INTERNATIONAL FINANCIAL REPORTING

A SHORT DURATION CONTRACTS PERSPECTIVE TO IFRS 17

Webinar – September 25, 2017

Presenters

- Gareth Kennedy, MAAA, ACAS – (Moderator)
  - Member, IFRS 17 Work Group
  - Chairperson, Financial Reporting Committee
- Marc Oberholtzer, MAAA, FCAS
  - Member, IFRS 17 Work Group, Financial Reporting Committee
- Lela Patrik, MAAA, FCAS
  - Member, IFRS 17 Work Group
- Laurel Kastrup, MAAA, FSA
  - Member, IFRS 17 Work Group
  - Incoming Vice President, Risk Management and Financial Reporting Council

Agenda

- Overview and Importance of International Financial Reporting Standard (IFRS) 17
- The General Model
- Premium Allocation Approach - with illustrative example
- Key Observations
- Questions

Overview

International Accounting Standards Board (IASB)

- No global standard for insurance
- IASB formed in 2000, Financial Accounting Standards Board (FASB) in 1973
- IFRS adopted by European Union (EU) in 2004
- IFRS 4 in 2004 left out diversity of insurance practice
- Until EU adopted IFRS US Generally Accepted Accounting Principles (GAAP) was the de facto global standard – needed to report using US GAAP to access US capital markets

Breadth of IFRS

Adoption of IFRS Standards

Fifteen of the G20 jurisdictions have adopted IFRS Standard for all or most companies in their public capital markets. Of the remaining five G20 jurisdictions:

- one (Japan) permits IFRS Standards on a voluntary basis for domestic companies (as of June 2016 companies accounting for 29% of the Tokyo Stock Exchange market capitalisation have adopted or plan to adopt IFRS Standards);
- three (China, India and Indonesia) have adopted national standards that are substantially in line with IFRS Standards but have not announced a plan or timetable for full adoption; and
- one (the United States) does not permit domestic securities issuers to use IFRS Standards but it does permit foreign securities issuers to use IFRS Standards as issued by the IASB, and approximately 500 companies do so.

* G20 Includes UK, Canada and European Union countries

Source: http://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/#analysis August 28,2017

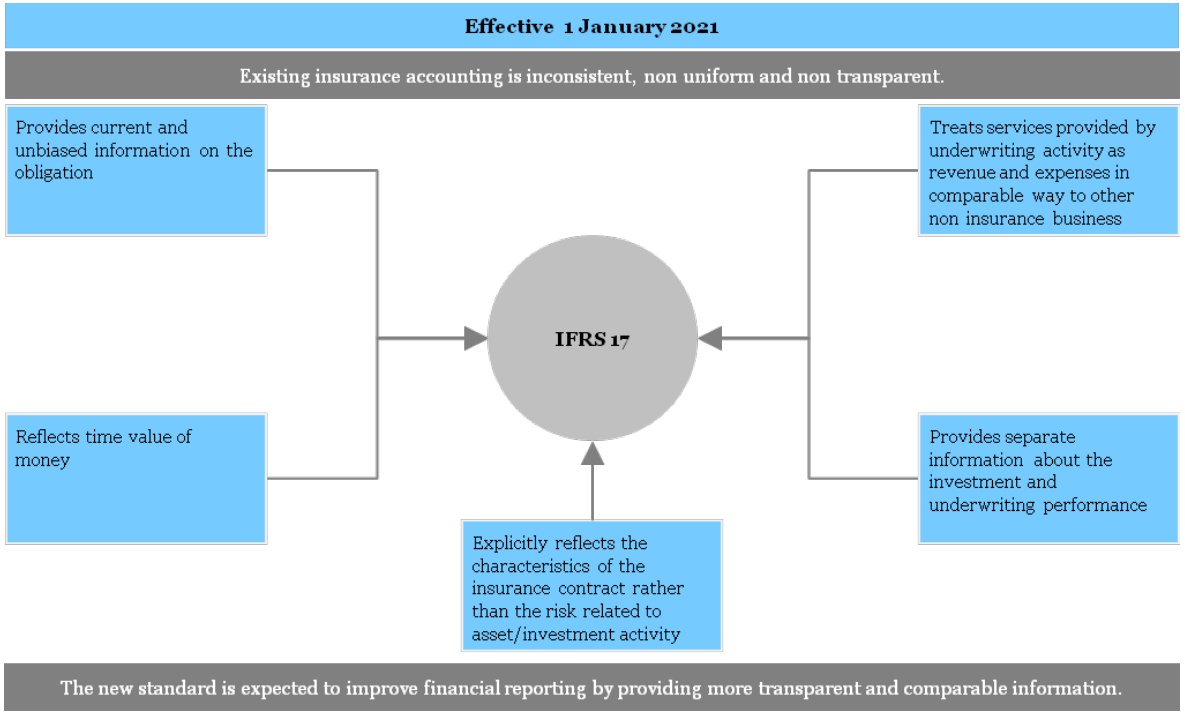
IFRS Insurance Project Objectives

- Reduce diversity of accounting practices that currently exist for insurance contracts
- Align insurance accounting with other business sectors, where possible
- Increase users' understanding of insurance financial statements
- Help investors make decisions

IFRS 17

- IASB adopted final version May, 2017
- Covers all insurance and reinsurance contracts
- Effective 1/1/2021
- There was an amendment to IFRS 4 that allowed insurance companies to defer adoption of IFRS 9, assets, until they implemented IFRS 17
- One “General Model” (formerly known as the Building Block Approach)
  - Simplification for short duration contracts (Premium Allocation Approach)

