

CAS Webinar

IFRS 17

Emerging hot topics for Non-Life Insurers

April 30, 2019

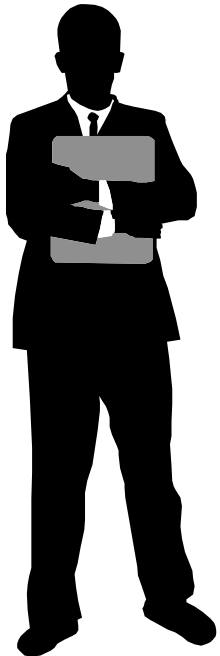
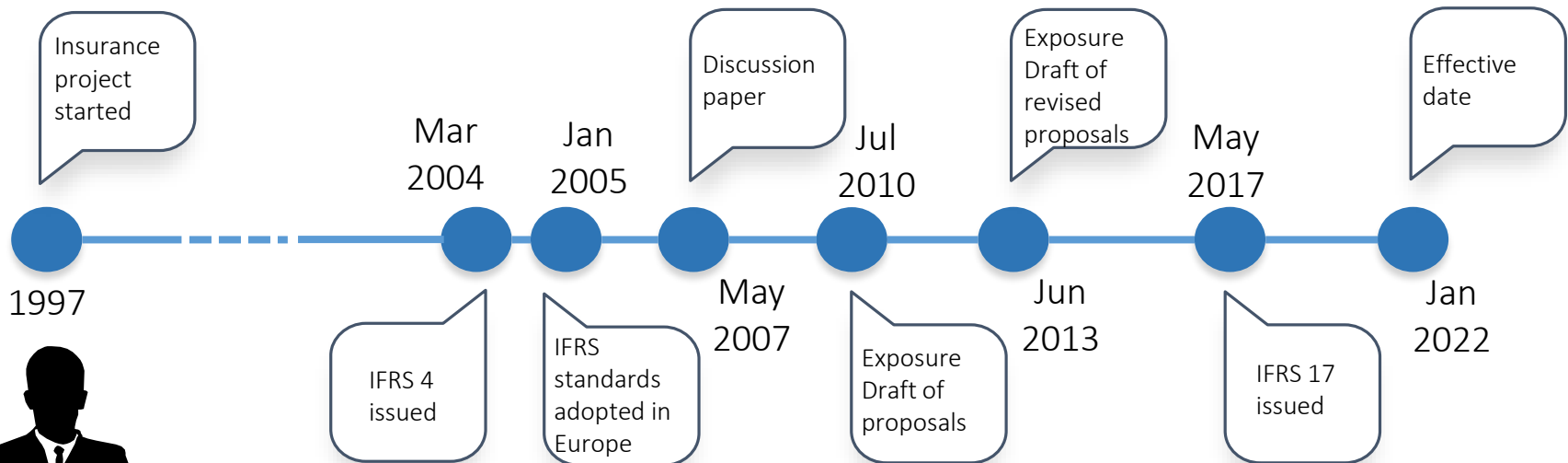
Agenda

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	<ul style="list-style-type: none"> • Long-term and whole life insurance, protection business • Certain annuities • US style universal life • Certain reinsurance written • Some P&C insurance contracts 	<ul style="list-style-type: none"> • Most P&C insurance and some reinsurance contracts • Short-term life and certain group contracts 	<ul style="list-style-type: none"> • 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

	Current IFRS/GAAP	General Model	PAA	
Unexpired risk	UPR less DAC	Contractual Service Margin Risk adjustment Discounting Expected value of future cash flows	Premium (less acquisition costs) unearned	Qualifying for the PAA Automatically available for contracts with coverage period twelve months or less. Unlikely that all contracts will automatically qualify for PAA model. Mixed measurement models within a reportable segment may make results difficult to interpret.
Expired risk	Undiscounted reserves for past claims (including IBNR)	Risk adjustment Discounting Expected value of future cash flows	Risk adjustment Discounting Expected value of future cash flows	Drivers of profit Changes to yield curves may require closer asset liability matching to manage income statement volatility. No prescribed method for measuring the risk adjustment but entity required to disclose methodology and confidence level and expected to be consistent year on year.

