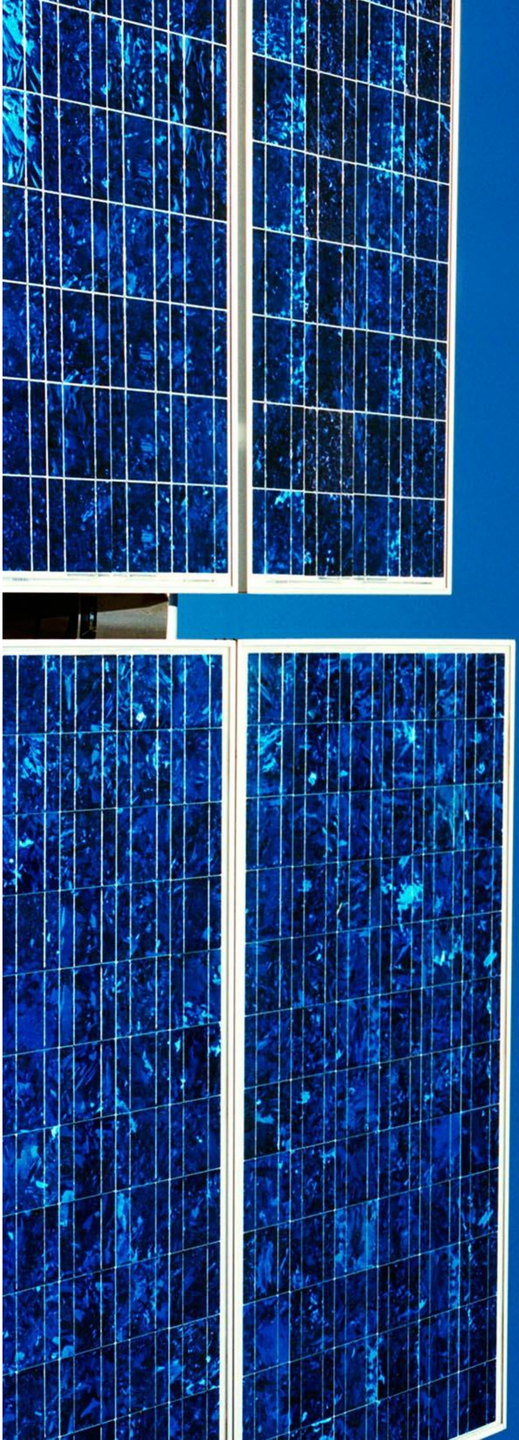

IFRS 17 insurance contracts: Selected Topics

Chris Nyce, Partner, KPMG

CLRS 2018

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Topics

- Discount rate – in depth
- Risk adjustment – in depth
- Presentation and disclosures
- Interactions with IFRS 9

Discount rate – in depth

Introduction

The discount rates applied to the estimates of future cash flows:

- reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts;
- are consistent with observable market prices
- exclude the effects of factors that affect observable market prices used in determining the discount rate, but do not affect the future cash flows of the insurance contract

Methodology decision

“Bottom up”

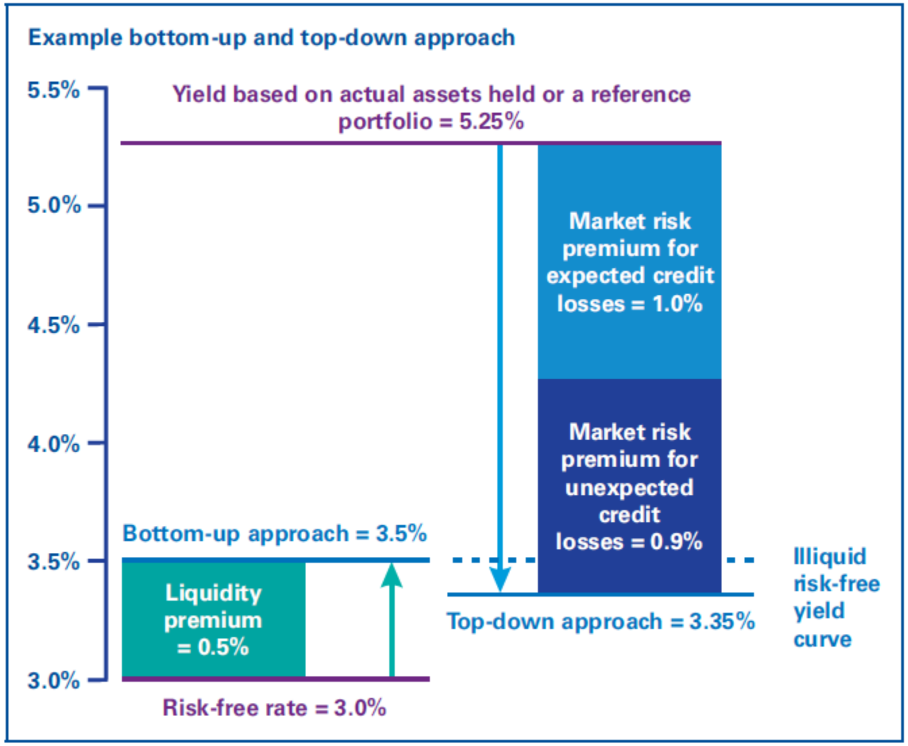
- Start with a risk-free yield curve in the appropriate currency
- Adjust for the difference between the liquidity of the financial instruments that underlie the rates observed in the markets and the liquidity characteristics of the insurance contracts