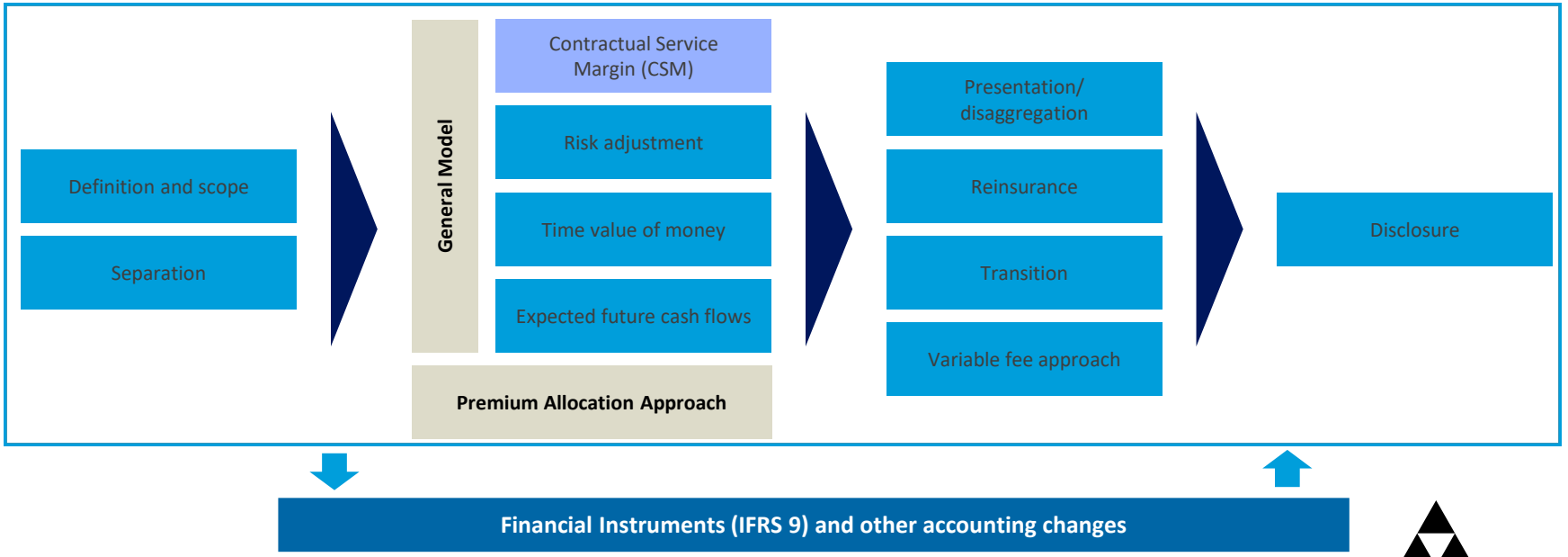
IFRS 17 Summary



Source: EY

IFRS 17 – A Comprehensive Framework

- The new standard provide a comprehensive framework to recognize, measure and report insurance and reinsurance contracts



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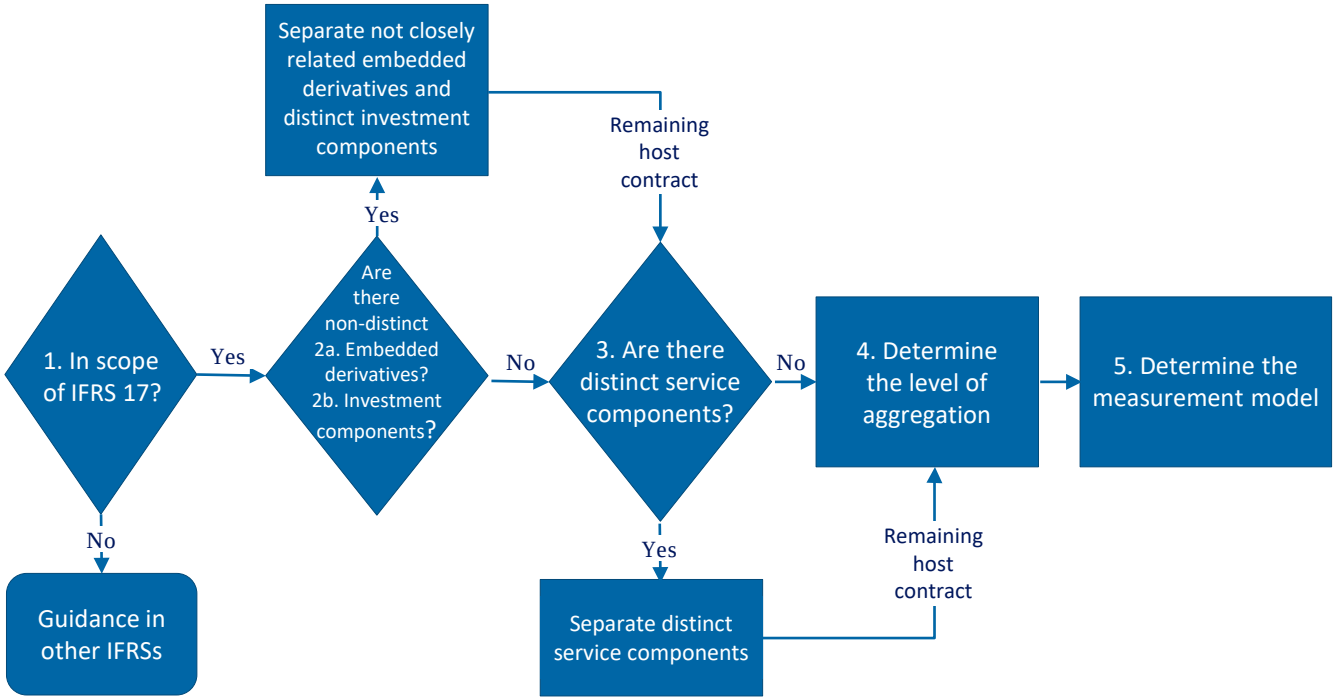
Insurance Contracts Measurement
Initial Recognition and Aggregation

