
(7) PAA Profit = (1) + (6)	**30**	**49**	**21**

UPR approach			
Year --->	**1**	**2**	**3**
(1) Earned Premium	1,000	-	-
(2) Incurred Losses	(800)	(100)	-
(3) UPR Profit = (1) + (2)	**200**	**(100)**	**-**

PAA
Profit emergence example: PAA vs. UPR model



	1	2	3	Total
UPR profit	200	(100)	-	100
PAA Profit	30	49	21	100

- Under PAA, profit emergence is delayed vs. UPR approach due to the presence of the risk adjustment.
- Under PAA, profit is smoother than the UPR approach due to the release of risk adjustment offsetting an increase to incurred claims in this particular example.

PAA eligibility
Why is the PAA a useful simplification of the General Model?

- LFRC, for unexpired risk, is accounted for using an Unearned Premium Reserve
  - Under the General Model, an entity is required to establish an estimate of the expected value of future cash flows for both the expired and unexpired risk (and determine a CSM).
  - Under the PAA, estimating the expected value of future cash flows is required only for the Liability for Incurred Claims, unless the group of contracts is determined to be onerous (which would then require the measure of the unexpired risk using the General Model framework to quantify the loss amount that must be recognized).

- Do not need to calculate a CSM
  - Do not need to determine the estimated lifetime profitability of the contract at issue date
  - No need to continue to solve for unlocked CSM at future valuation dates

- Companies can leverage current reserve estimates, with applicable adjustments:
  - Unbiased mean, discounting, risk adjustment
  - System updates are still needed to quantify and track these adjustments through time

PAA eligibility
Eligibility criteria – paragraph 53

An entity **may** simplify the measurement of a group of insurance contracts using the **premium allocation approach** if, and only if, at the inception of the group:

a. the entity **reasonably expects** that such simplification would produce a measurement of the **liability for remaining coverage** for the group that would **not differ materially** from the one that would be produced applying the General Model; or

b. the coverage period of each contract in the group (including coverage arising from all premiums within the contract boundary determined at that date) is **one year or less**.

Criterion (a) above is **not** met if at the inception of the group an entity expects **significant variability** in the fulfilment of cash flows that would affect the measurement of the liability for remaining coverage during the period before a claim is incurred.

What is the level of aggregation? | **What are the coverage units?** | **What is materiality?**

PAA eligibility
Key characteristics impacting eligibility

1. Longer coverage period, in general

2. Coverages in which the pattern of incurred claims is either highly seasonal or otherwise differs significantly from an even release over the coverage period (e.g., some multi-year warranty policies)

3. Long payout patterns for incurred claims, particularly in a higher and/or more volatile interest rate environments

4. Release of risk adjustment is not commensurate with incurred loss pattern

PAA eligibility
General Model and PAA Amortization Example

- GM CSM is amortized according to the "stand ready obligation", which is *generally* interpreted to be straight line over the coverage period for P&C insurance contracts.
- PAA LRC and other (i.e., non-CSM) components of the GM follow expected loss emergence[1].
- The example below illustrates differences arising from the amortization of LRC components. Key assumptions are:
  - Premium of $1,000 CU (all collected at time 0 on a 4 year policy), Loss Ratio of 80%
  - No discounting or expenses and Risk Adjustment = 10% of Unpaid Future Claims at each future period

	t = 0	t = 1	t = 2	t = 3	t = 4
Incurred loss pattern (% emerged during period)		75%	15%	5%	5%
CSM amortization pattern (based on coverage units)	100%	75%	50%	25%	0%

LRC Component	Amortization basis	t = 0	t = 1	t = 2	t = 3	t = 4
General Model						
(1) PV Fulfillment Cash Flows[2]	Incurred loss pattern	880	220	88	44	0
(2) Contractual Service Margin	CSM amortization pattern	120	90	60	30	0
(3) LRC = (1) + (2)		1000	310	148	74	0
PAA						
(4) PAA LRC	Incurred loss pattern	1000	250	100	50	0

The "front-loaded" loss emergence pattern drives divergence of the GM and PAA LRC over the projection period since it differs from the straight line CSM amortization pattern.

