

# **IFRS 17: Procrastinate at Your Peril!!**

Kyle Rudden (Moderator)  
Simone Brathwaite, Trevor Howes,  
Bertha Pilgrim, Cynthia Potts



# Acronyms

CAA	Caribbean Actuarial Association
CIA	Canadian Institute of Actuaries
CSM	Contractual Service Margin
FCF	Fulfillment Cash Flows
GMA	General Measurement Approach
IAA	International Actuarial Association
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards (promulgated by IASB)
LIC	Liability for Incurred Claims (approx. comparable to claim liabilities)
LRC	Liability for Remaining Coverage (approx. comparable to premium liabilities)
OCI	Other Comprehensive Income
PAA	Premium Allocation Approach (method for LRC)
TVOM	Time Value of Money

# Agenda

## 1. Introduction (Cynthia Potts)

- What and when
- Development of standards & guidance
- General concepts

## 2. Life Specific Issues (Simone Brathwaite)

- Risk adjustment
- CSM / aggregation
- Discount rate
- Policy loans

## 3. P&C Specific Issues (Bertha Pilgrim)

- Eligibility for premium allocation approach
- Discount rate
- Risk adjustment

## 4. Systems and Implementation Issues (Trevor Howes)

- Implementation & planning
- Revenue versus premium
- Transition approaches
- Technology implications

# 1 Introduction

Cynthia Potts, Eckler Ltd.



# What is IFRS 17?

- An international financial reporting standard issued by IASB on May 18, 2017
  - More than 20 years of extensive consultations
- It establishes “principles for the recognition, measurement, presentation and disclosure of insurance contracts issued.”
- It provides one accounting model for all insurance contracts in all IFRS jurisdictions
  - Life, P&C, direct insurance and reinsurance
  - National accounting bodies must endorse to become effective

# Reasons for change

*Overall goal:*

*To harmonize accounting standards worldwide*



- Enhance international comparability of insurance contract financial statements
- Simplify financial reporting for multinationals
- Greater focus on **transparency and accountability**

# Timeline (with deferral)

**May 18, 2017**

- Final standard issued by IASB

**Dec 31, 2020**

- Accounting date at which B/S adjustments to be quantified

**Each Quarter of 2021**

- Comparatives at each quarter-end to be developed

**January 2022**

- IFRS 17 comes into effect (under review by IASB)

**Q1 2022**

- First external reporting date

# Why all the Fuss?

- Significant **changes** implied for:
  - Derivation of insurance contract liabilities & revenue
  - Detailed disclosures along with financials
  - Process and collaboration between actuaries & finance
  - Software and systems to handle CSM calculations considering volumes & granularity of data
- Significant **uncertainty** in many areas
  - Options and interpretation issues
  - TRG discussions ongoing
  - Recently announced (tentative) deferral
  - Possibility that the standard will be re-opened



# Standards & Guidance – Overview



## Accounting Standards

IASB

### IFRS 17 Insurance Contracts

- ▶ The accounting standard from the IASB is the key source document describing how an IFRS 17 valuation is to be performed.

### Endorsement by Accounting Bodies

- ▶ Country by country?

## Actuarial Standards



### IAA Exposure Draft

- ▶ The non-binding model international standard of actuarial practice on IFRS 17 Insurance Contracts



### CAA Actuarial Standards of Practice

## Actuarial Guidance



### IAA Preliminary Draft of IAN

- ▶ Provides more detailed technical guidance on different aspects of IFRS 17 valuations
- ▶ Not authoritative, and language not directive



### CAA Guidance ? Reference to CIA Guidance?

# Level of aggregation for financial statements

Level of aggregation	Description
<b>Entity</b>	<ul style="list-style-type: none"> <li>▪ Level at which financial statements are consolidated</li> <li>▪ Similar to “insurer”               <ul style="list-style-type: none"> <li>▪ Except that insurance contracts may be issued by entities that are not insurers</li> </ul> </li> </ul>
<b>Portfolio</b>	<ul style="list-style-type: none"> <li>▪ Entity’s business is divided into portfolios of insurance contracts               <ul style="list-style-type: none"> <li>▪ Subject to similar risks</li> <li>▪ Managed together</li> </ul> </li> </ul>
<b>Group</b>	<ul style="list-style-type: none"> <li>▪ At a minimum, must separate new contracts into 3 groups within a portfolio:               <ul style="list-style-type: none"> <li>(i) onerous at initial recognition</li> <li>(ii) unlikely ever to become onerous</li> <li>(iii) all others</li> </ul> </li> <li>▪ Contracts assigned to groups at initial recognition</li> <li>▪ Within each category above, a group would be created for each annual cohort</li> </ul>