Recognition

Overview



Source: PwC

Measurement

Overview of Measurement Models

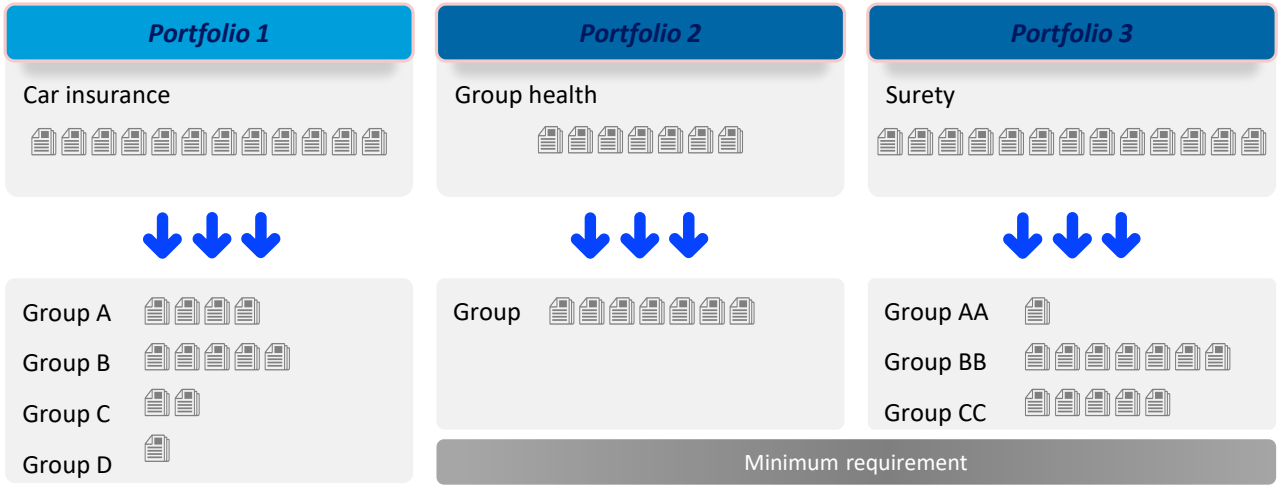
	General model	*Premium allocation approach (PAA)*	*Variable fee approach*
Why is it needed?	Default model for all insurance contracts	To simplify for short term contracts with little pre-claims variability	To deal with participating business where payments to policyholders are linked to underlying items like assets
Types of contract	• Long-term and whole life insurance, protection business • Certain annuities • US style universal life • Reinsurance written • Certain general insurance contracts	• General insurance • 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

Source: PwC

Measurement

Level of Aggregation – Portfolios and Groups of Contracts

- A ***portfolio:*** insurance contracts subject to similar risks and managed together
- Entity divides each portfolio of contracts into ***groups*** based on profitability and initial recognition date.



