TheActuary

The magazine of the Institute & Faculty of Actuaries

General insurance: The wide-ranging implications of IFRS 17

The new accounting standard for insurance contracts, IFRS 17, will have wide-ranging implications for (re)insurers, and many firms are preparing for significant changes to their business operations

08 JUNE 2017 | LAURA BARELLA AND ALICE BOREMAN

After 20 years in the making, the International Accounting Standards Board (IASB) has published the new accounting standard for insurance contracts, IFRS 17. It will be effective from 1 January 2021, with prior-year comparative reporting required. Here we provide a taster of the key changes to the recognition and valuation of insurance contracts that will affect general insurers.

Currently, comparisons across different industries, products, companies and jurisdictions are difficult. The IASB wants to achieve consistent accounting for all insurance contracts by all companies around the globe (although the US has opted out and US GAAP will persist) and enable comparability with non-insurance products.

Not only will this affect general insurers' operations, but it will also introduce changes to the presentation of results in the financial statements as well as potentially having an impact on the financial results themselves.

General measurement model

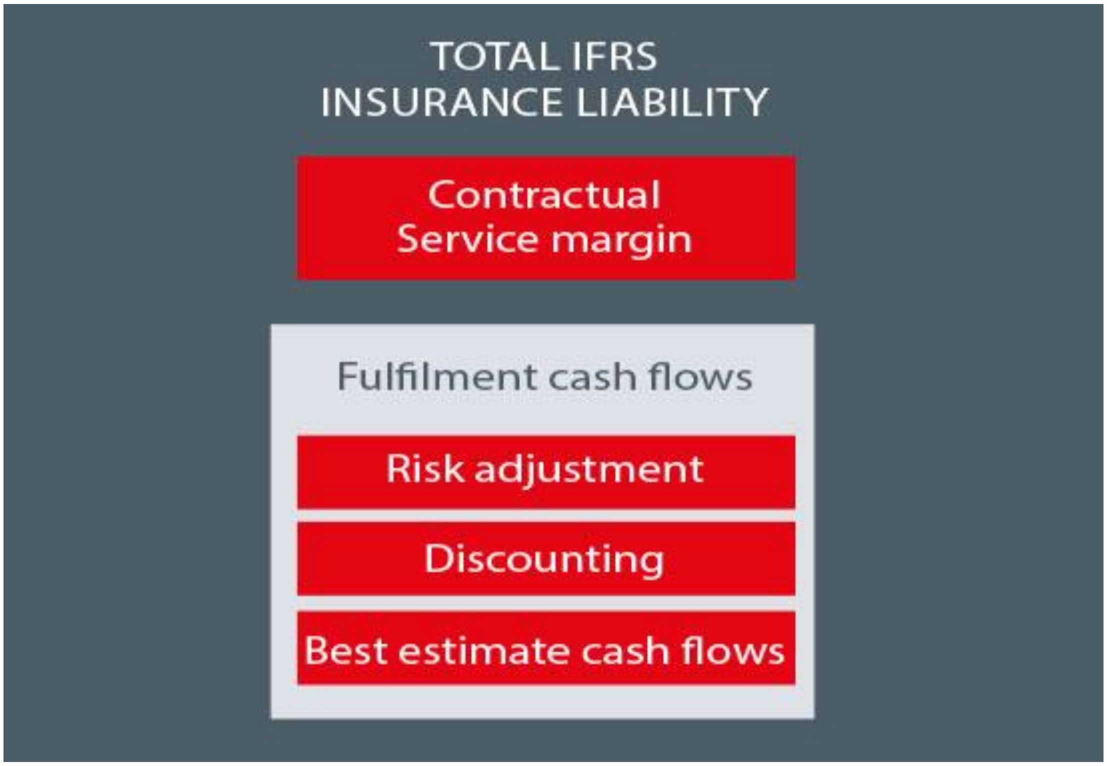
The general measurement model for liabilities under IFRS 17 is known as the building block approach (BBA) and all (re)insurance contracts will be measured as the sum of:

