Insights

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IFRS 17 does not spare anyone

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Introduction

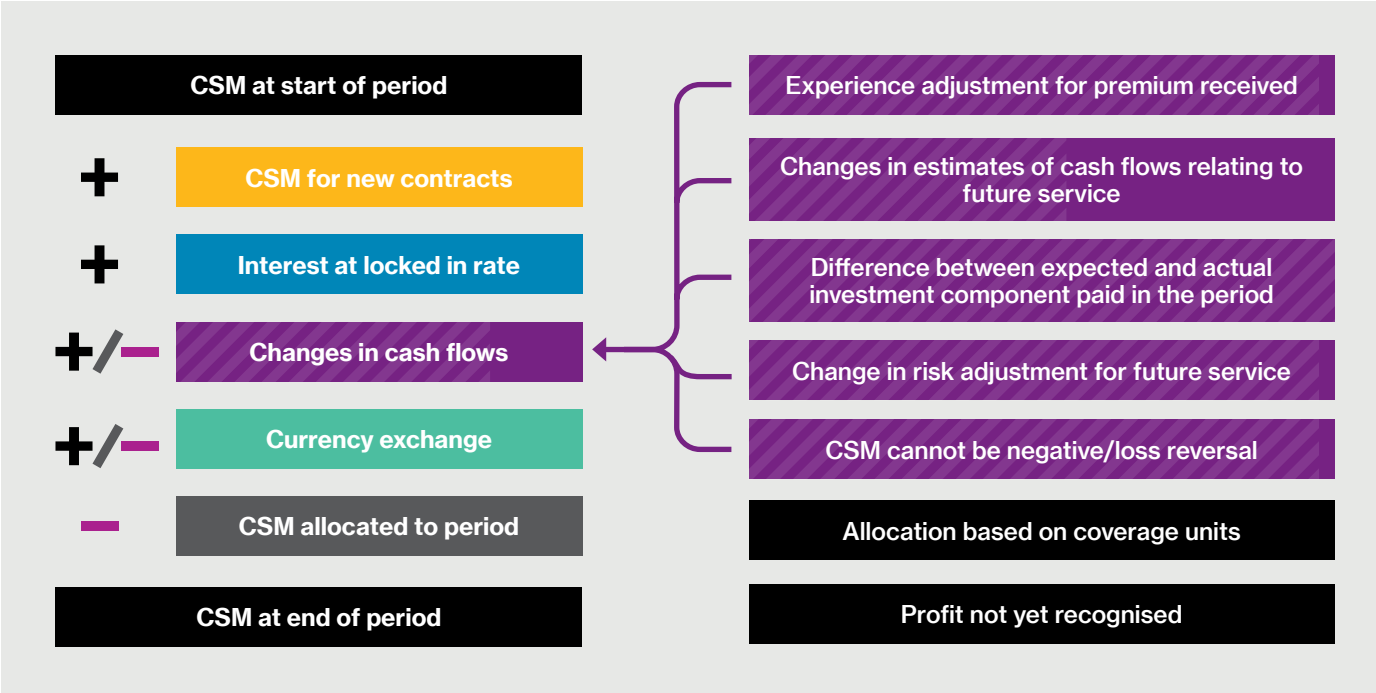
On 18 May 2017, the International Accounting Standards Board published the final version of International Financial Reporting Standard 17 Insurance Contracts (IFRS 17), effective for reporting periods commencing on or after 1 January 2021. This is a major milestone in what has been a long journey from the commencement of the Insurance Contracts Project in 1997. The publication of IFRS 17 is a trigger for the insurance industry to ramp up its efforts to understand and implement IFRS 17.

Central to IFRS 17 is the General Measurement Model which insurance companies will apply to determine the liabilities for their insurance contracts. A key and complex element of the General Measurement Model is the Contractual Service Margin (CSM), which serves to ensure profits are recognised over time as services are provided.

This article will tackle the main areas for an insurer to focus when implementing the IFRS 17. The central points discussed in the following sections are the CSM, challenges regarding the implementation of IFRS 17, areas within IFRS 17 where substantial judgement is needed, and automation and workflow improvements.