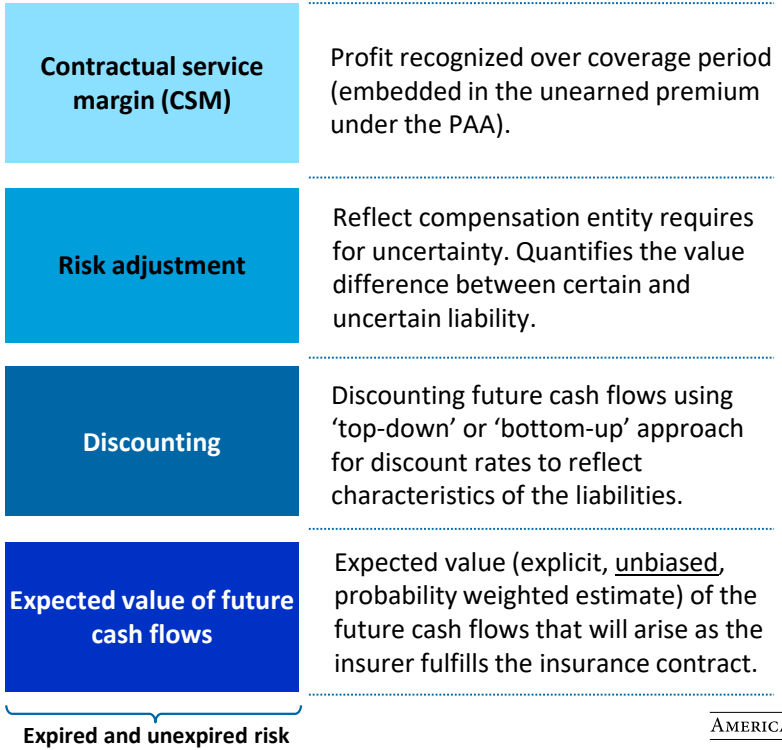
Source: PwC

Premium Allocation Approach (PAA)
Model Measurement Objectives and Eligibility

General Model

Overview

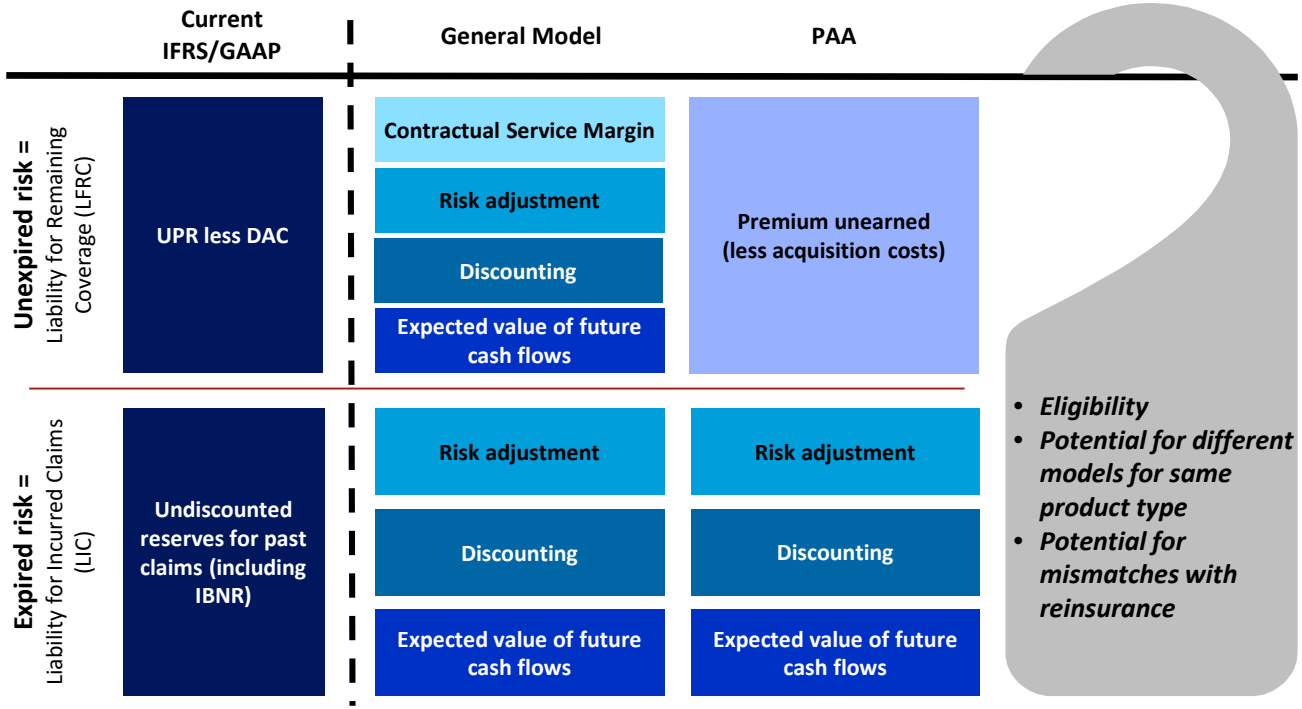
- Default model for all insurance contracts
- Starts with an estimate of the expected value of discounted future cash flows
- Discounting – option to use yield curves at date contract issued (other comprehensive income (OCI) option)
- Explicit margins:
  - CSM – to prevent gain on policy inception
  - Risk adjustment – reflect uncertainty (non-financial risk)
- Day 1 loss recognized in income statement
- Cash flow approach for all liabilities: past claims (including IBNR) and future cover



Source: PwC

PAA

Model comparison



*Size of blocks for illustrative purposes only.

Source: PwC

PAA vs. US GAAP

Overview

- The “Premium Allocation Approach” (PAA) option is expected to be applicable to and elected for most property/casualty 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 will differ from current US GAAP in several key respects:
  - 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 during the coverage period differs significantly from the passage of time
  - Other key differences: (1) exclude non distinct investment component from revenue and claims incurred expense, (2) ceding commissions netted against reinsurance premiums, (3) present deferred acquisition cost (DAC) net against LFRC, and (4) more granular level of onerous contract testing (akin to UPR deficiency test)

PAA

Measurement Requirements

Liability for Incurred Claims

- Includes all incurred and reported and also not reported losses (IBNR)
- Measurement: General Model building blocks (CSM is not relevant for expired risk)
- Explicit, unbiased, probability-weighted estimate (expected value) of future cash flows needs to be determined
- Risk adjustment:
  - (i) An explicit risk adjustment needs to be calculated and disclosed
  - (ii) Technique is, opposed to Solvency II requirements, not prescribed
  - (iii) Unit of account at which diversification benefits can get calculated not prescribed either
- Discounting not required if cash flows are expected to be received/paid within one year from the date the claims are incurred.

Liability for Remaining Coverage

- Recognition of premiums over the coverage period
- Calculation for initial measurement:
  - (i) The premium received
  - (ii) Less acquisition costs, unless recognized directly as an expense (if coverage period is 12 months or less acquisition cost can be expensed immediately if desired)
- Calculation for subsequent measurement:
  - Premium revenue recognized on basis of passage of time but if the expected pattern of release from risk during coverage period differs significantly from passage of time, then on basis of expected timing of incurred insurance service expenses.
- Adjustment for time value of money not required for unearned premium if there is not a significant financing component or if provision of each part of coverage and premium due date is no more than a year.

