CLRS 2018

IFRS 17: A Deep Dive into Key Issues

September 6, 2018

Session description

International Financial Reporting Standard (IFRS) 17 – Insurance Contracts will present some issues and challenges to P&C actuaries as they work to implement the new standard, effective with reporting in 2021. These issues include determination of unit account (why it matters and what needs to be considered), issues surrounding estimating cash flows and acquisition costs, PAA eligibility assessment/coverage units, risk adjustment approaches, discounting (is OCI option worth it?), and reinsurance matters including the treatment of profit commissions, reinstatement premiums and sliding scale commissions.

Agenda

1. Future cash flows
2. Discounting
3. Risk adjustment
4. Level of aggregation
5. PAA eligibility
6. Reinsurance

4 – Level of aggregation

Level of aggregation

Overview

1. Objective

- Portfolios must be comprised of contracts with similar risks that are managed together
- Within a portfolio, contracts are grouped at a more granular level based on profitability and issue date considerations
- The characteristics of the contracts comprising a particular group will determine the appropriate measurement model to be used (Premium Allocation Approach or General Model)
- The overall aggregation decision will determine the recognition and amortization of Contractual Service Margin (CSM)

2. Aggregation requirements*

Top-down approach:
Start at portfolio level (similar risks, managed together)

3 groups at inception **:
- Onerous;
- Profitable with no significant risk of becoming onerous; and
- Other profitable contracts

Risk of contracts becoming onerous:
- Internal reporting
- Sensitivity of fulfilment cash flows

Requires that a group shall not include contracts issued more than one year apart

3. Effect of regulation

Some laws or regulations prevent insurers from pricing for certain risk indicators (eg gender)

If a law or regulation specifically constrains
- insurer's practical ability to set a different price or level of benefits for policyholders with different characteristics,
- then ignore that characteristic for grouping (eg male or female drivers)

Level of aggregation
Why is it so important?

Profit Emergence

For general model groupings, CSM is calculated at the group level. For PAA groupings, profit emergence considers seasonality within a group. Therefore, the level of aggregation is one of the key drivers of profit emergence.

Enhanced granularity could have adverse financial impacts resulting in potentially more onerous contracts. Losses on onerous contracts are recognized immediately in P&L.

Losses due to unfavorable assumption updates could be recognized faster under IFRS 17 than under IFRS 4. IFRS 4 allows a higher level of aggregation for Liability Adequacy Testing (LAT).

Operational Considerations

Level of aggregation requirements will result in operational challenges for adopters. New capabilities and enhancements to the data and systems architecture will be required to store and process large volumes of data.

Maximizing the number of contract groupings that qualify for PAA can reduce operational complexity

Financial Reporting Impacts

Decisions on the level of aggregation will impact valuation, but also financial reporting and disclosure requirements.

The appropriate level of aggregation will result in better information on performance, profitability and drivers of change providing management the ability to make well informed decisions.

Level of aggregation

Paragraph 24 – measurement

An entity shall apply the recognition and measurement requirements of IFRS 17 to the groups of contracts issued determined by applying paragraphs 14–23. An entity shall **establish the groups at initial recognition**, and shall not reassess the composition of the groups subsequently. To measure a group of contracts, **an entity may estimate the fulfilment cash flows at a higher level of aggregation than the group or portfolio**, provided the entity is able to include the appropriate fulfilment cash flows in the measurement of the group, applying paragraphs 32(a), 40(a)(i) and 40(b), by allocating such estimates to groups of contracts.

Level of aggregation

To what degree does it really matter?

- Regardless, because of Paragraph 24, companies may utilize the same (or very similar) reserve segmentation as is used today under US GAAP.

- Allocation based on unit of account needed if:
  - General model – CSM determination and amortization
  - Onerous contracts – recognition of loss in P/L
  - Presentation of groups in asset vs. liability positions

- When is allocation back to unit of account not needed?
  - PAA eligible
  - Not onerous

Level of aggregation – QUESTIONS

1. What are some key examples of how companies are thinking about level of aggregation?
2. Does it matter on the face of the financial statements?
3. When does it actually matter?
4. What do you do with a reinsurance treaty that spans multiple lines of business?

5 – PAA eligibility

PAA eligibility
Guidance – 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.