Contractual Service Margin (CSM)

The CSM is designed to result in a smooth release of profit as insurance services are provided, which results in zero day 1 profit. The initial CSM is determined as a balancing item in order to achieve this outcome. As the CSM cannot be negative, losses are in effect recognised immediately.



Roll-forward of CSM

IFRS 17 sets out a roll-forward approach for determining the CSM and its release over time. The principal elements of the roll-forward are the addition of the CSM for any new contracts, accretion of interest at a locked in rate, changes in estimates of cash flows relating to future coverage, currency exchange effects and allocation of part of the CSM to the profit or loss for the period.

- The CSM for new contracts is similar to a market-consistent new business value. For a typical insurance contract, it represents the excess of the value of premiums over a risk-adjusted value of claims and expenses.
- Interest is accreted to the CSM each period. The interest rate for the interest accretion is locked in at rates applicable at the time the contracts were issued. Subsequent movements in market yields do not impact the CSM.
- The changes in cash flows relate to changes in the expected value of future cash flows.

  Experience adjustments, for example, a higher realised mortality are considered to relate to current or past experience and therefore do not impact the future cash flows. However, there are two exceptions to this. Firstly, the CSM roll-forward allows for an experience adjustment in relation to premiums received, as this is associated with future coverage. Secondly, there is an experience adjustment related to the repayment of investment components. This is included as there will generally be interaction between such payments during the period and any future payments (eg if there are more surrenders than expected during a period, resulting in higher repayments of investment components, there must be fewer surrenders or maturities in future periods as a result of this experience). The experience adjustment serves to minimise profit or loss volatility due to the timing of repayments of investment components.

  The CSM is also adjusted for changes in the risk adjustment relating to future service.

- The CSM is also adjusted for changes in the currency exchange rates.
- A part of the CSM is allocated to the profit or loss reported for each period. The allocation is based on the amount of coverage provided during the period relative to the amount of coverage expected to be provided over future periods.
- The CSM cannot be negative.

The discount rate used for the CSM roll-forward under the General Measurement Model being 'locked in' has the potential to result in accounting mismatches between the CSM and the assets supporting the insurance contracts.

These mismatches could be quite material and artificial for business such as participating business and unit linked where an insurer's future profit is to a greater or lesser extent directly linked to its share of the fair value of the underlying pool of assets that an insurer and policyholders participate in.

The IASB recognised this and specified a modification to the General Measurement Model for contracts with such directly participating business. The modification is commonly referred to as the Variable Fee Approach (VFA).

In effect, this unlocks the discount rate used for the CSM roll-forward for this business, resulting in the insurer's share of any future change in the fair value of the underlying pool of assets flowing through into the CSM. As a consequence, the accounting mismatch and profit or loss volatility that would otherwise exist is avoided, or at least reduced.

Challenges regarding the implementation of IFRS 17

The issues insurers face will vary, depending on the nature of the insurance liabilities, current insurance accounting and existing systems, models and processes.

Key considerations for both life and general insurers include:

- There will be a one-time transition exercise to the new standard, notably to determine the CSM applicable to existing business (the remaining deferred profit yet to emerge on these contracts) as at 1 January 2020 (as at least one year of comparatives is required). The default position will be to determine what the CSM would have been at the start and end of 2020 as if IFRS 17 had always applied, with simplified approaches available.
- Potential differences in measurement approach between primary insurance and reinsurance.
- How to determine and run off the risk adjustment allowing for management's views. IFRS 17 is principles-based, allowing companies to set their own approach.

There will also be a number of key considerations for just life insurers, including:

- The roll-forward of the CSM. Understanding and appropriately implementing the necessary workings of the CSM to eliminate day 1 profits and spread effects over time will be critical to successfully adopting IFRS 17.
- For IFRS 17 the time value of options and guarantees in the insurance portfolio should be determined. For some insurers in Hong Kong, this is new. In most cases, stochastic calculations will be required to determine the time value of options and guarantees. To allow for stochastic calculations, models will need to be adjusted. A common method to determine the time value of options and guarantees is using risk neutral economic scenarios.
- The application of the requirements to participating insurance contracts; an area where market practice is likely to develop in the coming years. The VFA, which is expected to apply to participating contracts, should allow investment gains and losses to be recognised over time, with the CSM being varied to achieve this. The key considerations are to what extent and how the VFA can be applied.
- The extent to which the illiquidity of cash flows should be considered in the discount rates.
- Exclusion of any investment component from reported revenue.