* 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:

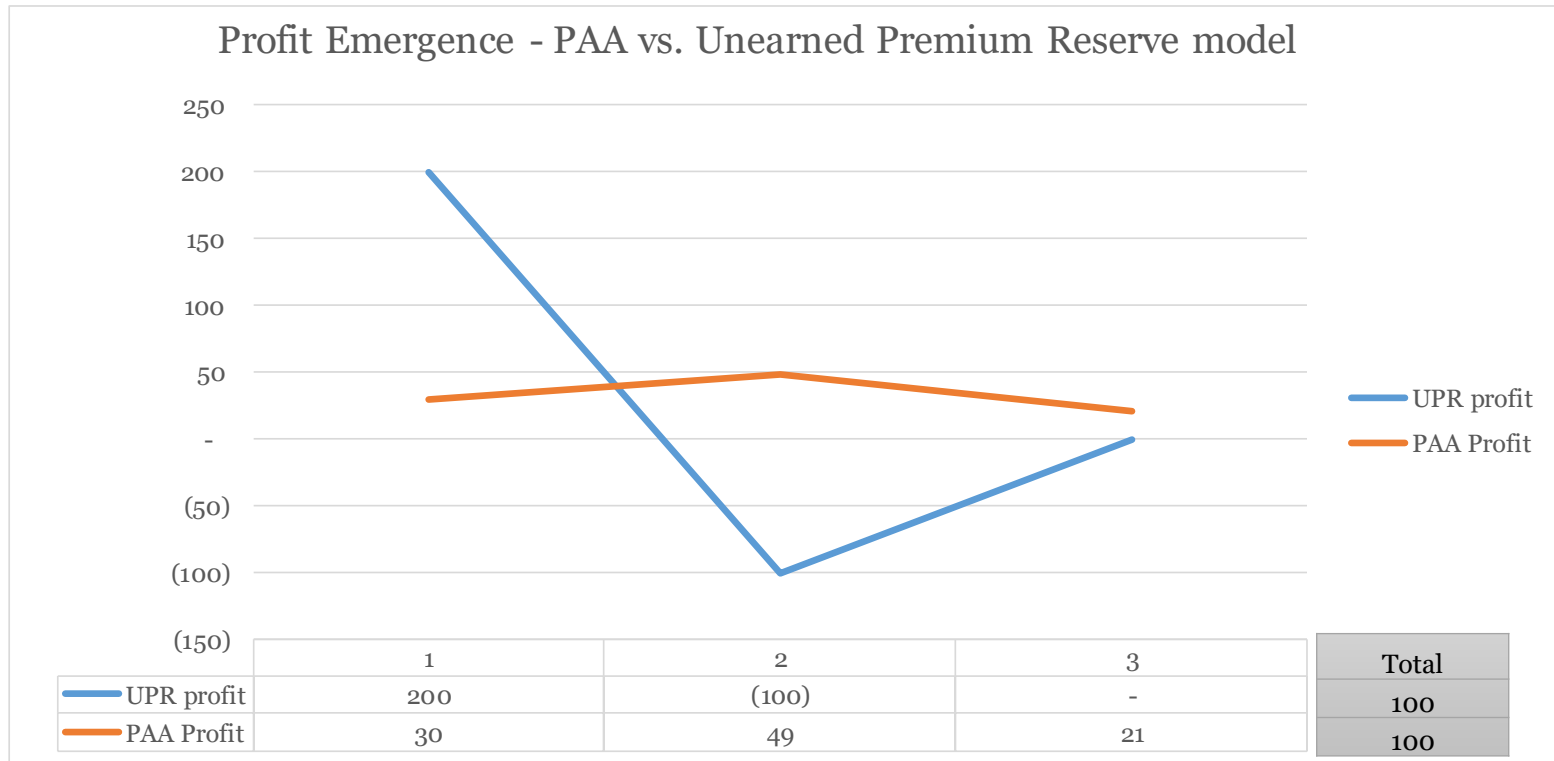
- Example is for one unit of account – e.g. Underwriting Year 2017 Auto Liability
- Premium equals 1,000 currency units (CU)
- Initial expected/unbiased mean loss ratio on policy = 80%; additional 100 CU of claims are incurred during year 2. Thus, total profit = 100 CU.
- 20% of claims are paid in the 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



- 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 deemed 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