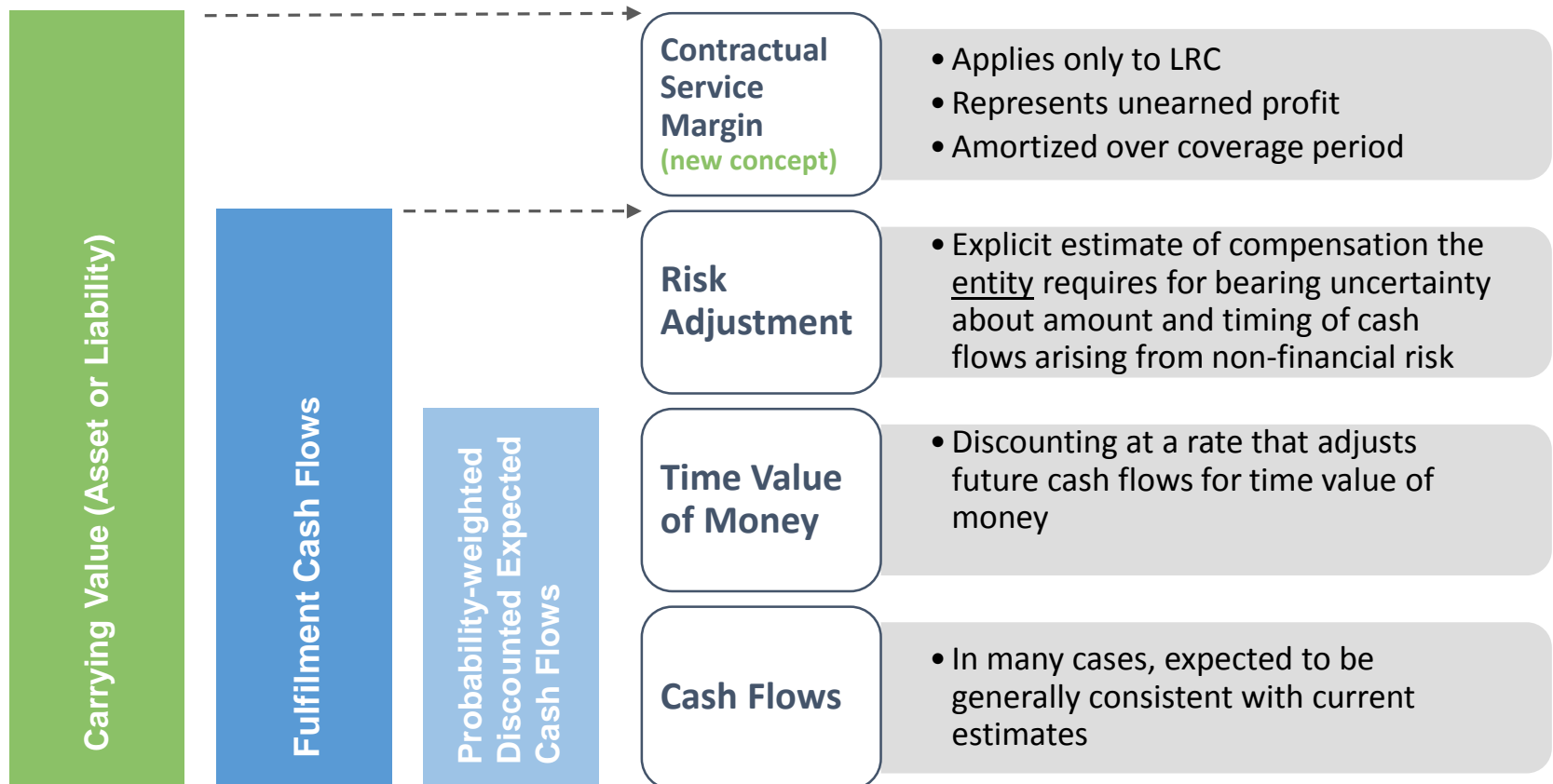
# Level of aggregation (continued)

Level of aggregation	Applications
Entity	<ul style="list-style-type: none"> <li>▪ Balance sheet, income statement</li> <li>▪ Risk adjustment determination</li> </ul>
Portfolio	<ul style="list-style-type: none"> <li>▪ Disclosures (e.g. confidence level, yield curve)</li> <li>▪ Measurement approach (GMA vs PAA)</li> <li>▪ Other comprehensive income (OCI) Option</li> </ul>
Group	<ul style="list-style-type: none"> <li>▪ Insurance contract liabilities               <ul style="list-style-type: none"> <li>▪ Allocation of actuary's estimates to individual groups is permitted</li> </ul> </li> </ul>

***The level of aggregation for financial statements need not dictate the level of aggregation for the actuary's analysis.***

***Furthermore, the grouping of contracts into annual cohorts (consist with policy years) does not prevent the actuary from analyzing the contract liabilities on an accident period basis.***