For all insurers, there will also be significant additional disclosure requirements. This includes a new income statement which will take time to get used to.

Areas within IFRS 17 where substantial judgement is needed

There are a range of areas of IFRS 17 where substantial judgement is required, including product grouping, discount rates and the risk adjustment. The IFRS 17 principles leave much room for different interpretations and methodologies. Depending on the methodology implemented, the resulting balance sheet and/or statement of comprehensive income behaviour will be significantly different. Therefore, it is important for insurers to consider various methodologies and consider the financial and operational impacts for each before deciding on which methodology to adopt.

Product grouping

IFRS 17 requires the business to be segmented into portfolios of contracts that have similar risks and are managed together, eg it would not be appropriate to combine endowment policies with term insurance policies.

Portfolios need to be sub-divided into at least three groups, contracts that are:

1. onerous at outset

2. have no significant possibility of becoming onerous

3. other contracts

The allocation to groups is to be done on a contract-by-contract basis, except when an insurer can determine, using reasonable and supportable information, that a set of contracts will all be allocated to the same group.

Groups are further split in annual cohorts. Contracts within a group cannot be issued more than one year apart.

The CSM roll-forward described above is to be performed separately for each resulting group of contracts. The more groups there are, the more likely some groups will become onerous.

Discount rate

The discount rate setting is another area with considerable judgement.

The main principle in determining the discount rate is that the discount rates need to be consistent with the market prices for financial instruments whose cash flows are consistent to those of the insurance liabilities in terms of timing, currency and liquidity.

IFRS 17 allows two different ways setting the discount rates for insurance contracts that do not vary based on performance of underlying items: the bottom-up approach and the top-down approach.

The bottom-up approach starts with a suitable risk-free curve and adjusts this to reflect the different liquidity characteristics of the insurance liabilities. In effect an illiquidity premium is added. Considerable judgement will be required regarding the methodology to be used for the determination of the illiquidity premium.

In contrast, the top-down approach starts with the yield on a reference portfolio of assets and then removes allowances for any factors not relevant to the contracts. In reality, the most common adjustments that would be needed relate to duration mismatches and credit risk, for both expected and unexpected defaults. Relatively little guidance is given as to how to determine the adjustment for credit risk, although reference is made to estimating the effect of credit risk using credit derivatives.

A key point to note is that the discount rate needs to reflect the characteristics of the liabilities and as such the choice of backing assets should not influence this (where the liabilities do not depend on the asset performance).