Onerous Contract Test

- Under the PAA it can be assumed that no contracts in a portfolio at initial recognition are onerous unless the **facts and circumstances** indicate otherwise. Also under the PAA, an assessment should be made as to whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently by assessing the likelihood of changes in the facts and circumstances.
- Measurement: General Model

Source: PwC

Expected Value Future Cash Flows

Overview

- Measurement objective
  - Current estimate of the probability weighted mean of the full range of possible outcomes
  - Incorporates all available information in an unbiased way
  - Explicit estimate – estimate of expected value of future cash flows is separate from the adjustment for discount and the risk adjustment
  - In practice, developing explicit scenarios and simulation is not required and this measurement objective may be met by a deterministic approach that demonstrates that the estimate reflects an expected value

Expected Value Future Cash Flows

Included vs. Excluded Cash Flows

Included

- Claims and benefits, including paid in kind
- Discretionary payments and payments that vary with returns on underlying items
- Payments from embedded derivatives, including options and guarantees
- Insurance acquisition cash flows
- Claim handling costs
- Policy administration and maintenance costs
- Transaction-based taxes and levies
- Recoveries such as salvage and subrogation
- Fixed and variable overheads*
- Other costs*

Excluded

- Some not directly attributable acquisition costs, such as product development and training costs
- Assets investment returns
- Cash flows from reinsurance contracts held
- Income taxes
- Cash flows related to components separated from insurance contracts

* Only if directly related to the fulfilment of the contract.

Source: PwC

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 rate
  - Use rates that reflect the characteristics of the underlying cash flows in terms of timing, currency, and liquidity
  - The method to estimate the applicable discount rates is not specified
- Options
  - 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

Discount Rate

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

Discount rate excludes own-performance risk

Source: PwC

Risk Adjustment

Overview

- The risk adjustment for non-financial risk for insurance contracts measures the ***compensation*** that the entity would require to make the entity ***indifferent*** between: (a) ***fulfilling*** a liability that has a range of possible outcomes arising from non-financial risk; and (b) ***fulfilling*** a liability that will generate fixed cash flows with the same expected present value as the insurance contracts.
- Key characteristics impacting risk adjustment:
  - Frequency and severity
  - Contract duration
  - Probability distribution
  - Amount of information known
  - Emerging experience

Risk Adjustment

Key Characteristics

- Fulfilment value
  - Reflect the uncertainty associated with fulfilling the liability
  - Not transfer value
- Company perspective
  - Not exit or fair value since those are market perspectives
- Explicit
  - Separate from the expected value cash flows
- Contract risk
  - Consider risk arising from the contract only (e.g., not investment risk)
- Diversification
  - Reflect the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk
  - As considered in the original pricing
- No prescribed method
  - But required to disclose implied confidence level

PAA

Eligibility criteria

- 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.

PAA Eligibility

May Prove 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 → 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
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	

Source: PwC

PAA

Why is it a useful simplification of the General Model?

- Unexpired risk is accounted for using an Unearned Premium Reserve (similar to current US GAAP)
- 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
- Under most cases, there are a reduced amount of calculations needed for the PAA (e.g., no need to project future incurred losses unless facts/circumstances indicate that a contract is onerous)
  - Onerous contract determination simplified
- Companies can leverage current US GAAP reserve estimates, with applicable adjustments:
  - Unbiased mean, discounting, risk adjustment
  - System updates are still needed to quantify and track these adjustments through time

Premium Allocation Approach (PAA)
Illustrative Example

Illustrative Example

Initial Assumptions

- Values shown for one unit of account
- Coverage type: Workers' Compensation
- Coverage period
  - Contract issue date: July 1, 2017
  - Policy term: 10 Months
  - Accident year: July 1, 2017 to April 30, 2018
- Cash flows
  - All premium received on issue date and no contracts are expected to lapse during the coverage period
  - Claims assumed to be incurred evenly throughout the coverage period
  - Claims are settled and paid for $70 higher than expected on August 31, 2018
  - Therefore risk is released / premium is earned evenly throughout the coverage period
  - The Company has additionally elected to expense acquisition costs when incurred
- Discount – n/a
  - Because the time between providing coverage and the premium due date is less than one year, the Company chooses not to discount its liability for remaining coverage (unearned premium)
  - Because claims will be paid within one year of being incurred, the Company chooses not to discount its liability for incurred claims
- For simplicity, there is no investment component to these contracts
- None of the contracts that have been issued are onerous
- Financial statements required to be prepared as of December 31, 2017, June 30, 2018, and December 31, 2018

Illustrative Example

Financial Positon as of December 31, 2017

Activities between July 1, 2017 and December 31, 2017:

Activity		Amount	As of Date
Premium Received	$	1,220	7/1/2017
Acquisition Expense Paid	$	(20)	7/1/2017
Incurred Claims	$	600	12/31/2017
Risk Adjustment	$	36	12/31/2017

Statement of financial position as of December 31, 2017

	Assets	Liabilities/Equity
Cash (a)	$ 1,200	
Insurance Contract Liability (b)		$ 1,124
Equity		$ 76
(a):		
Premium Received	$ 1,220	
Acquisition Expense Paid	$ (20)	
Total	$ 1,200	
(b):		
Liability for remaining coverage*	$ 488	
Incurred Claims	$ 600	
Risk Adjustment on Claims	$ 36	
Total	$ 1,124	

*=4/10 months of coverage remaining x Total Premium Received

Statement of profit or loss for the 6 months ended December 31, 2017

Insurance Revenue (c)	$ 732
Insurance Services Expense (d)	$ (656)
Profit/(Loss)	$ 76
(c):	
*=6/10 months of coverage provided x Total Premium Received	$ 732
(d):	
Incurred Claims	$ 600
Risk Adjustment on Claims	$ 36
Acquisition Expense	$ 20
Total	$ 656