- 'Fulfilment' cashflows (updated at each reporting date), which are defined as:

  – The present value of probability-weighted expected cashflows (best estimate cashflows); plus
  – An explicit risk adjustment for insurance risk

- Contractual service margin (CSM), which is the expected profit from the unearned portion of the contract

Under the BBA, the CSM is amortised and profits are recognised over time as insurance services are provided over the coverage period of the contract (over the term of the policy). However, losses from onerous (or, more simply, 'loss making') contracts are recognised immediately. After the end of the coverage period, any future profit or loss from the run-off of the liabilities (which, in general insurance, usually extends past the end of the coverage period) will flow straight through into the income statement.



Possible simplification

One of the most important questions for general insurers will be whether to use a simplification option known as the premium allocation approach (PAA). This is an alternative to the BBA. This simplification is only permitted in certain circumstances and is only applicable to unexpired risks, but the incurred claims liabilities must still follow the BBA model. Under the PAA approach, the CSM is not required. Rather, at inception, the liability for unexpired risks, or the “liability for remaining coverage” as it will be known under IFRS 17, is calculated as the premiums received less associated acquisition costs. Over time, the liability for remaining coverage is updated to reflect additional premiums received (if any) and the profit that has been recognised in the income statement for the coverage that was provided in that period; that is, the premium earned over the period. Again, similarly to the BBA, any losses from onerous contracts must be recognised immediately at inception and, after the end of the coverage period, any future profit or loss from the run-off of the liabilities will flow straight through into the income statement.

This approach will be permitted for contracts where the period of cover is one year or less, or where the measurement of the liability for remaining coverage would not differ materially from that estimated using the BBA. The standard states that the latter requirement is not met if, at inception, there is expected to be significant variability in the fulfilment cashflows affecting the measurement of the liability for remaining coverage during the period before a claim is incurred. Further, it states that variability in the fulfilment cashflows increases with the length of the coverage period of the contract. In other words, this means that multi-year policies covering risks such as construction, energy, engineering, accident and health, directors and officers, credit and surety, mortgage indemnity and warranty business may not meet the PAA eligibility criteria. Where a firm wishes to use the PAA approach, this will need to be justified, and agreed with its auditor as an appropriate approximation.

Similarities with Solvency II

These core valuation principles for measuring liabilities for insurance contracts may sound familiar from Solvency II; however, there are a number of key differences, as detailed in the table below:

As can be seen from this comparison, the standard leaves a number of areas open to interpretation or offers options for individual companies to make suitable choices. The Solvency II balance sheet is, by and large, prescribed, so there are a number of additional judgments that need to be made by companies in translating between the bases. In order for general insurers to get to grips with the new standard, there are a number of key areas to think about, and firms will need to decide what these changes mean for them. For example:

- Eligibility to use the PAA simplification option (discussed above)
- Level of granularity for measurement and recognition of onerous contracts
- Accounting policy for determining and reporting risk adjustment
- Discount rate selection
- Additional complexities around accounting for outwards reinsurance
- Reporting and disclosures

TOPIC	IFRS 17	SOLVENCY II
Recognition	Earliest of start of coverage and premium receipt (plus onerous contract test)	Date party to contract
Measurement model	Building Block Approach (BBA), or Premium Allocation Approach (PAA) for eligible contracts	No choice, cashflow approach more closely aligned to BBA under IFRS 17
Discount rate	Company-specific, principles-based	Prescribed
Risk allowance	Risk adjustment – no prescribed method	Risk margin – cost of capital approach is prescribed
Contractual service margin	Eliminates day-one gain (measure of unearned profit)	No similar concept, day-one gain taken immediately into own funds
Other comprehensive income (optional)	Isolates the impact of discount rate changes from the rest of the P&L	No similar concept

