

Overview and Practical Considerations of the new Insurance Contract Standard: IFRS 17

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The new accounting standard for insurance contracts, expected to be called IFRS 17 (previously known as IFRS 4 Phase 2) is currently expected to be issued in the first half of 2017. In this briefing note we discuss some of the key challenges companies will face in adopting and applying this new standard for insurance contracts.

Introduction

The International Accounting Standards Board (IASB) continues to work on the Insurance Contracts project. The aim of this project is to provide a single principle-based standard to account for all types of insurance contracts that an insurer holds¹. The project also aims to enhance comparability of financial reporting between companies, jurisdictions, and capital markets.

Phase I of this project was completed in 2004 with the introduction of International Financial Reporting Standard (IFRS) 4: Insurance Contracts. However this was intended only as an interim standard.

Phase II is still underway. In July 2010, the IASB issued an exposure draft of IFRS 4 Phase II. In June 2013, a second exposure draft was issued outlining the draft standard and focusing on key areas for consultation. Currently it is expected that the final standard will be published in the first half of 2017 and it is expected to be called IFRS 17.

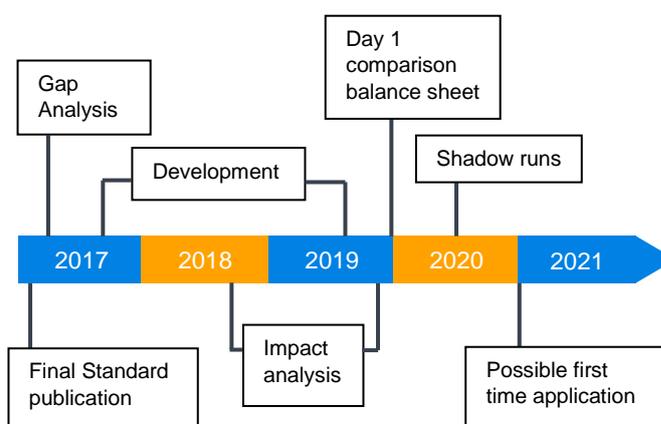
The new standard is expected to raise a number of practical challenges for insurance companies. While it is an accounting standard, implementation will require a multi-disciplinary program requiring involvement from accounting teams, risk management teams as well as a heavy actuarial involvement. In this briefing note we identify and discuss some of the most significant practical challenges companies will need to consider.

¹ An insurance contract is defined as a contract under which one party accepts significant insurance risk from another party by agreeing to compensate them if a specified uncertain future event adversely affects them.

Project Management Timeline

The timeline in Figure 1 illustrates the work which will need to be undertaken by companies between now and the expected implementation date:

FIGURE 1: EXPECTED TIMELINE



Companies will need to carry out a gap analysis and start developing systems and actuarial models almost immediately after publication of the final standard. Before the first time application, companies will need to have carried out an impact analysis and some shadow runs to refine reporting processes. It is expected that the first time application of the standard will be on or after 21st January 2021 but this may mean that an opening balance sheet as at the end of 2020 will be required. Companies will need to start preparing early for a successful implementation.

Valuation of Liabilities

GENERAL MODEL

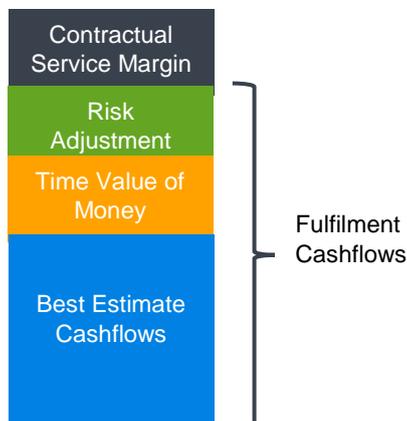
Under IFRS 17 long-term insurance liabilities without direct participation features² will be calculated using the building

² Direct participation contracts are contracts where:

- The contractual terms specify that the policyholder participates in a defined share of a clearly identified pool of underlying items;
- A substantial share of the return from the underlying items is paid to the shareholders;
- A substantial proportion of the expected cashflows paid to the policyholder vary with the cashflows of the underlying items.

block approach of the General Model. This consists of a number of components as shown in the diagram in Figure 2:

FIGURE 2: BUILDING BLOCK APPROACH



These components are summarised in the following paragraphs.

Best Estimate Cashflows

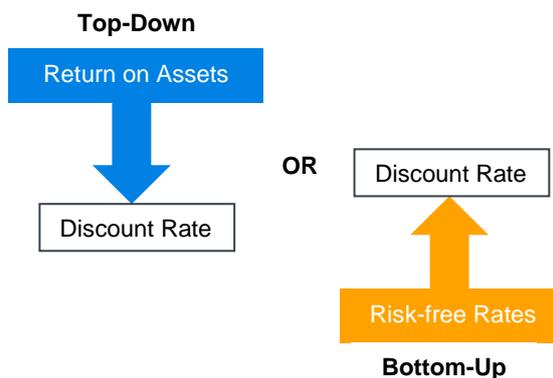
It is expected that most European companies will use a similar approach to the Solvency II Best Estimate Liability (BEL) for calculating the best estimate cashflows.

Assumptions used in the projection of the cashflows will need to be current best estimate. European companies can use the same best estimate assumptions as they are using for Solvency II, but there will be some differences in assumptions due to different definitions. For example, expense assumptions for IFRS 17 should only include expenses directly attributable to the contract, whereas under Solvency II expense assumptions should be based on all expenses incurred in servicing the insurance obligations.