Strategies that companies are taking

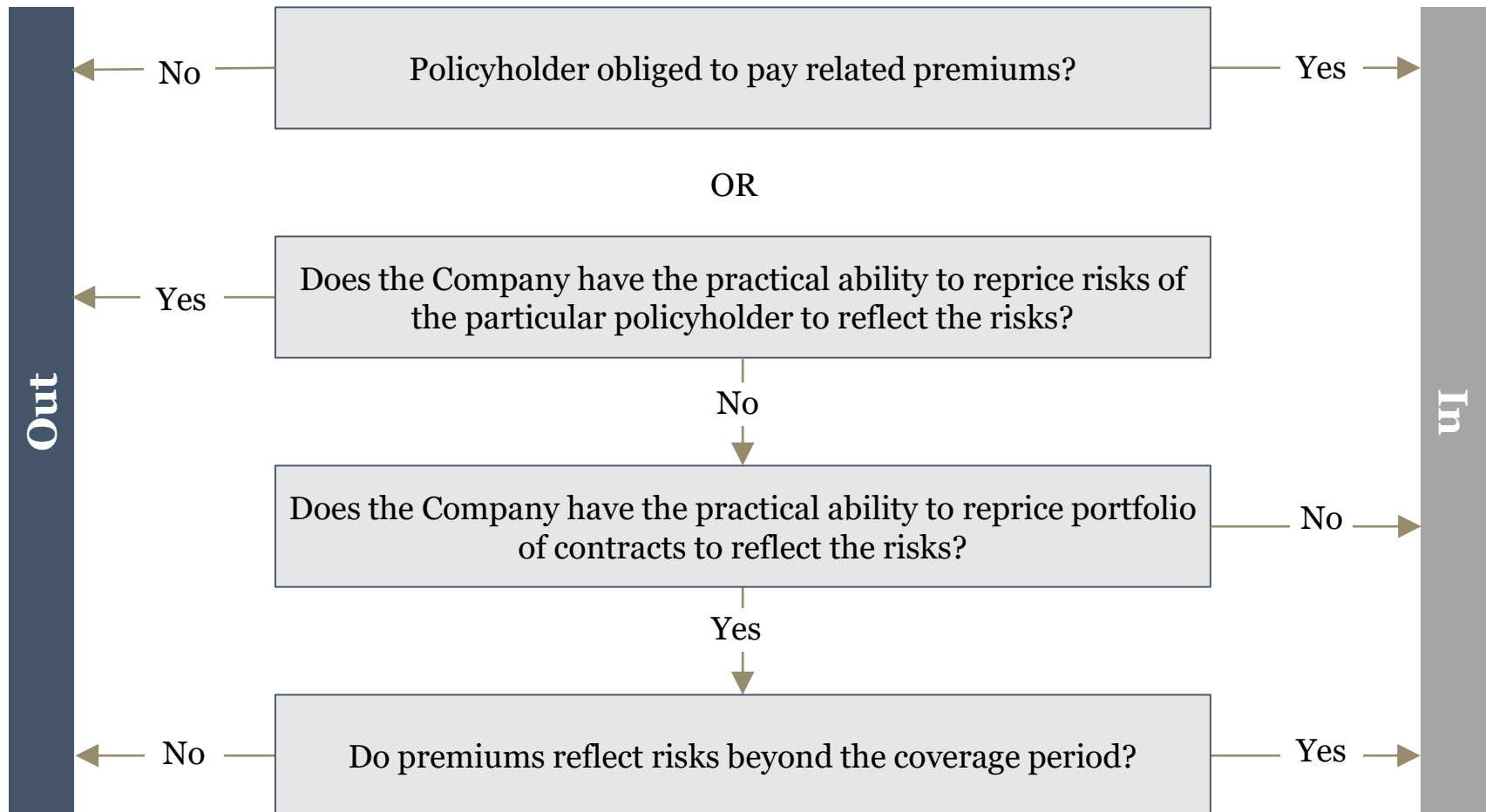
1. Education to understand characteristics of products that create challenges
2. Taking inventory of products written – claims emergence characteristics, contract boundaries, materiality, etc.
3. Preliminary PAA eligibility assessments on types of products (may not be aligned with level of aggregation 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?