Level of granularity

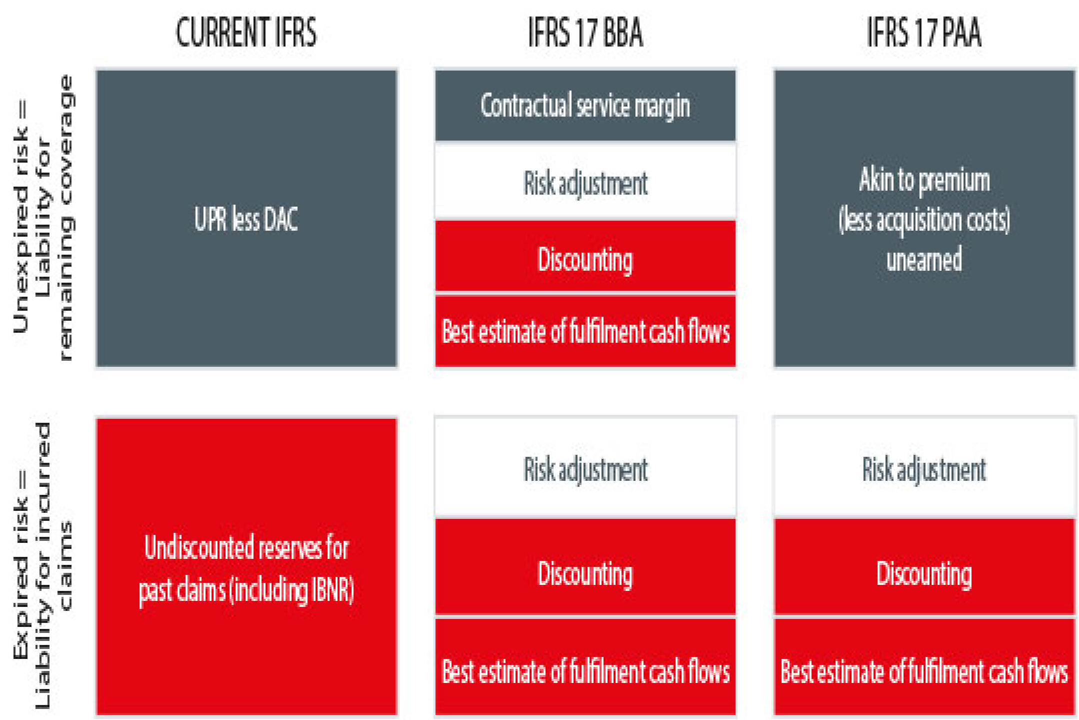
Under the new standard, there are requirements on the level of granularity at which the recognition and measurement principles should be applied. Specifically, the principles should be applied at a ‘portfolio’ level, where portfolio is defined as a group of contracts with similar risks which are managed together.

Dividing into these portfolios sounds eminently sensible. However, because the implication of recognising losses immediately means that loss-making contracts should not be allowed to offset profitable ones, insurers will need to split portfolios further. Portfolios will need to be split into groups (once at inception only) which include contracts written within the same 12-month period and contain: 1) onerous contracts (if any); 2) contracts that have no significant possibility of becoming onerous subsequently (if any) and; 3) the remaining contracts in the portfolio (if any). There is, however, an exemption where regulatory pricing constraints exist – for example, currently, loss-making male drivers would not need to be separated from profit-making female drivers because of the EU Gender Equality Law. Further, when using the PAA, it should be assumed that no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise.

Accounting policy options for risk adjustment

If using the BBA, for most general insurers, the profit from the CSM will be released over a short time period providing little flexibility. The risk adjustment, however, will run off gradually over the full term to settlement of all insurance obligations. Therefore, the risk adjustment will be a key driver of the profit profile over time (sometimes referred to as the profit signature). The risk adjustment on gross cashflows is defined as the compensation that an insurer requires to make it indifferent between the present value of uncertain cashflows and the present value of certain cashflows. For ceded cashflows a risk adjustment must be held to represent the transfer of risk from the insurers to the reinsurer from the underlying insurance contracts.

The insurer needs to decide on the appropriate policy, methodology and assumptions for setting the risk adjustment. Guidance is provided on factors to consider; these are predominantly focused on appropriately reflecting the risk characteristics of the insurance contracts. However, IFRS 17 does not prescribe an approach and so there is significant flexibility. Accounting policy should be considered carefully, given its impact and how the approach will respond appropriately to changes over time – for example, risk changing over the underwriting cycle.