1. The amortization of the risk adjustment may also differ from the incurred loss pattern if the required % of reserves needed to bear risk is selected to vary with time.
2. PV Fulfillment Cash Flows = PV Future Cash Flows + Risk Adjustment

PAA eligibility
Strategies that companies are taking

1. Education to understand characteristics of products that create challenges

2. Taking inventory of products written – claims emergence characteristics, contract boundaries, materiality, etc.

3. Preliminary PAA eligibility assessments on types of products (may not be aligned with level of aggregation yet)

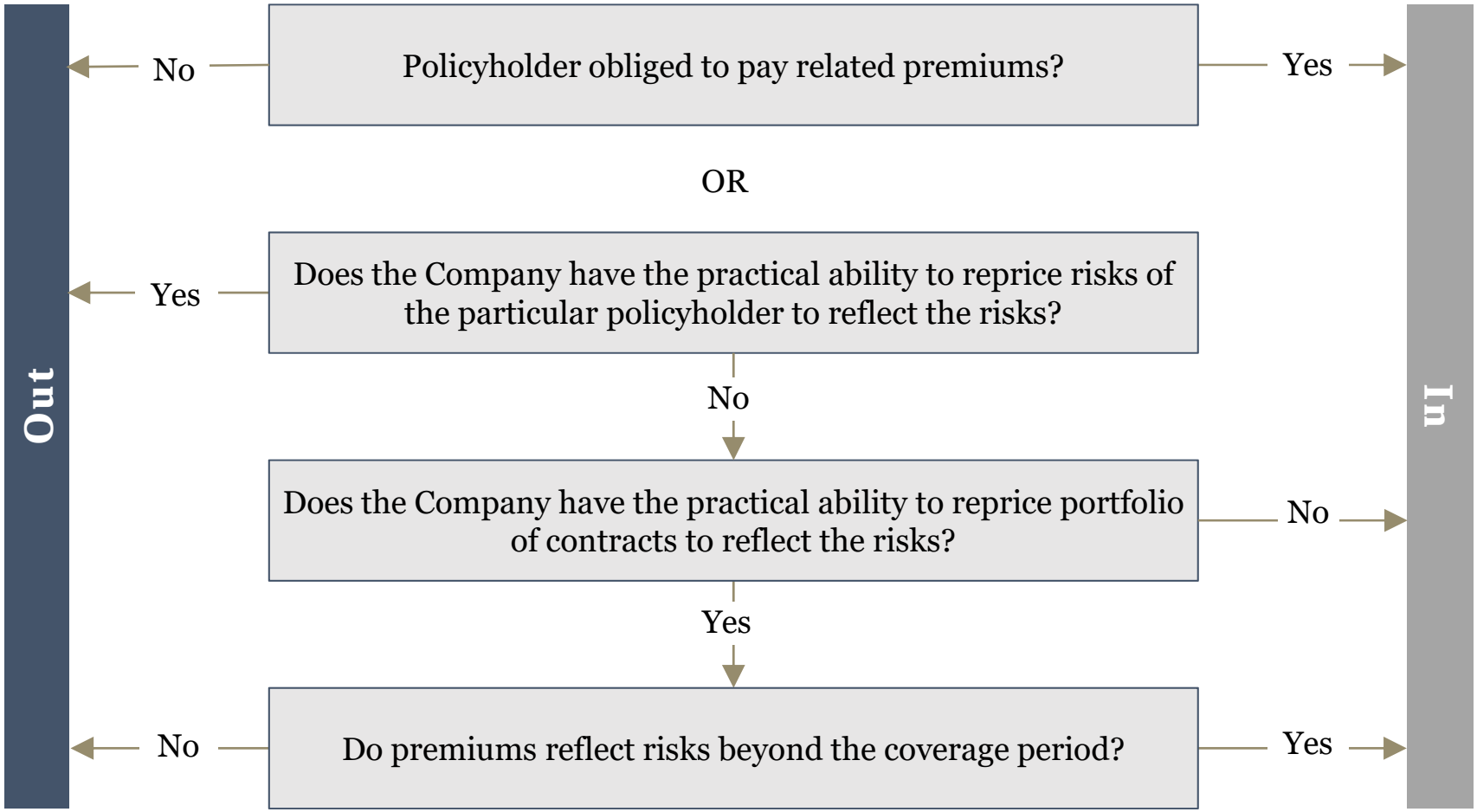
4. Strategic opportunities

   - Examine flexibility of Level of Aggregation groupings
   - Re-evaluate key assumptions, such as the risk adjustment during the pre-claim period
   - Evaluate/reassess accounting policy definition of "materiality" in the context of paragraph 53(a)
   - Revise future contract language to create annual contract boundaries