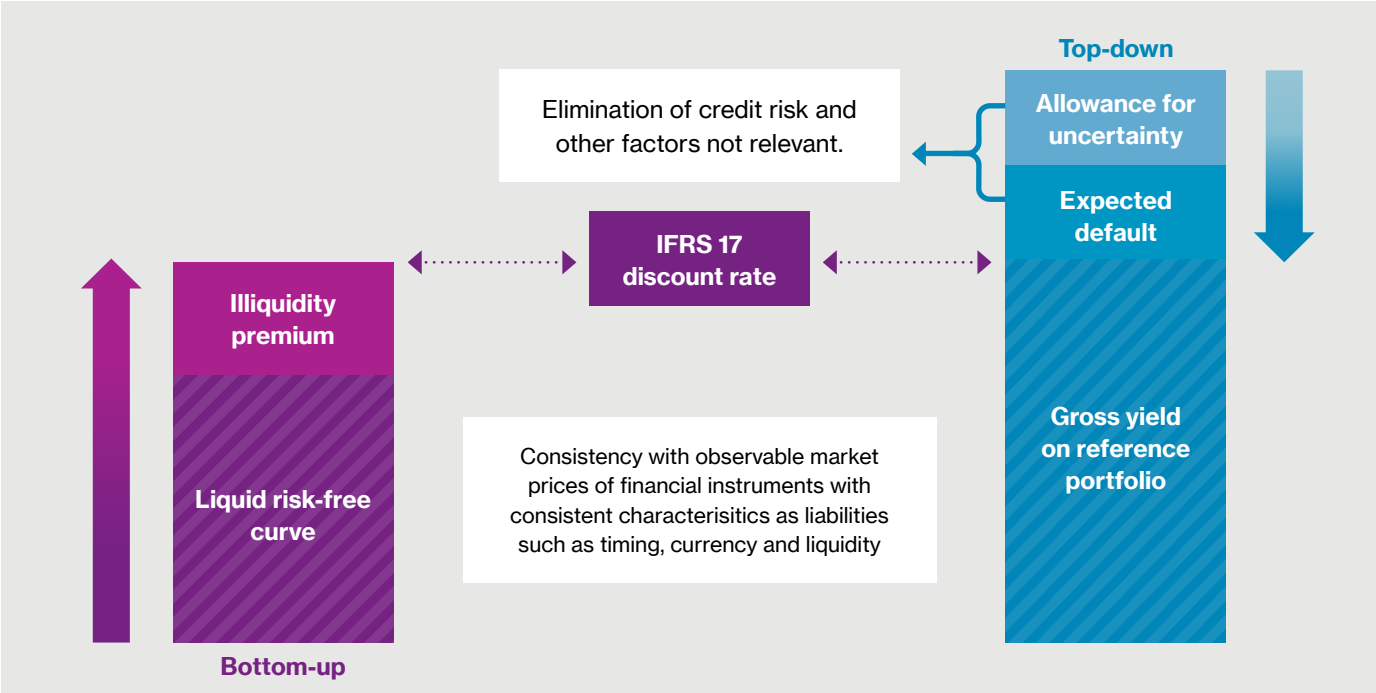
In theory both approaches should lead to the same discount rate. However, in practice this may not be the case.

Risk adjustment

IFRS 17 contains only general guidance about the methodology for the calculation of risk adjustment. A key principle is that the risk adjustment should 'reflect the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk' and some general characteristics such as the risk adjustment should be larger for contracts with lower frequency, higher severity or longer duration.

This is a potentially material area for judgement to be applied as, for many companies, the risk adjustment could be significant relative to annual profits.

While the need to apply judgement when interpreting various aspects of the final standard represents a significant challenge for insurance companies, it is also an opportunity. The principles-based approach implies that a variety of approaches are potentially acceptable. This means that companies can select approaches which work best for them.

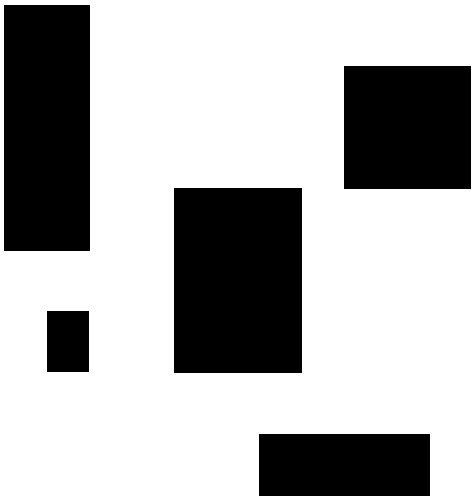


Automation and workflow improvements

IFRS 17 is much more complex than the current reporting standards. As the time available to companies to produce results will not be increasing, automation and/or workflow improvements will be essential for a successful implementation of IFRS 17. This will require a revolution in the actuarial reporting processes.

Currently, the processes around actuarial models are in many cases heavily manual. To make IFRS 17 a success, insurers will need to introduce best practice reporting processes incorporating an Enterprise workflow process for IFRS 17, which will need to be defined specific to each business, linked to its overall information technology architecture. This process needs to be repeatable through automation and scheduling and have appropriate definitions of roles, access controls and the ability to lock down models. It should also have automated handling of data, contract grouping and calculations, all the way through to reporting of results.

The major changes required for the implementation of IFRS 17, should not be viewed as just a compliance exercise, but more as an opportunity for broad process improvement, ultimately releasing resources from performing valuations to being more engaged in considering the outcomes and business implications of the new reporting metrics.



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