Source: PwC

Illustrative Example

Financial Positon of June 30, 2018

Period 1 Profit	76
Period 2 Profit	64
Total	140

Activities between January 1, 2018 and June 30, 2018:

Activity		Amount	As of Date
Incurred Claims	$	400	3/31/2018
Risk Adjustment on Claims	$	24	3/31/2018

Statement of financial position as of June 30, 2018

	Assets	Liabilities/Equity
Cash	$ 1,200	
Insurance Contract Liability (a)		$ 1,060
Equity		$ 140

(a):

Liability for remaining coverage*	$ -
Incurred Claims**	$ 1,000
Risk Adjustment on Claims**	$ 60
Total	$ 1,060

*All premium has been earned by 6/30/2018

**	Incurred Claims	Risk Adjustment
Incurred on 12/31/2017	$ 600	$ 36
Incurred on 3/31/2018	$ 400	$ 24
Total Incurred	$ 1,000	$ 60

Statement of profit or loss for the 6 months ended June 30, 2018

Insurance Revenue (b)	$ 488
Insurance Services Expense (c)	$ (424)
Profit/(Loss)	$ 64

(b):

*=4/10 months of coverage provided x Total Premium Received	$ 488

(c):

Incurred Claims in period	$ 400
Risk Adjustment on Claims	$ 24
Total	$ 424

Source: PwC

Illustrative Example

Financial Positon of December 31, 2018

Period 1 Profit	76
Period 2 Profit	64
Period 3 Profit	(10)
Total	130

Activities between July 1, 2018 and December 31, 2018:

Activity		Amount	As of Date
Increase to estimate of incurred claims	$	70	8/31/2018
Paid claims	$	(1,070)	8/31/2018

Statement of financial position as of December 31, 2018

	Assets	Liabilities/Equity
Cash	$ 130	
Insurance Contract Liability (a)		$ -
Equity		$ 130

(a):

Premium Received	$	1,220
Deferred Acquisition Costs Paid	$	(20)
Claims Paid	$	(1,070)
Total	$	130

(b):

Liability for remaining coverage	$	-
Incurred Claims	$	1,070
Paid Claims	$	(1,070)
Total	$	-

Statement of profit or loss for the 6 months ended December 31, 2018

Insurance Revenue	$	-
Insurance Services Expense (b)	$	(10)
Profit/(Loss)	$	(10)

(b):

Incurred Claims	$	70
Release of Risk Adjustment on Claims*	$	(60)
Total	$	10

*Risk adjustment of $60 is released at the time of claim payment.

Source: PwC

Observations

- Eligibility
- Impact of Discounting
- OCI Option
- Onerous Contracts
- Reinsurance
- Risk Adjustment
- Key Operational Impacts

Eligibility

- Application of the **PAA is optional**, subject to certain criteria being met:
  - Contract coverage period is one year or less, or
  - PAA is a reasonable approximation to General Measurement Model
- Specific considerations apply to **multi-year contracts**, such as:
  - Warranty, seasonal catastrophe covers, group business
  - Risks with claim durations greater than 1 year, for example in industries such as construction, shipping and energy
  - Reinsurance written on a risk attaching basis
- Need to asses whether PPA is a reasonable approximation
  - For multi-year contracts it may be necessary to model on transition to determine whether the PPA will provide no material difference in valuation to the IFRS 17 BBA.
  - Companies need to start on a inventory of contracts that will need a demonstration
- Business As Usual (BAU) processes will also need to confirm continued eligibility year-on-year for new business

Impact of Discounting

Separating the Financial Element

Current GAAP*	
Premiums earned	10,000
Incurred claims and expenses	(9,500)
Underwriting result	**500**
Investment income	291
Income tax	(221)
Profit or loss	**570**
Fair value movements on FVOCI assets	-
OCI related income tax	-
Total comprehensive income	**570**

IFRS 17**	
Insurance contract revenue	10,000
Insurance claims and expenses	(9,259)
Insurance service result	**741**
Investment income	291
Insurance finance expense	(241)
Net financial result	**50**
Income tax	(222)
Profit or loss	**570**
Discount rate changes on insurance liability	-
Fair value movements on FVOCI assets	-
OCI related income tax	-
Total comprehensive income	**570**

***Current GAAP**: Common presentation of non-life business under GAAP, assuming that claims are not discounted and assets are accounted for at FVTPL.

****IFRS 17:** Assumes assets accounted for at FVTPL, IFRS 17 OCI option not taken.

Key message

The key change is that the finance element of claims is separated from the income statement line that relates to claims.