3 – Level Aggregation & Onerous Contracts

Contract boundary
Assessment considerations

Is the cash flow in the boundary of an insurance contract?

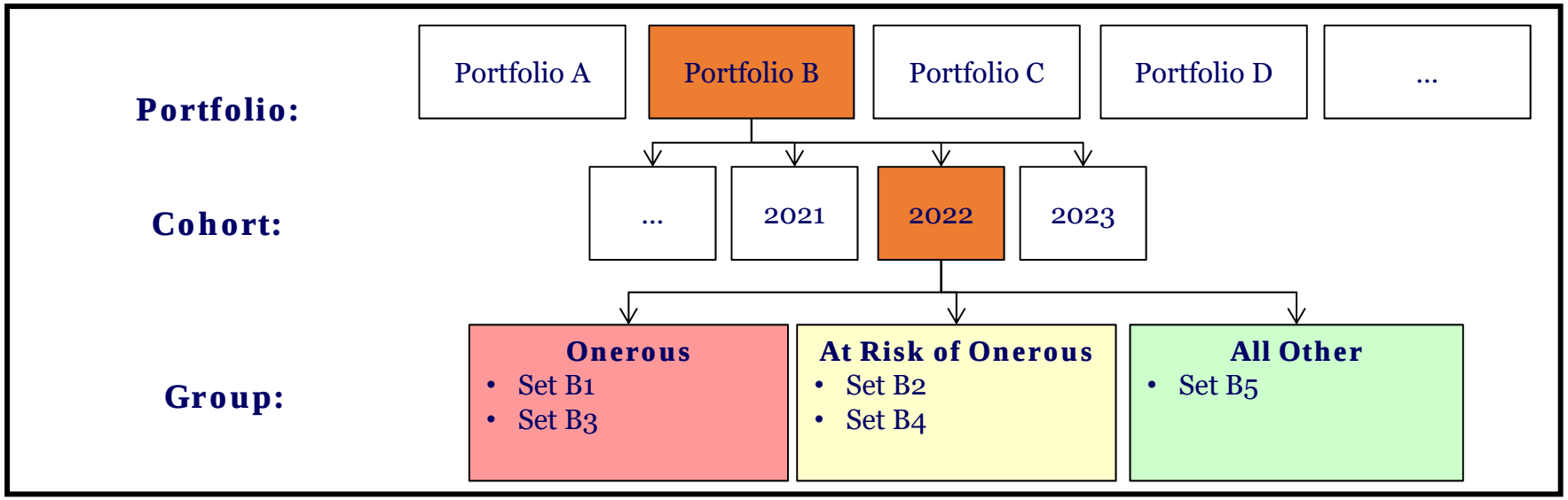


Level of aggregation
Definitions and when does it matter?

- Potential to leverage measurement segmentation utilized today & then allocate back, when it matters
- When does it matter?
  - PAA eligibility testing
  - Onerous contract assessment & tracking
  - CSM if in General Model
  - Asset/liability position

The level of aggregation is the combination of contracts into:

- **Portfolios:** comprised of contracts with similar risks that are managed together
- **Cohorts:** contain contracts written no more than one year apart (i.e., divide portfolios based on issue date)
- **Groups:** divide portfolios based on onerous, at risk of becoming onerous, and all other contracts (can be determined in **sets** rather than contract by contract)



*Level of aggregation is determined separately for ceded reinsurance.