# General measurement approach (GMA)



# Questions ??



# 2

## Life Specific Issues

Simone Brathwaite, Oliver Wyman



# *IFRS 17 Pain points!*

## *Some of them..*

### Pain Points

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**1** Risk Adjustment

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**2** CSM/Aggregation

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**3** Discount rate

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**4** Policy loans

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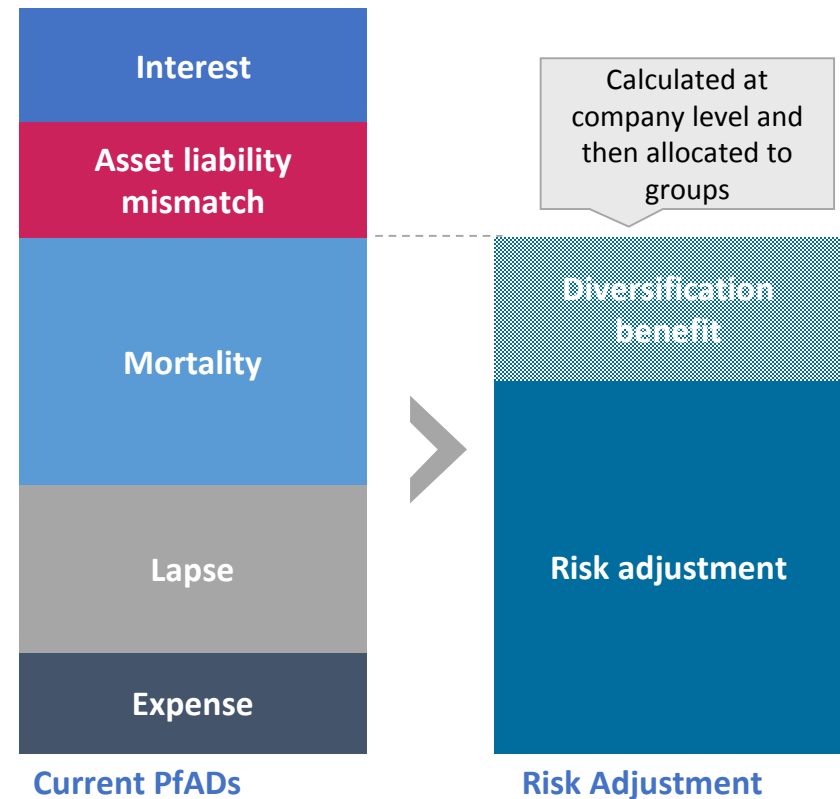
# Risk Adjustment

The compensation required for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk

## Main aspects of Risk Adjustment development

Aspect	Commentary
<b>Approach selection</b>	<p>No approach specified. Approaches being considered:</p> <ul style="list-style-type: none"> <li>• Use of margins (similar to current CIA guidance)</li> <li>• Cost of capital</li> <li>• Quantile/VaR</li> </ul>
<b>Diversification</b>	<p>Entity permitted to embed diversification benefits considered when determining RA since it is the compensation required for bearing that risk</p>
<b>Confidence level calculation</b>	<p>Since PVFCF is 'expected value', entity must specify confidence level of losses corresponding to Risk Adjustment</p>

## Illustrative approach using current margins





*The **contractual service margin** is a component of the asset or liability for the **group** of insurance contracts that represents the **unearned profit** the entity will recognise as it provides services in the future.*

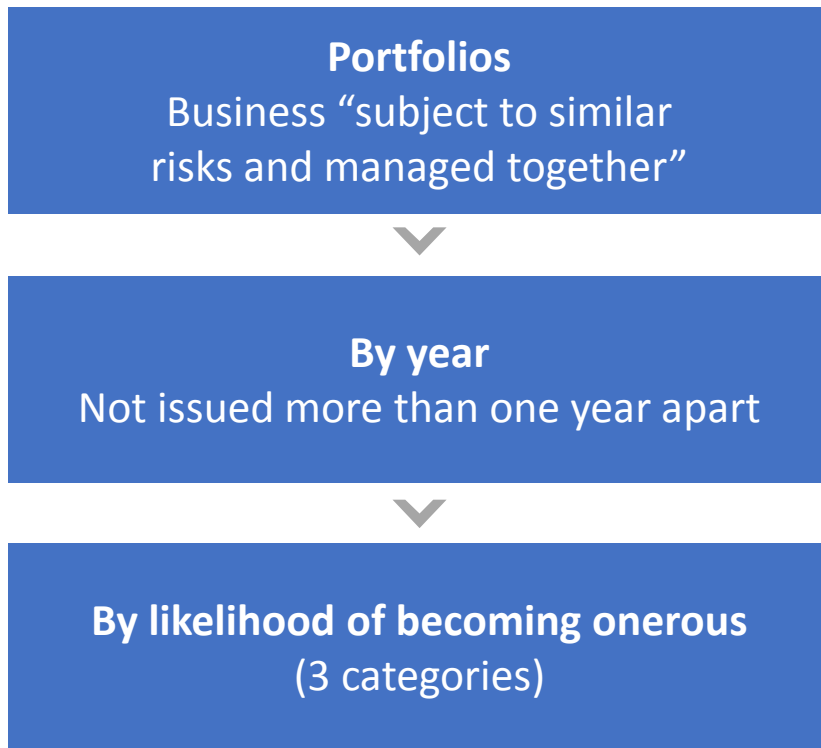
IFRS17.38

Note CSM is relevant for the group of contracts. Must define the group first in order to establish CSM