Source: KPMG

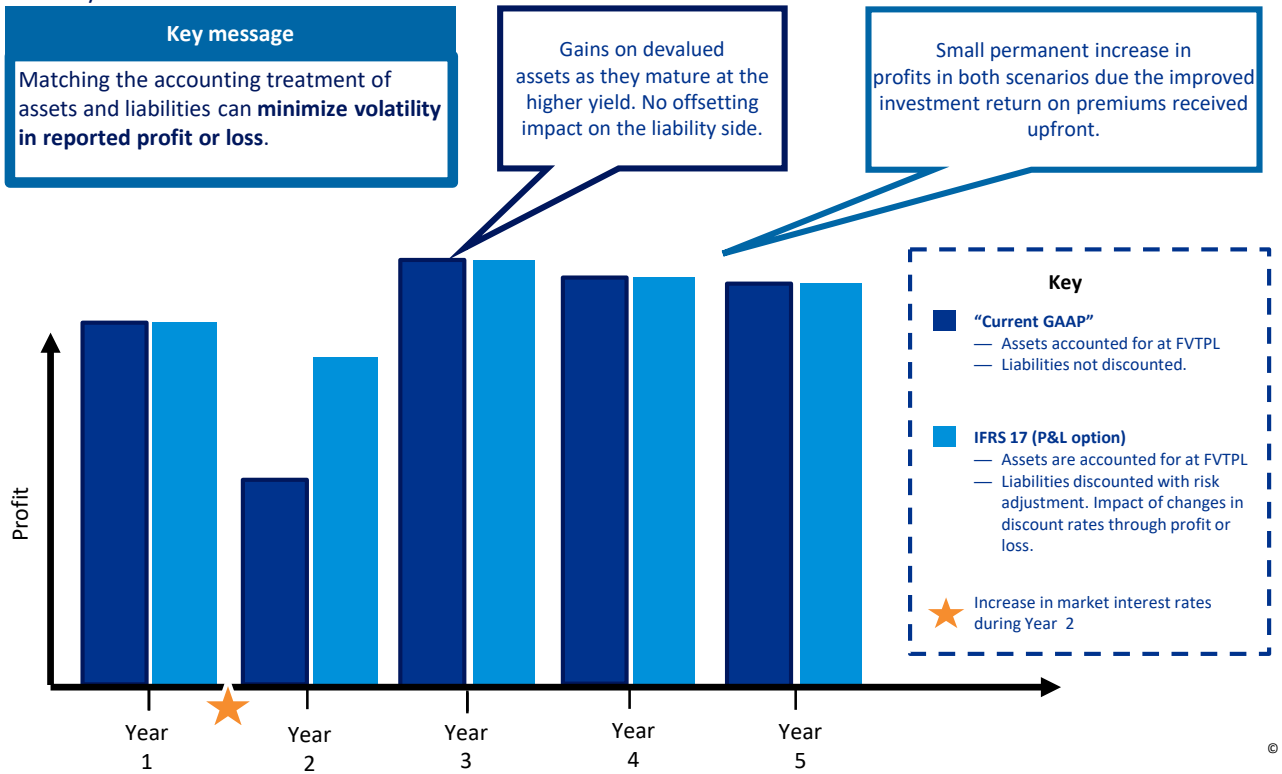
OCI Impact

Increase in Yield

To demonstrate how the OCI option can be beneficial to insurers, consider a scenario where there is an increase in the market yield:

Key message

Matching the accounting treatment of assets and liabilities can **minimize volatility in reported profit or loss**.



Source: KPMG

Presentation of the IFRS 17 OCI Option

IFRS 17 (assets at FVTPL; IFRS 17 OCI option not used)	
Insurance contract revenue	10,000
Insurance claims and expenses	(9,147)
Insurance service result	**853**
Investment income	17
Insurance finance expense	(67)
Net financial result	**(50)**
Income tax	(225)
Profit or loss	**578**
Discount rate changes on insurance liability	-
Fair value movements on FVOCI assets	-
OCI related income tax	-
Total comprehensive income	**578**

IFRS 17 (assets at FVOCI; IFRS 17 OCI option used)	
Insurance contract revenue	10,000
Insurance claims and expenses	(9,147)
Insurance service result	**853**
Investment income	324
Insurance finance expense	(241)
Net financial result	**83**
Income tax	(262)
Profit or loss	**674**
Discount rate changes on insurance liability	174
Fair value movements on FVOCI assets	(307)
OCI related income tax	37
Total comprehensive income	**578**

Key message

Impact of change in yields on the insurance contract liabilities is shown 'below the line' under the OCI option.

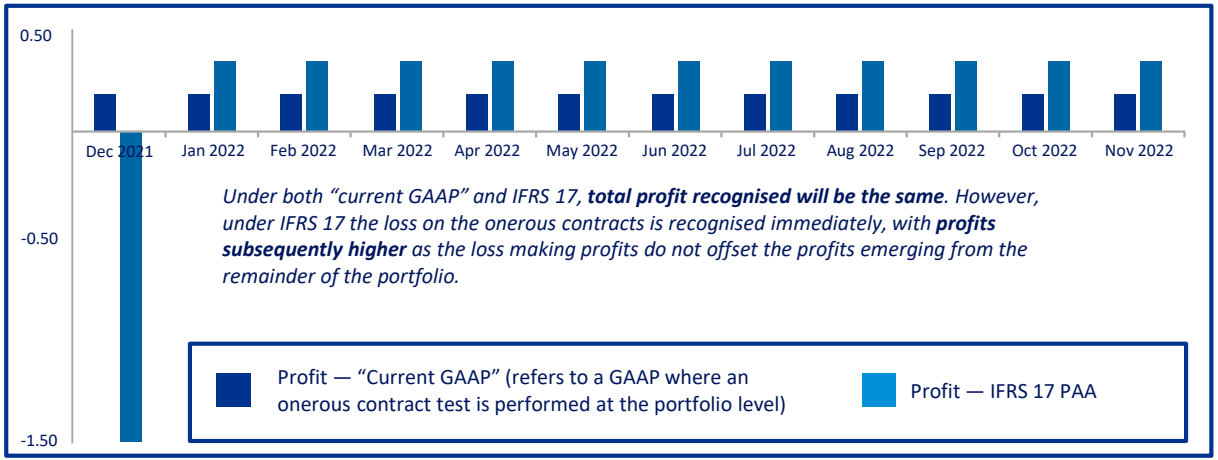
Option to present the impact of changes in discount rates in OCI

Source: KPMG

Onerous Contracts

Increased P&L Volatility

- Insurers will need to identify onerous contracts upfront and separate them from profitable contracts
- For contracts identified as onerous, the BBA is used
- Insurers consistently writing some onerous contracts may suffer a permanent reduction in net assets as losses are recognized earlier.