“Top down”:

- Start with a yield curve reflecting current market rates of return implicit in a FV measurement of a reference asset portfolio
- Adjust for factors that are not relevant to the characteristics of the insurance contracts

Comparison of approaches

Numbers are illustrative only



Considerations

Can you use risk-free yield curves or adjustments to yield curves promulgated by regulators or actuarial associations?

- Need to assess whether these meet the principles of IFRS 17 re use of observable market prices and adjustments to take account of liability characteristics
- Curves determined with a time lag – suggests that these are not “current”
- Some aspects of the methodology might be leveraged

Managing volatility (1)

Insurance finance income/expense comprises the change in the carrying value of the group of insurance contracts arising from the effects of or changes in:

- the time value of money, and
- financial risk.

An entity can choose as its accounting policy, to present the insurance finance income/expense:

- In profit or loss; or
- Disaggregated between profit or loss and OCI (the disaggregation policy choice).

IFRS 17	
Insurance revenue	X
Incurred service expenses	(X)
Insurance service result	**X**
Investment result	X
Insurance finance expenses	(X)
Net finance result	**X**
Profit or loss	**X**
Other comprehensive income	X
Comprehensive income	**X**

Managing volatility (2)

Considerations when determining whether or not to apply the disaggregation policy choice:

- The expected classification and measurement of financial assets under IFRS 9
- The entity's approach to accounting mismatches and volatility in the financial statements
- The resources and effort needed for changes in systems and processes to arrive at the desired solution

For example – if the entity prefers that all changes flow through profit or loss, both for the insurance contracts liability and the supporting assets the following choices are likely:

- Not applying the disaggregation policy choice
- Designating financial assets as at fair value through P&L (FVTPL) (IFRS 9 choice)

Risk adjustment – in depth

Chris Nyce – Partner , Nathaniel Loughin – Manager

Risk adjustment for non-financial risk

An adjustment to reflect the compensation an entity requires for bearing the uncertainty about the amount and timing of cash flows that arises from non-financial risk as the entity fulfils the contract.

It reflects the entity's perception of the economic burden of the risk that it bears.

No specific method prescribed. However, the confidence level corresponding to the result of other techniques used is required to be disclosed.

Building block 3 – Risk adjustment

The compensation the insurer requires for bearing the uncertainty about the amount and timing of the cash flows that arise from non-financial risk

Entity specific measure of the compensation to make the entity indifferent between:

- Fulfilling a liability that has a range of possible outcomes arising from non-financial risk; and
- Fulfilling a liability that will generate fixed cash flows with the same expected present value.

Re-measured each reporting period

(1) Contract fulfilment

50% chance

Pay 90

50% chance

Pay 110

Expected value is to pay **100**

(2) Fixed liability

100% chance

Pay 100

Fixed liability pays **100**

Given the variability in the outcomes, an entity would be likely to require more consideration to fulfil the obligation for the contract than to settle the obligation by paying a fixed amount.