CSM is not the total profit that insurer will realize. Other drivers of total profit are

- Investment income
- Non-directly attributable expenses
- Release of risk adjustment (although IFRS 17 regards this as compensation and not as profit per se)

# IFRS 17 requires “Groups” to be created by dividing business into:



**Illustrative portfolio I**

In-force	2020	2021	2022	2023
<b>1. Onerous at inception</b>				
<b>2. No significant possibility of becoming onerous</b>				
<b>3. Any other Business</b>				

## Note

- Groups are determined at initial recognition and are not subsequently reassessed
- A group could consist of one contract

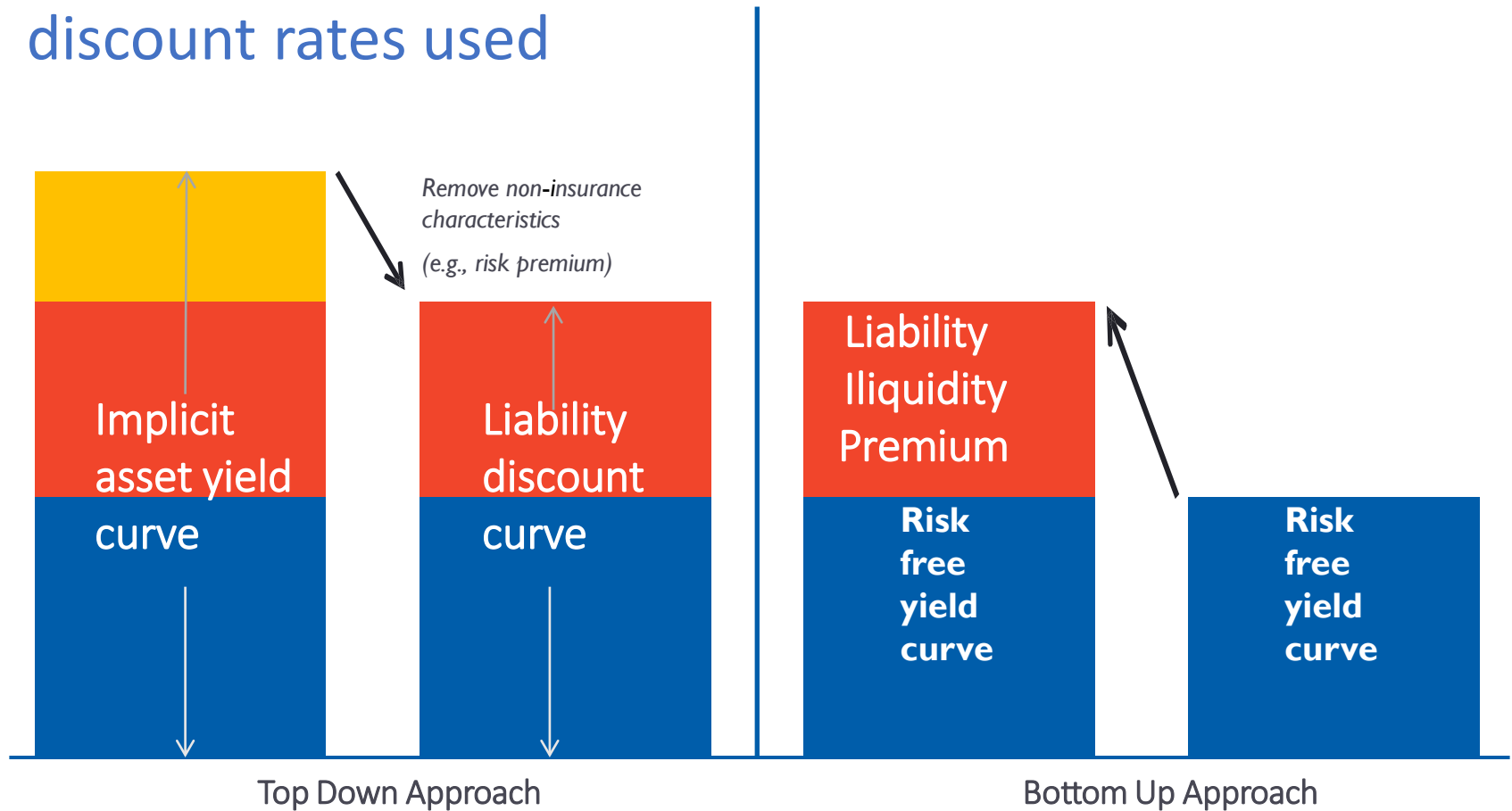
# Aggregation implications on CSM release