Discount rate selection

The discount rate should reflect the risk characteristics of the cashflows arising from the insurance contracts. It should not reflect risk characteristics of financial instruments held by the insurer unless the insurance contract cashflows have the same risk characteristics.

The discount rate can be determined using either a top-down (starting with an actual or expected reference portfolio rate) or a bottom-up (starting with a risk free rate of return) methodology.

IFRS 17 provides insurers the option to choose to take the volatility due to changes in discount rates straight to profit and loss or through other comprehensive income (OCI). This accounting policy choice is connected to the classification of financial instruments in IFRS 9 (many insurers will have the option to defer the implementation of IFRS 9 from 2018 to the 2021, such that IFRS 9 applies at the same time at which IFRS 17 becomes effective).

The treatment of changes in current discount rates in IFRS 17 for insurance contracts creates a potential opportunity to reduce accounting mismatches.

Additional complexities around accounting for outwards reinsurance

Under IFRS17, you must model outwards contracts in the same way as inwards business. This means calculating:

- Discounted best-estimate cashflows
- Plus allowance for credit risk
- Plus risk adjustment (reflecting the risk ceded)
- Plus contractual service margin (if applicable).

With the PAA eligibility test having to be applied to outwards contracts too, multi-year reinsurance coverage may have to be measured on a BBA basis. Careful consideration will also need to be taken on how retrospective reinsurance covers are accounted for.

All of this may lead to potential asymmetry between gross and ceded profits/losses.

Presentation and disclosures

Financial statements will look different under IFRS 17. Perhaps the biggest change will be to the income statement, which will no longer show written premiums (these will be disclosed in the notes instead) and revenue and expense will be recognised as earned (not received) or incurred (not paid). Disclosures will be more burdensome under IFRS 17 and in particular will involve detailed reconciliations between opening and closing balances as well as disclosure of the confidence level of the insurance liabilities.

IFRS 4*	IFRS 17
Premiums	Insurance revenue
Investment income	Incurred claims and expenses
Incurred claims and expenses	Insurance service result
Change in insurance contract liabilities	Investment income
Profit or loss	Insurance finance expense
	Net financial result
	Profit or loss
	Discount rate changes on insurance liability (optional)
	Total comprehensive income

(*) Common presentation in the statement of comprehensive income in applying IFRS 4.

Note: Grey shading denotes line items on the balance sheet

Closing remarks

The standard will go live on 1 January 2021 and it is therefore important for general insurers to begin considering the changes now. As actuaries, we should get involved in the transition to IFRS 17 within our own companies; questions you may want to consider are:

- Does this affect the company you work for (are you operating domestically or under US GAAP)?
- What will be the impact on your financial results at transition and going forward? Include thinking about accounting policy choices around PAA eligibility, discount rates and the risk adjustment.
- What is the operational impact on data, systems, processes and people?
- Is there a working group already set up in your company? Who is on it?

- Are there projects already under way to transform finance/actuarial processes? Are they thinking about IFRS 17? How does this integrate with IFRS 9 work, which may already be under way?

We think that 2017 should see firms begin a process of engaging with key stakeholders, establishing timelines to perform impact analyses and making plans for implementation. This should set companies up to be able to have a timely implementation with time for a dry run before 2021.

Latest findings

The IFoA set up a Working Party in 2015 to consider IFRS 17 for general insurers, and we are exploring the implications together with practical suggestions for implementation. The Working Party presented at GIRO 2016 and will be presenting at GIRO 2017 to provide an update on our work.

This article reflects the understanding of the IFoA's IFRS 17 for General Insurers Working Party up to the point at which the final IFRS 17 Standard was published.

Laura Barella *is chair of the IFoA IFRS 17 Working Party for General Insurance, and senior actuarial manager at PwC*

Alice Boreman *is a manager in Deloitte's actuarial insurance practice and a member of the IFoA IFRS 17 for General Insurers Working Party*