Level of aggregation
Onerous contract considerations

- A group of contracts is considered onerous when **future service** fulfillment cash flows are loss making (i.e., when expected cash outflows exceed expected cash inflows)
- The loss component for onerous contracts is the portion of LFRC that is recognized immediately in the Income Statement, and excluded from revenue

	General Model	PAA
How are onerous contracts identified?	Onerous contracts are identified through explicit measurement of each set of contracts	Assume no contracts are onerous unless **facts and circumstances** indicate otherwise
How is the loss component measured on initial recognition of a group of contracts?	The amount by which fulfillment cash outflows exceed fulfillment cash inflows	The loss component is the amount by which fulfillment cash flows exceed the LFRC excluding loss component
How is the loss component measured when onerous contracts are first identified on subsequent recognition?	The amount by which unfavorable changes in fulfillment cash flows exceed the contractual service margin	
How are changes in the loss component measured	Changes in fulfillment cash flows are allocated between the loss component and LFRC excluding loss component	

Level of aggregation

Key to loss component measurement for onerous contract groupings

- Groups with gains cannot offset those with losses
- Once Level of Aggregation is established at initial recognition, measurement of LFRC and any associated loss component is measured/tracked at that level

Illustrative Example

Level of Aggregation	Unearned Future Gain/(Loss)	Total LFRC	Total Loss Component
Entity Level	Entity 1,200	1,200	0
Business Unit Level	BU 1 900 | BU 2 400 | BU 3 (100)	1,300	100
Line of Business (LoB) Level	LoB 1A 300 | LoB 1B 600 | LoB 2A 500 | LoB 2B (100) | LoB 3A (200) | LoB 3B 100	1,500	300

4 – Discounting

Discounting
Overview

- Expected value of future cash flows is required to be discounted to reflect the time value of money and financial risks related to those cash flows
- Discount rates should:
  - **Reflect the time value of money**, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts;
  - **Be consistent with observable current market prices** for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity; and
  - **Exclude the effect of factors that influence such observable market prices** but do not affect the future cash flows of the insurance contracts.
- Options
  - Method to determine rates is not specified - may use a "top-down" or "bottom-up" approach.
  - Use of a yield curve or a single discount rate is not specified.
  - Discounting is not required if cash flows are expected to be received/paid within one year from the date the claims are incurred.
  - "OCI option"
    - Entities have an accounting policy choice to recognize the impact of changes in discount rates in profit or loss or in OCI to reduce some volatility in profit or loss.
    - Use of locked-in rates (based on policy issuance date for General Model and loss occurrence date for PAA) for discounting in I/S.

Discounting
Determining discount rates

Top down discount rate

Actual or expected reference portfolio rate	7.0%
Duration mismatches	0.3%
Market risk premium for expected credit losses	-1.0%
Market risk premium for unexpected credit losses	-0.6%
Insurance contract discount rate	**5.7%**

Difference between the two methods not required to be reconciled

Bottom up discount rate

Insurance contract discount rate	**5.5%**
Liquidity premium	1.5%
Risk free rate of return	4.0%

Discount rates:

- Single rate used for illustration; yield curve expected to be commonly used.
- Discount rates to be determined at inception and subsequent measurement dates
- Discount rates exclude own-performance risk

Discounting
OCI option

- The Balance Sheet is always discounted using current rates, regardless of this option
- Exercising this option would send changes in discount rates to other comprehensive income (OCI) (i.e., changes in discount rates would therefore not impact the Statement of Profit & Loss)
- For example, consider:
  - A loss of 1,000 currency units (CU) is incurred at time 0 and paid at the end of year 5
  - Initial discount rate of 3% increases to 6% at the end of year 2

Discount Values

Year End	0	1	2	3	4	5
Using Locked 3% Rate	(137)	(112)	(85)	(57)	(29)	-
Using Current Rate (Balance Sheet)	(137)	(112)	(160)	(110)	(57)	-

Presentation of discount changes without exercising the locking/OCI option

Year	0	1	2	3	4	5	Total
Profit and Loss (P&L)	(137)	26	(49)	50	53	57	-
Other Comprehensive Income (OCI)	-	-	-	-	-	-	-
Total	**(137)**	**26**	**(49)**	**50**	**53**	**57**	**-**