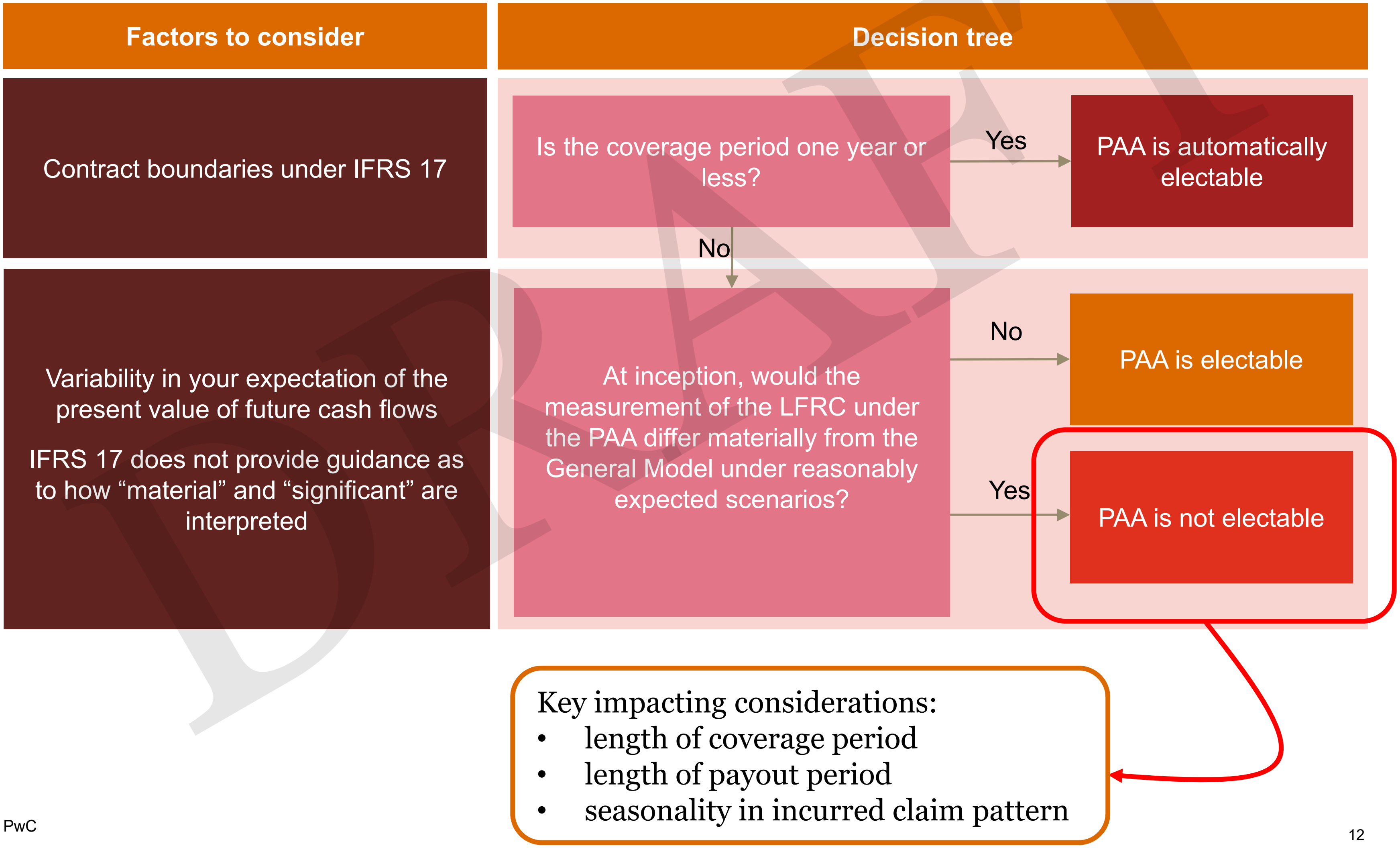
What is the unit of account?

What are the coverage units?

What is materiality?

PAA eligibility

Eligibility might be challenging for certain P&C products



Factors to consider	Decision tree
Contract boundaries under IFRS 17	Is the coverage period one year or less? Yes: PAA is automatically electable No
Variability in your expectation of the present value of future cash flows IFRS 17 does not provide guidance as to how "material" and "significant" are interpreted	At inception, would the measurement of the LFRC under the PAA differ materially from the General Model under reasonably expected scenarios? No: PAA is electable Yes: PAA is not electable

Key impacting considerations:
- length of coverage period
- length of payout period
- seasonality in incurred claim pattern

PAA eligibility

Key considerations impacting eligibility

- **Materiality**
  - Not defined
  - What perspectives might you consider?

- **Reasonably expects**
  - Range of scenarios to consider?
  - Change in expected losses? Change in discount rates?

- **Revenue recognition**
  - Revenue recognition under BBA vs. PAA
  - What are coverage units? Flexibility in interpretation?
  - What happens when expected loss emergence is not even?

- **DAC recognition under PAA**
  - Straight-line, or should it match the premium earning pattern?

PAA eligibility
Key characteristics impacting eligibility

1. Longer coverage period, in general
2. Seasonality in incurred claims pattern (i.e., multi-year hurricane covers)
3. Long payout patterns for incurred claims, particularly in a high interest rate environment
4. Release of risk adjustment is not commensurate with incurred loss pattern
5. Situations where there is significant volatility in “written premium” throughout the coverage period

PAA eligibility – QUESTIONS

1. Why is the industry so focused on PAA eligibility?
2. On what types of products have you performed eligibility testing?
3. Where do you think the greatest challenges exist?
4. What are some key considerations / strategies being pursued by companies to demonstrate eligibility?

QUESTIONS?

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