- Insurers writing loss making business may face more income statement volatility under IFRS 17 compared to current accounting in most jurisdictions. This is demonstrated below, demonstrating monthly profit and loss arising in a simple scenario where an insurer enters into a portfolio of contracts on 1 December 2022. The following facts are relevant:
  - 90% of the contracts are expected to be profitable;
  - 10% of the contracts are expected to be loss making;
  - Overall, the portfolio is expected to be profitable.

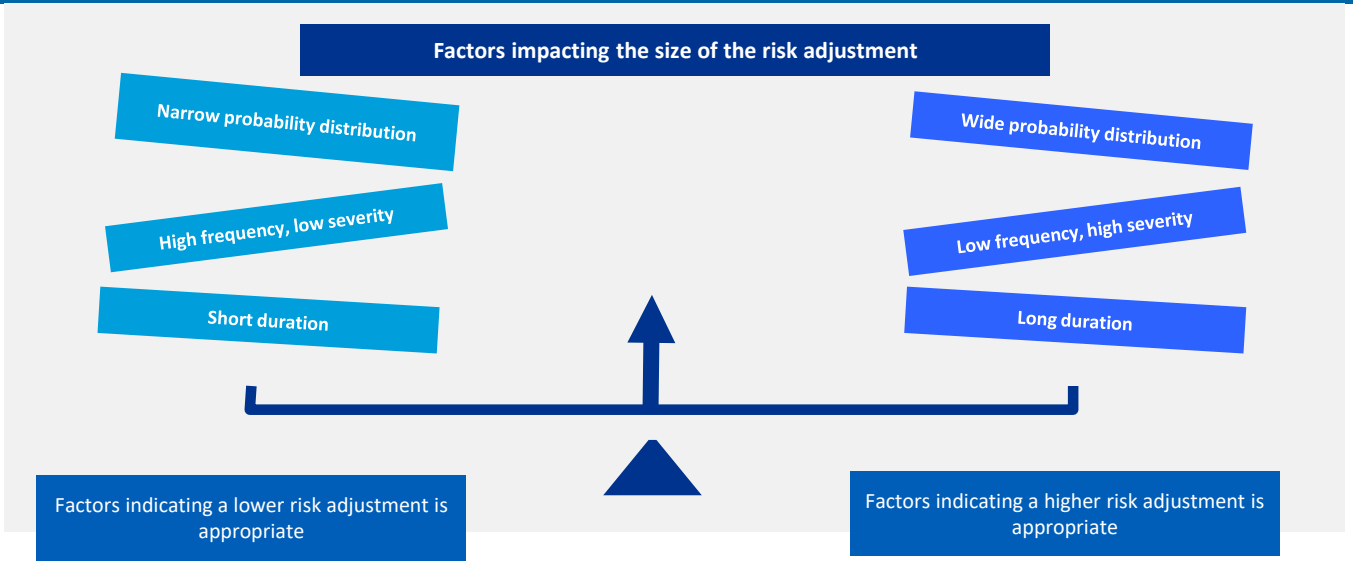
Source: KPMG

Ceded Reinsurance

- Ceded reinsurance largely follows the approach for indirect and assumed business although there are some key differences:
  - The decision on whether PAA is applicable needs to be considered separately for the ceded reinsurance
  - No gains or losses are made on inception (unless coverage is retroactive)
  - An allowance for expected credit losses is included within the cash flows reinsurance) date of recognition of any underlying contract
  - Ceding commissions— treated as a cash flow with premium related commissions presented net against premium, and claim related commissions offset claims liability cash flows. For example a contract with $1m of ceded premium today and a 30% ceding commission to offset the cedant's acquisition costs would be presented as $0.7m of ceded premium under IFRS 17
  - Recognition date is the later of reinsurance contract group inception date and (if proportional
  - The risk adjustment is based on the amount of risk transferred, i.e., difference between the gross and the net risk adjustments

Claims Liabilities

Risk Adjustment



- Risk adjustment may bring ERM-related functions into the financial reporting process, which will require controls on more processes.
- The new disclosures, together with the impact of discounting and the risk adjustment on reported profit, may mean that closer management scrutiny and tighter governance is required — especially soon after implementation. Processes may need to be developed to reflect this increased scrutiny.

Source: KPMG

Key Operational Impacts

- For many non-life insurers, the first step towards IFRS 17 implementation is coming to grips with the eligibility criteria for the PAA
- Insurers with both life and non-life business will need to think through how implementation decisions impact those businesses differently
- The level of aggregation requirements may drive a need to identify and measure onerous contracts at a more granular level. May need to look at pricing to identify ***onerous*** contracts.
- Other key challenges will include setting discount rate and risk adjustment methodologies, tackling the new presentation and disclosure requirements and making policy decisions on the use of OCI
- IFRS 17 will have both financial and operational consequences
- Operational impacts include producing new required disclosures, updating the reporting systems and processes (general ledger, chart of accounts, accounting rules engine and data feeds), and establishing suitable governance procedures.

Questions?

Contact:

Nikhail Nigam

Policy Analyst, Risk Management & Financial Reporting

nigam@actuary.org

(202) 223-8196