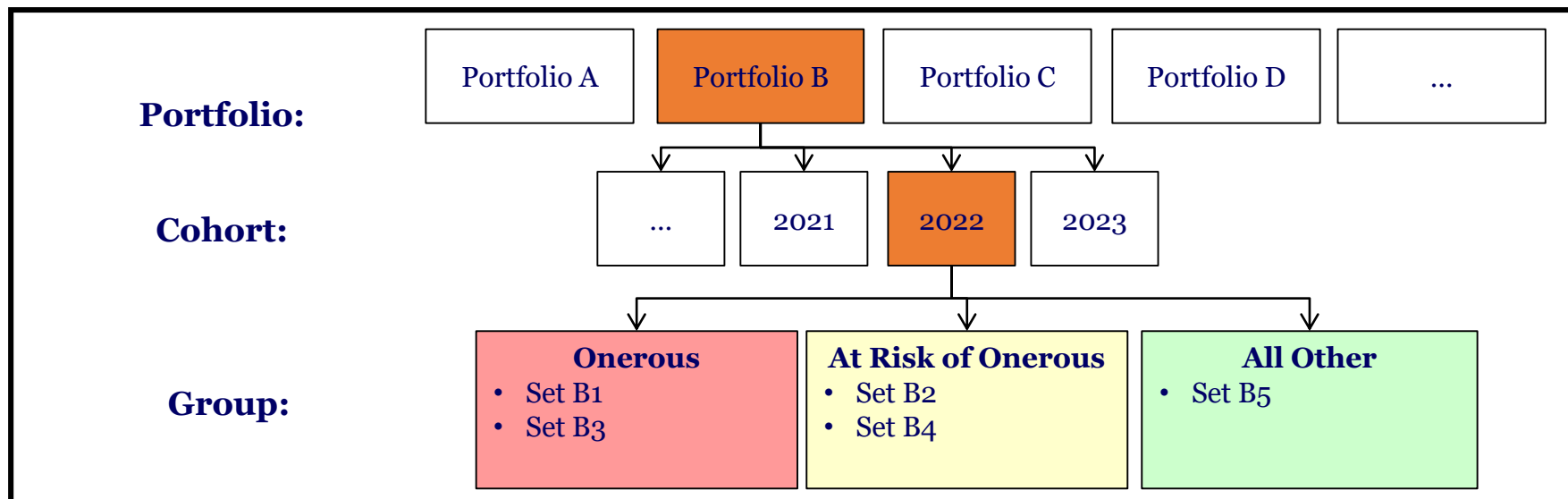
Level of aggregation

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

<u>Level of Aggregation</u>	<u>Unearned Future Gain/(Loss)</u>						<u>Total LFRC</u>	<u>Total Loss Component</u>
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

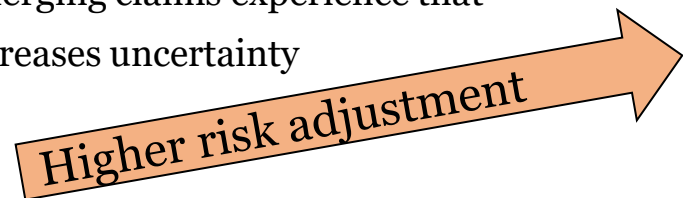
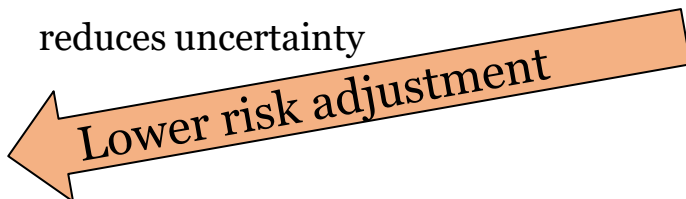
• Key characteristics

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

Ceded Reinsurance

Matching cash flows

It is unclear whether it will be possible to match cash flows arising through reinsurance with the underlying contracts.

- **Coverage period** – Coverage periods for the reinsurance contract is unlikely to reflect that of the underlying contracts.
- **Measurement model** – PAA eligibility assessment for reinsurance contract may differ from the underlying contract.
- **Level of aggregation** – Different level of aggregation between reinsurance and underlying contract portfolios.
- **Pattern of amortization of the CSM** – Likely to differ between the underlying contracts and the reinsurance recoverable.
- **CSM for reinsurance held can be positive or negative** – Day 1 gains and costs are deferred for reinsurance contracts held (unless the coverage relates to past events), while only day 1 gains are deferred for the underlying insurance contracts and day 1 losses are recognized immediately in profit or loss.

* Proposed IASB amendment is expected to provide opportunities for alignment between certain reinsurance and associated underlying insurance contract measurement

Investment components / net cash flows

What are they?