Building block 3 - Risk adjustment (2)

Characteristics of underlying risks	Risk adjustment
— Low frequency and high severity risks such as catastrophe losses — Long-duration contracts — Wide probability distributions — Little known about trends and current estimates — Emerging claims experience increases uncertainty regarding estimates	Higher
— High frequency, low severity losses — Short-length contracts — Narrow probability distributions — More known about trends and current estimates — Emerging claims experience reduces uncertainty regarding estimates	Lower

Comparing Techniques

Technique	Advantages	Disadvantages
Confidence Level (VaR)	• Relatively simple • Consistent with disclosure requirements	• Can be volatile • Poor capture of tail risk • Not generally useful for allocation to lower levels • Computation requirements • Need an assumption about the risk profile (distribution
Conditional Tail Expectation (CTE)	• Relatively simple • Easy to translate to VaR disclosure • Better capture of tail risk • Can be used to allocate to lower levels	• Computation requirements • Need an assumption about the risk profile (distribution)
Cost of Capital (CoC)	• Low level of granularity	• Translation to VaR • More complex and requires additional variables, assumptions and sensitivities
Current IFRS 4 approach to non-economic margins (per assumption basis)	• Familiar • Low level of granularity • Less compute needs	• Is it IFRS 17 compliant? • Translation to VaR • Incorporation of diversification benefits

Presentation and disclosures

Vishal Patel – Director

What does it look like? (1)

- Insurance contract revenue (premium) is allocated to periods in proportion to the value of coverage (and other services) by reference to the estimated pattern of expected claims and expenses.
- Insurance contract revenue excludes the amounts to be paid to policyholders regardless of whether an insured event occurs (‘the investment component’).
- Written and earned premiums will be replaced by a new measure, insurance contract revenue that is fundamentally different.
- Amounts related to reinsurance ceded will continue to be separately presented from amounts related to direct insurance contracts.

Simplified example of the presentation

Presentation of Statement of Financial Performance	
Insurance contract revenue	**475**
Claims and benefits incurred	-320
Fulfilment expenses incurred	-60
Recognition of acquisition costs	-20
Changes in estimates of future cash flows (if not offset against the contractual service margin)	-10
Losses on initial recognition of insurance contracts	-30
Unwind of previous changes in estimates	5
Underwriting result (Gross margin)	**40**
Investment income	60
Insurance finance expense (i.e., Interest on insurance liability)	-54
Profit or loss	**46**
OCI: Change in insurance contract liability due to changes in discount rate	9
OCI: Fair value movements on FVOCI assets	-10
Total comprehensive income	**45**

What does it look like? (2)

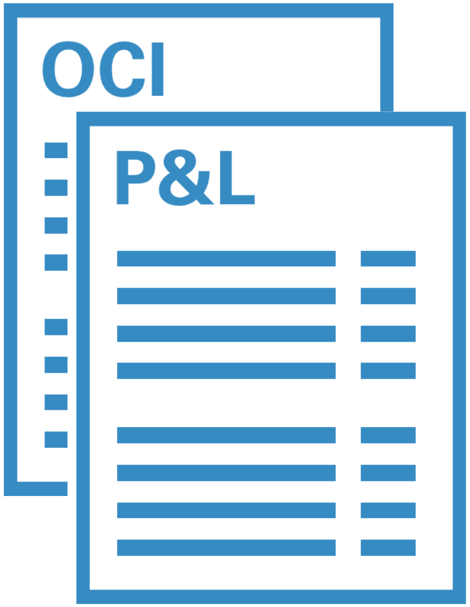
CONSOLIDATED STATEMENT OF INCOME
For the year ended December 31, 2017

Premiums written	XX
Premiums earned	XX
Claims incurred	XX
Policy acquisition costs	XX
Operating expenses	XX
Total expenses	XX
Net investment income	XX
Income before taxes	XX

IFRS 17 (excluding reinsurance) Statement of Financial Performance	
Insurance Contract Revenue	X
Claims incurred	X
Amortization of acquisition costs	X
Losses on initial recognition of insurance contracts	X
Underwriting result (Gross margin)	X
Investment income	X
Insurance finance expense (i.e. Interest on insurance liability)	X
Profit or loss	X
Other comprehensive income:	X
Change in insurance contract liability due to changes in discount rate	X
Fair value movements on FVOCI assets	X
Total comprehensive income	X

Note these are not exact mappings, but instead convey where the main concepts are expressed on a US GAAP statement and IFRS 17 statement, and how some US GAAP accounts have to be split out differently under IFRS 17

Presentation: Statement of financial performance



- **Investment components are excluded from insurance revenue and service expenses.**
- **Entities can choose to present the effect of changes in discount rates and other financial risks in profit or loss or OCI to reduce volatility.**
- **Separation of underwriting and finance results.**

Presentation: Statement of financial position

An entity presents separately:

- Groups of insurance contracts that are assets.
- Groups of insurance contracts that are liabilities.

Reinsurance contracts held assets and liabilities are presented separately, and separately from insurance contract assets and liabilities.