There are implications of choosing groups at different granularity levels

Lesson	Implication
<p><b>1</b> Level of aggregation impacts the balance sheet and income statement at initial recognition, due to asymmetrical treatment of profit and loss</p>	<p>Larger groups are better when trying to maximize offsets</p>
<p><b>2</b> Even if grouping choices have the same initial recognition impact, they may affect future results post a change in experience / assumptions</p>	
<p><b>3</b> Grouping influences CSM release patterns; the "<i>distribution of coverage units</i>" could be a grouping consideration</p>	<p>Smaller groups are better when aiming for a faster CSM release</p>
<p><b>4</b> Claims and 'reserve release' are treated at the Group level</p>	<p>Groups that are too small will not only lose reserve offsets but also lose the ability to absorb claims</p>

# Discount rate

IFRS 17 allows two approaches to develop the discount rates used



\*The industry has termed the element of the discount rates reflecting the liquidity characteristics of the liability: the illiquidity premium

\*\* While illustrated as being equivalent, there is no requirement that the two approaches yield matching results

Ref B81- B85

# Discount rate

## Most prevalent approaches compared

### Entity's own asset (with adjustments)

#### *Top-Down*



- Enables partial linkage between the liability discount rate and supporting asset returns This reduces earnings volatility as assets/liabilities will move together for changes in risk-free rates and liquidity premium



- Operationally difficult to produce.
- Trading activities in the asset portfolio can affect the liability value (disadvantage of CALM today)

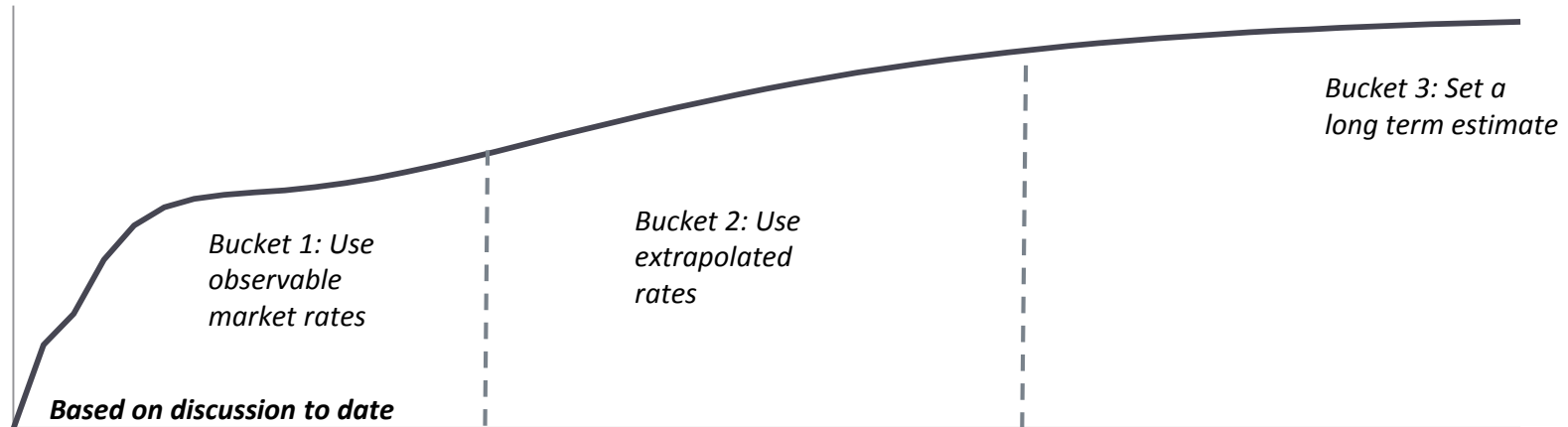
### Bottom-up leveraging corporate benchmarks based on target investment strategy

#### *Bottom-up*

- Operational simplicity
- Separation between liability reference portfolio and actual asset portfolios, easier to make adjustments to align liquidity characteristics if needed
- Suitability of benchmarks may be questioned
- Theoretically variation of returns on different asset credit classes not attributable to liquidity
- Lack of control over data and methodology used to derive the benchmark rates
- Less flexibility to change the external benchmark choice after it has been set
- May lead to a disconnect between the liability discount rate and return on supporting assets which may cause earnings and surplus volatility

# Discount rate

There are several core decisions to make when developing the discount rates



## Observable

Observable  
horizon length

## Extrapolated

Approach

Convergence  
timepoint

## Ultimate rate

Risk Free: Spot or Forward

Risk Free: Level

Update frequency

Ultimate illiquidity premium

# IFRS 17: Policy loans are not a distinct component which can be separated

## Current and future policy loans to be reflected as liability cashflows

- Under IFRS 17, liability cash flows may refer to any component of the insurance contract that is covered by IFRS 17 excluding separated components.
- Under IFRS 17 cash flows do include components that might sometimes be currently seen as separate but aren't under IFRS 17 e.g. policy riders or policy loans
  - IFRS 17.BC114 indicates that policy loans are non-distinct investment components
  - IFRS 17: Paragraphs 11-12: An entity is prohibited from applying IFRS 15 or 9 to components of an insurance contract when separation is not required
  - IFRS 17 : BC 31-35: Separation is only allowed if the component is “distinct”
- Under IFRS 17 separation of policy loans is prohibited because the component is not distinct
  - The policyholder is unable to benefit from the policy loan unless the underlying policy is in force (a lapse in the underlying policy causes the policy loan to lapse)
- If future policy loans are within the contract boundary, expected future loans and repayments should be included in the cash flows as well as interest accrued on outstanding loans<sup>1</sup> (IAN)