Presentation of discount changes with exercising the locking/OCI option

Year	0	1	2	3	4	5	Total
Profit and Loss (P&L)	(137)	26	27	27	28	29	-
Other Comprehensive Income (OCI)	-	-	(76)	23	25	27	-
Total	**(137)**	**26**	**(49)**	**50**	**53**	**57**	**-**

5 – Risk Adjustment

Risk Adjustment
Overview

Reflects the compensation that the entity requires for bearing uncertainty about the amount and timing of the cash flows that arises from non-financial risks

- Insurance liabilities are uncertain, and hence an entity should value those liabilities higher than a certain liability with the same expected value
- The IFRS 17 risk adjustment represents the additional cost of the uncertainty inherent in insurance liabilities

Example:
- Suppose I have a 50% chance of having to pay 200 CU and 50% chance of having to pay 0 CU
- I determine I am willing to pay up to 105 CU rather than risk having to pay 200 CU
- The risk adjustment in this case is 5 CU

- <u>Key characteristics</u>
  - Company perspective (not exit or fair value since those are market perspectives)
  - Diversification (to the extent considered in the original pricing)
  - Consider risk arising from the contract only (e.g., not investment risk or general operational risks)
  - Non-hedgeable risks only (e.g., non-financial risks)
  - Explicit and not in expected cash flows (thou shall not double count)
  - Fulfilment value (vs. transfer value)

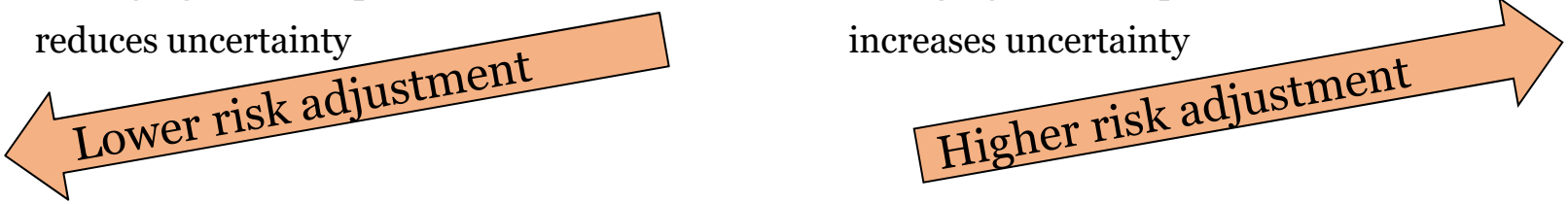
Risk Adjustment
Methodologies & characteristics

- IFRS does not prescribe a method for estimating the risk adjustment. Possible methods:
  - Cost of Capital
  - Confidence Level/Percentile/Value at Risk (VaR)
  - Tail Value at Risk (TVaR)

- Regardless of the estimate technique used, the entity **must disclose** the confidence level corresponding to the risk adjustment estimate

- IFRS 17 gives some guidance on which types of liabilities should receive a greater or smaller risk adjustment:

- High frequency and low severity	- Low frequency and high severity
- Short duration contracts	- Long duration contracts
- Narrow probability distributions	- Wide probability distributions
- More-known-about trends	- Little-known-about trends
- Emerging claims experience that reduces uncertainty	- Emerging claims experience that increases uncertainty



6 – Ceded Reinsurance

Reinsurance
Overview & challenges

Reinsurance contracts issued (i.e., assumed) = insurance contracts issued

- Note that ceding commissions are netted against premiums, with the net amount treated as revenue under the contract
- Investment components and certain other cash flows are accounted for on a net basis

Reinsurance contracts held (i.e., ceded reinsurance) -> special requirements

- F/S presentation is gross (i.e., not netted on the balance sheet or the income statement), thus measurement (& other considerations) are separate for ceded reinsurance.
- This can create challenges:
  - Matching cash flows – level of aggregation, measurement model, CSM release pattern (if General Model), onerous vs. deferred gain
  - Risk attaching contracts, even when the underlying contracts have coverage periods of 1 year or less, would need to be tested for PAA eligibility
  - Investment components and net presentation of certain other cash flows – identification, measurement, tracking
  - Program structures with special considerations for net impacts

Questions?

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