Disclosures (1)

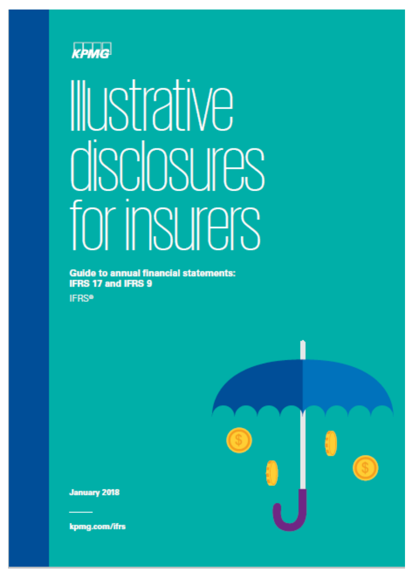
Information should be disclosed at a level of granularity that helps users assess the effects contracts have on…

Financial position

Financial performance

Cash flows

New disclosures relate to expected profitability and attributes of new business



Disclosures (2)

New key disclosures

Amounts recognised	Significant judgements	Nature and extent of risks
— Additional reconciliations as a result of the new measurement model in tabular format, including components of changes — Inputs used to determine revenue recognised in the period — Effect of the insurance contracts initially recognised in the period — An analysis of total interest expense — Additional transition disclosures	— More detailed disclosures of methods and processes for estimating inputs — Effect of changes in the methods and inputs, together with an explanation of the reason for each change (IFRS 4 requires to disclosure the effect of changes in assumptions) — Disclosure of confidence level to which the risk adjustment corresponds — Disclosure of the yield curves used to discount cash flows that do not depend on returns from underlying items	— Quantitative information about effect on profit or loss and equity of contracts' sensitivities to insurance risk (IFRS 4 includes an option to provide qualitative or quantitative information). — Reconciliation of disclosures about claims development with the carrying amounts of insurance liabilities — For liquidity risk, amounts payable on demand, highlighting the relationship between these amounts and carrying amounts of related contracts — Regulatory requirements

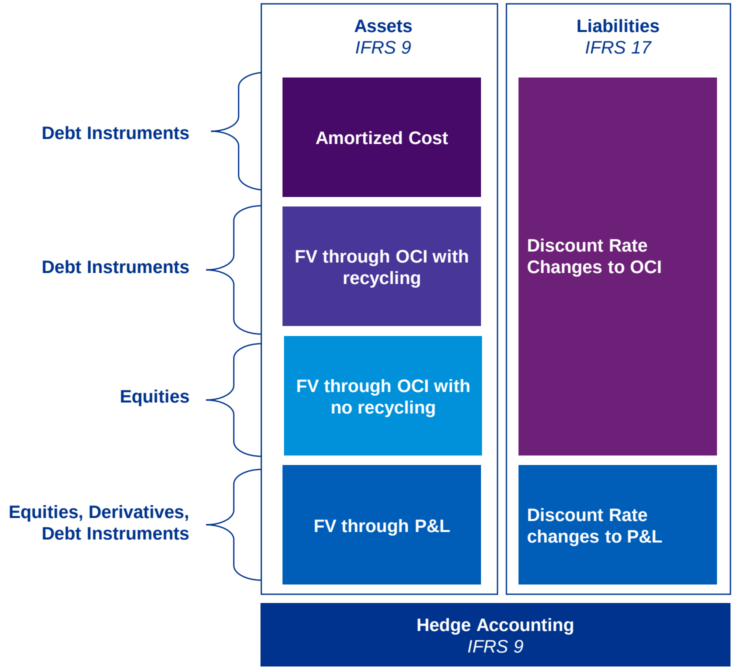
IFRS 9 Interactions

IFRS 9 for Insurers - Adoption Date

- IFRS 9 is effective for annual periods beginning on or after 1 January 2018. There is an optional deferral of the IFRS 9 effective date at the reporting entity level for companies whose predominant activity is issuing contracts in the scope of IFRS 4 Insurance Contracts (i.e. IFRS 17 implementers).
- Such companies would be able to defer application of IFRS 9 no later than reporting periods beginning on or after 1 January 2021.
- In addition, when an insurance entity first applies IFRS 9, it may elect to apply the overlay approach to certain financial assets until the IASB's new standard for insurance contracts is applied. An insurance entity applies the overlay approach retrospectively. However, an entity restates comparative information under the overlay approach if, and only if, it restates comparative information when applying IFRS 9

Aligning IFRS 9 and IFRS 17

Accounting mismatches may occur but accounting policy choices and transition provisions can reduce them. Elections on both the asset and liability side should be carefully explored by the Company to manage assets and liabilities:



Thank you

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