# Policy loan is not considered an asset, rather a component (reduction) of the investment component of the insurance contract liability

	IFRS 4 – CALM	IFRS 17
<b>Treatment in valuation of insurance contract liabilities</b>	<ul style="list-style-type: none"> <li>As an asset class with its distinct return assumption based on contractual terms, used as part of asset portfolio supporting insurance contract liabilities in CALM</li> <li>Typically recognize existing policy loans and repayment pattern; typically don't forecast future new policy loans</li> </ul>	<ul style="list-style-type: none"> <li>As an advance on, or reduction of, the non-distinct investment component of the insurance contract liability, reflecting contractual terms</li> <li>Probability-weighted cash flows to include expected future policy loan activity such as new loans and repayments of loans (including at initial recognition) – <i>unless deemed immaterial</i></li> </ul>
<b>Change in estimate</b>	<ul style="list-style-type: none"> <li>Changing the assumed future repayment pattern or policy loan interest rates (if contractually permitted) affects CALM liability and current period earnings</li> </ul>	<ul style="list-style-type: none"> <li>Changing the assumed future repayment pattern or policy loan interest rates affects probability-weighted cash flows related to future service and is treated accordingly in CSM (i.e. absorbed by CSM to extent possible)</li> </ul>
<b>Statement of Financial Position</b>	<ul style="list-style-type: none"> <li>Asset side</li> </ul>	<ul style="list-style-type: none"> <li>Liability side, reducing Insurance Contract Liabilities</li> </ul>
<b>Statement of P&amp;L</b>	<ul style="list-style-type: none"> <li>Policy loan interest included in Investment Income</li> <li>Contributes to 'change in insurance contract liability'</li> </ul>	<ul style="list-style-type: none"> <li>Excluded from insurance revenue, insurance service expenses, and investment income</li> <li>Included as a reduction to finance expense of the Investment Component of Insurance Contract Liability</li> </ul>

If using the same best estimate assumptions in IFRS 17 as in CALM, the net best estimate liability should also be the same in IFRS 17 as in IFRS 4