Examples:

- Reinstatement premium (mandatory)
- Ceding/profit commissions
- Retrospectively rated contracts

- An investment component represents the amounts that an insurance contract requires the Company to repay to the policyholder even if an insured event does not occur.
- If an investment components is **not distinct** then it is accounted for under IFRS 17, but the income statement – both revenue and incurred expense – is net of the impact. This net treatment is the same for cash flows that based on premiums and losses and are settled net (such as mandatory reinstatement premiums).
- If an investment component is **distinct**, then should be separated from the host insurance contract and accounted for under IFRS 9; typically observed with certain life contracts. The investment component is distinct if:
 - The investment component is distinct if:
 - it and the insurance component are not highly interrelated, and
 - a contract with equivalent terms is sold or could be sold separately in the same market.
 - Highly interrelated means:
 - the Company cannot measure one component without the other, or that a lapse/maturity of one component causes lapse/maturity of the other

Investment components / net cash flows

Example: reinstatement premium

- Original Premium = \$250 thousand
- Policy limit = \$1 million with 1 reinstatement
- Reinstatements are mandatory, terms:
 - Obligatory
 - Proportional in amount, 100% as to time
- Losses
 - Scenario 1 = \$500k
 - Scenario 2 = \$1.5 million

Investment components / net cash flows

Example: reinstatement premium

All mandatory reinstatement premiums are netted against incurred claims, and thus are not considered part of the insurance contract revenue. IFRS 17 views these premiums as an offset to losses incurred on the contract.

Statement of Comprehensive Income	scenario 1		scenario 2	
	IFRS 17 net approach	Existing Practice	IFRS 17 net approach	Existing Practice
Insurance Contract Revenue				
Original	250,000	250,000	250,000	250,000
<u>Reinstatement Premium</u>	-	125,000	-	250,000
Total	250,000	375,000	250,000	500,000
Claims Incurred				
Original	(500,000)	(500,000)	(1,500,000)	(1,500,000)
<u>Adjustment for Reinstatement Premium</u>	125,000	-	250,000	-
Total	(375,000)	(500,000)	(1,250,000)	(1,500,000)
Underwriting Margin	(125,000)	(125,000)	(1,000,000)	(1,000,000)

Recorded incurred claims are reduced from the actual incurred claim amount by the amount of the mandatory reinstatement premium

Ceded Reinsurance

Programs with special considerations

Challenge:

- Certain business has been written with a commercial intention of having the reinsurance support profitability/viability of the program for the insured on a net basis
- If the measurement / assessment of profitability is examined separately gross & ceded, then mismatches of cash flows (mismatch in profit/loss recognition) will result
- Currently the industry is examining programs to evaluate whether they can netted against the underlying insurance contract liability

Examples include:

- US Crop insurance program
- US National Flood Insurance Program
- Japan CALI system

7 – Next Steps for IASB

So where are we now?

IFRS 17 was issued in 2017, but will now be amended & deferred

Since IFRS 17 was issued in May 2017, many in the industry have been raising issues with IFRS 17 that they believe the IASB needs to address to ensure that there is a high quality accounting standard for insurance contracts.