# Questions ??

# 3

## P&C Specific Issues

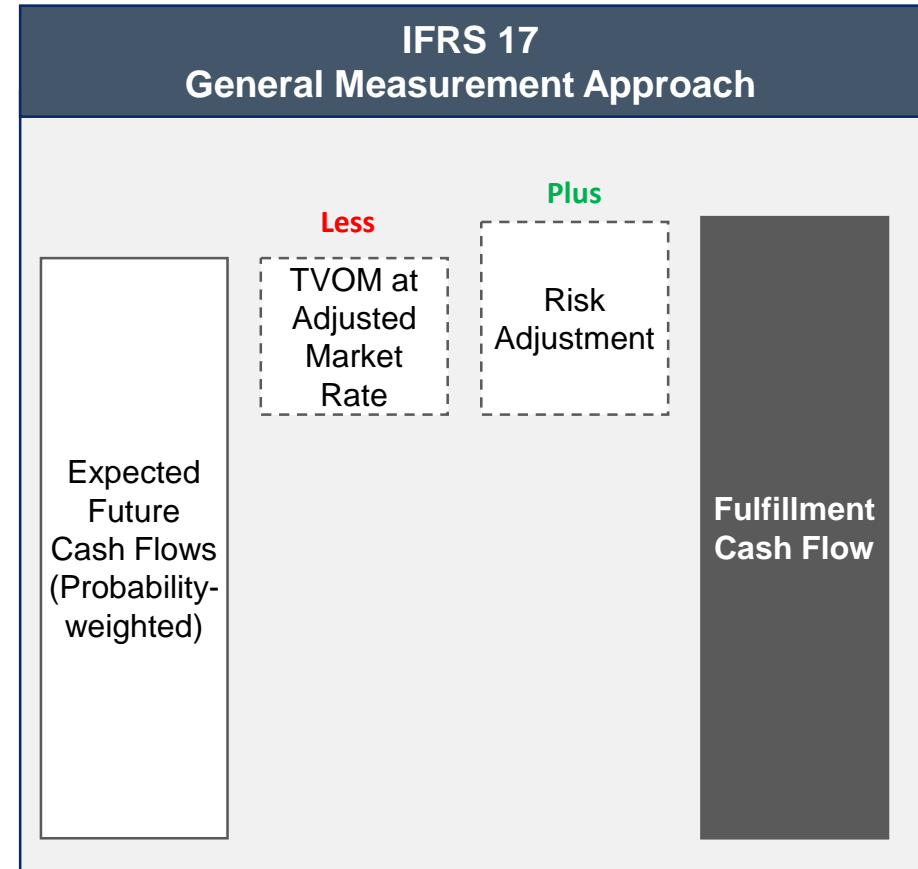
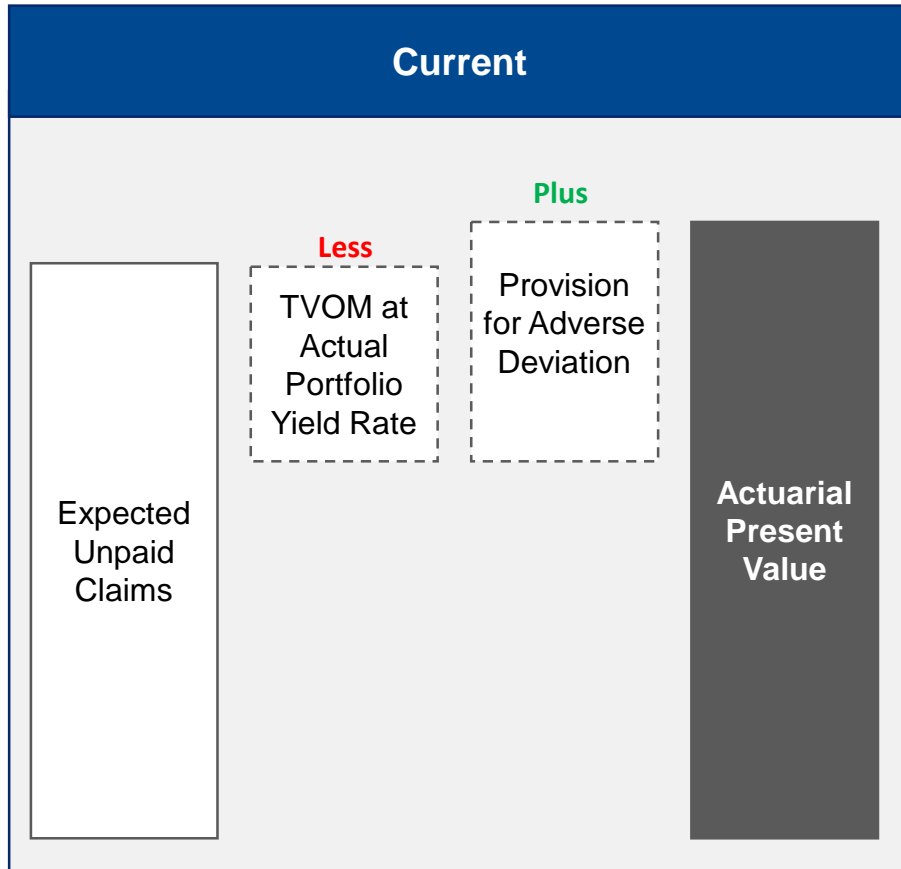
Bertha Pilgrim, Eckler Ltd.



# IASB Expectations

“ The Board expects that most of these [Property and casualty] companies will apply the simplified approach for the majority of their contracts. The Board expects that the greatest effect of implementing IFRS 17 for these companies will come from the need to consider the requirement to discount and apply an explicit risk adjustment for incurred claims.”

# Liability for incurred claims (LIC)



# Discount rate (curve) for P&C

## Most prevalent approaches compared

### Reference Portfolio (with adjustments)

*Top-Down*



- Does not require explicit illiquidity premium

### Risk Free Rate + Illiquidity Premium

*Bottom-up*

- Risk free curves are generally readily available
- Can be updated frequently



- Complexity of the derivation of a reference portfolio rate
- Complexity of credit risk adjustments
- Different reference portfolios may be required for different levels of insurance contract illiquidity
- Challenging to include non-fixed income investments (additional adjustments required, and difficult to match timing)

- Guidance not clear on how to assess the relative liquidity of P&C liabilities (LIC and LRC)
- Difficult to derive explicit illiquidity premiums

# Liability for remaining coverage (LRC)

## Current Premium liabilities at valuation date

Unearned premium

**Less**

Deferred policy  
acquisition expense

**Plus**

Premium deficiency  
reserve  
(if required)

**Closing Balance of  
Premium Liabilities**

## IFRS 17 GMA at initial recognition

Estimated future  
cash flows

**Plus**

Time value of money

**Plus**

Risk adjustment  
for non-financial risk

**Plus**

Contractual service margin

**Closing Balance of LRC  
per GMA**

## IFRS 17 Simplification (PAA) at initial recognition

Premium received

**Less**

acquisition expenses paid  
(unless expensed)