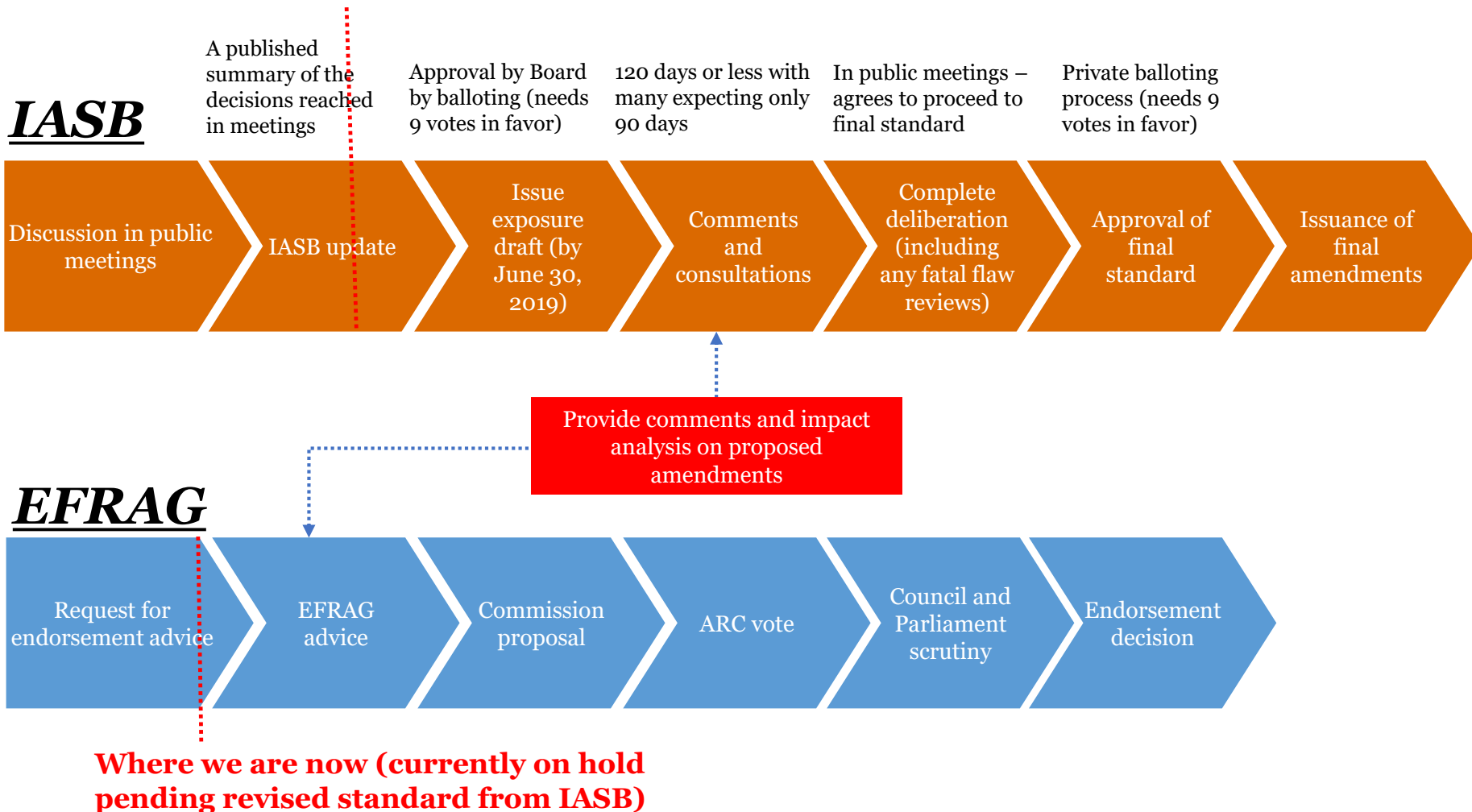
The drive to amend IFRS 17 gained momentum in late 2018 after EFRAG issued a letter to the IASB with their concerns about IFRS 17.

Since that time, the IASB has been gathering and considering all of the concerns raised across the globe to include in their re-deliberation process about IFRS 17. The re-deliberations of the 25 issues were completed in March and a revised exposure draft with the changes resulting from these re-deliberations is expected by the end of June 2019.

IFRS 17 – guidance amendments

IASB drafting process & EFRAG endorsement process

Where we are now



IFRS 17 – guidance amendments

Key amendments impacting P&C contracts

Issue	Status
Effective Date – Date of initial application of IFRS 17	Partially addressed – while the CFO Forum has not asked for a specific time period for deferral (only the need for a high quality standard), other organizations and associations globally have asked for at least a 2 year deferral.
IFRS 9 – Temporary exemption from applying IFRS 9	Addressed – the IASB approved the deferral of IFRS 9 to match the new proposed IFRS 17 effective date.
Level of aggregation – annual cohort requirement for insurance contracts	Closed without any changes – the IASB rejected all proposed changes to the level of aggregation requirements.
Acquisition cash flows – deferral for renewals outside of the contract boundary	Addressed – the IASB approved the extension of acquisition cash flows beyond the current contract boundary – this will be a requirement not a policy choice.
Presentation – Separate presentation of groups of assets and groups of liabilities	Partially addressed – the IASB approved a change to the presentation to be done at a portfolio level instead of a more granular level which should help reduce the amount of asset/liability splits but may not address the issue for all.
Presentation – Separate presentation of groups of assets and groups of liabilities	Partially addressed – the IASB approved a change to the presentation to be done at a portfolio level instead of a more granular level which should help reduce the amount of asset/liability splits.
Premium Allocation Approach – premiums received	Closed without any changes – considered by the IASB, but they decided to not make any changes at this time.
Reinsurance Contracts Held – initial recognition where underlying insurance contracts are onerous	Addressed – the IASB approved a change to the recognition of proportionate reinsurance contracts held when the underlying contracts are onerous.

Questions?

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