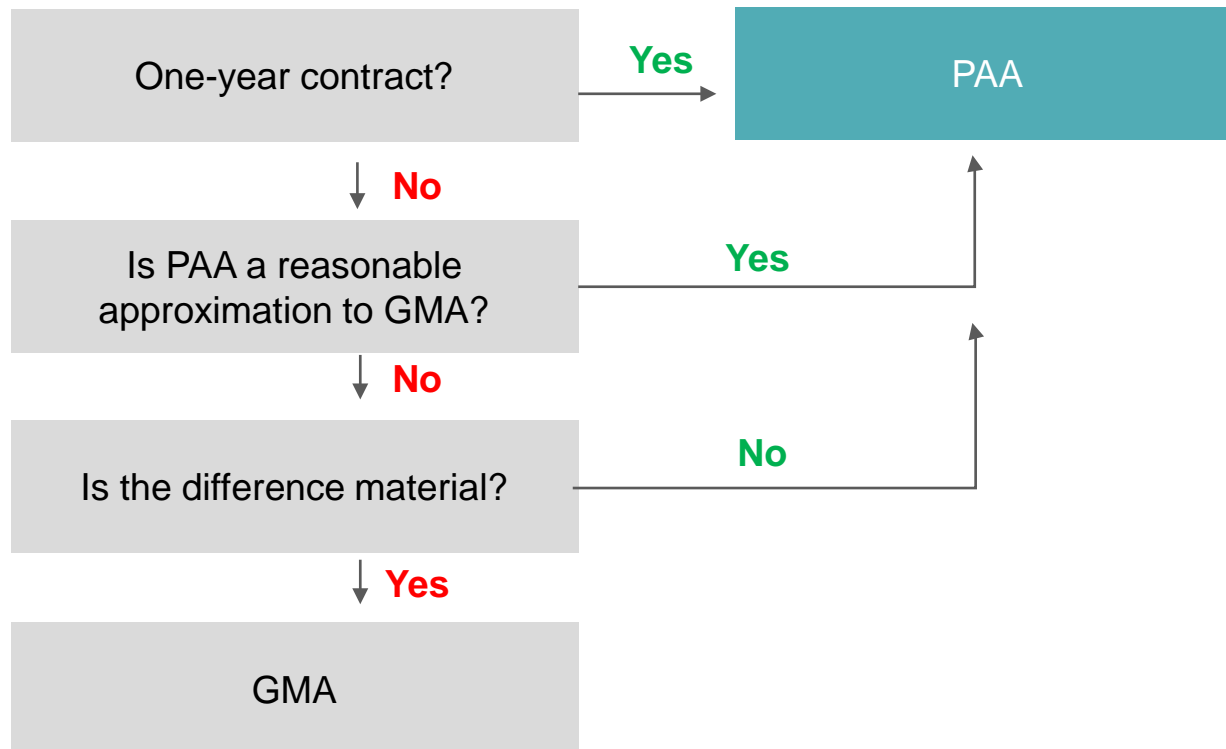
**Plus**

loss component  
(if contracts onerous)

**Closing Balance of LRC  
per PAA**

# Eligibility for premium allocation approach

## When can the PAA be used?



# Risk Adjustment for P&C

- P&C less likely than life counterparts to base RA on current margin approach
  - CIA focus on cost of capital and confidence level
  - Develop guidance for smaller entities (and “special” cases such as start-up and runoff)
- Challenges
  - Reflecting entity’s view at an aggregate level
  - Diversification generally not reflected in current margin approach
  - Potential gross/ceded mismatch



# Questions ??



## 4

# Systems & Implementation

Trevor Howes, Moody's Analytics



# Implementation of IFRS 17

- Understanding and education
- Choosing from options; setting policies
  - Which measurement approach? (GMA/VFA/PAA)
  - Determining approach to new IFRS 17 groups
    - Profitability measurement
    - Use of OCI for changes in current discount rate
  - Risk Adjustment methodology and confidence level
  - Choosing Coverage Units for CSM amortization
- Selecting, justifying, executing transition methodology

# Planning Systems and Processes

- New calculation of CSM by group (for GMA)
  - How many groups? How defined?
  - Managing historical data by group
  - How new contracts assigned to groups?
  - Roll forward from prior period balances
  - Combining actuarial calculations and accounting data
  - Disclosures, review and audit, management info

# Revenue vs. Premiums

- Premiums paid/invoiced/written are no longer the primary revenue base
- Actuarial estimates of current service costs with excess held in CSM if non-onerous
- Actuaries may need actuarial models to generate estimated service costs by group for the period
  - Life vs. P&C challenges (unless PAA applies)
  - How to reflect business changes over current period

# Transition approaches

## Full Retrospective Approach

Required unless impracticable

*If full retrospective approach is impracticable, choose between....*

### Modified Retrospective Approach

- Approximation to full retrospective
- Limited number of specific simplifications allowed
- Must be based on reasonable and supportable information
- **If such information is not available, must use fair value approach**

### Fair Value Approach

- Total carrying value at transition date set equal to fair value of in-force contracts
- CSM at transition determined as balancing items

# Technology Implications

- New solution component needed to manage data, perform CSM calculations by group, feed GL, support analysis/disclosure
  - Should be designed/shared/managed by both actuaries and accountants
- SaaS implementation approach will have advantages
  - Quick scalability at low cost
  - Easy updates of software and environment by vendor

# Questions ??