Time Value of Money

Unlike Solvency II, there is no prescribed method for calculating the discount rate in IFRS 17. The discount rate should be set so that it is consistent with observable market prices of financial instruments comparable with the cash flows of the insurance liabilities. Companies will need to determine an appropriate discount rate to use – a “top-down” (starting with return on reference assets) or “bottom-up” (starting with risk-free rates) approach may be used, as illustrated in Figure 3.

FIGURE 3: DISCOUNT RATE



Risk Adjustment

It is also expected that most European companies will use a similar approach to the Solvency II Risk Margin for calculating the Risk Adjustment, although the approach for this is not specified so alternative methods could be used.

Practical Challenges

- A confidence level equivalent for the Risk Adjustment will need to be calculated and disclosed. This will be a challenge given that it is uncommon for companies to determine the distribution of outcomes. Actuarial models and processes may need to be updated to compute this.
- The choice of Risk Adjustment method will influence how future profits will flow to the Profit and Loss Account (P&L), so this should be chosen with care. It may be logical for most European companies to use the Solvency II Risk Margin approach but this will lead to a significant Contractual Service Margin (CSM). Using an alternative method which calculates a higher Risk Adjustment will lead to a lower CSM which will alter the release of future profits to the P&L. The impact of using alternative methods should be considered.

Contractual Service Margin (CSM)

The main challenge in terms of valuation of the liabilities will be with the CSM as this is a completely new concept. The CSM is calculated at inception of the contract and then released over the coverage period of the contract in a systematic way that best reflects the remaining transfer of services provided under the contract. In this way the CSM recognises profits over the lifetime of the contract rather than at inception. The CSM cannot be negative so losses from unprofitable contracts are immediately booked in the P&L.

Practical Challenges

- Actuarial models will need to be updated to calculate the CSM, as unlike the best estimate cashflows and Risk Adjustment, there will be no similar calculation to leverage off.
- The CSM will need to be calculated separately at least for each cohort of business, and the discount rate used to calculate the CSM for each cohort is locked-in at contract commencement (i.e. interest on the CSM and changes in the fulfilment cashflows absorbed in the CSM are calculated using the locked-in discount rates from contract commencement). It may be difficult for companies to keep track of the CSM calculation for each of the different groups of contracts at each valuation as well as keep track of the locked-in discount rates associated with each group. Increased data storage may be required to deal with this.
- Determination of the CSM at the first calculation date will also be challenging. This is explained further in the Transition section below.

2. Experience variances in the best estimate cashflows and Risk Adjustment flow straight to the P&L.
3. Changes in the discount rate can either flow through the P&L together with the locked-in discount rates at inception or can be separated out and shown separately in Other Comprehensive Income (OCI). Companies can choose how to present the discount rate changes so that they can reduce accounting mismatches.
4. The amortisation of the CSM will also flow to the P&L.

The flow of future profits to the Income Statement will depend on the methods used for calculating the Risk Adjustment and CSM, so these should be selected with care. Care should also be taken in determining the assumptions used as these also affect the flow of profits to the P&L.

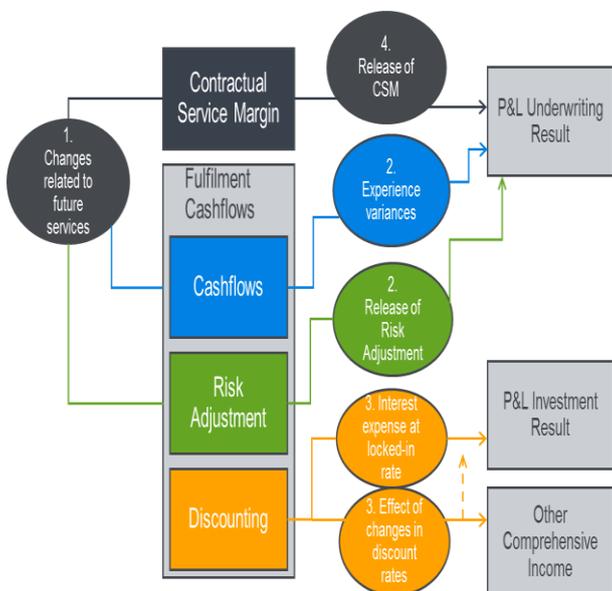
Practical Challenges

- There will need to be a clear separation of changes in the best estimate cashflows and Risk Adjustment related to past and future coverage in order to report these accurately either through absorption in the CSM or through the P&L.
- The accretion of interest on the CSM over the lifetime of the contract and changes in the fulfilment cashflows related to future services absorbed in the CSM will be based on locked-in discount rates. The need to track and maintain locked-in yield curves for each cohort of business in order to calculate this will be difficult to implement.
- The CSM for each group of business is amortized over the remaining coverage period taking into account the expected number of policies in-force. The need to segment the portfolio and keep track of the CSM for different groups of business will be challenging.
- If companies are presenting changes in the discount rate in OCI, the discount rate used at inception will need to be locked-in and reported separately in the P&L. Again the need to track and maintain locked-in yield curves for different cohorts of business will be testing.

Subsequent Valuation (changes in liabilities)

The diagram in Figure 4 illustrates how changes in the value of liabilities flow to the CSM, the P&L and Other Comprehensive Income (OCI) in the Income Statement:

FIGURE 4: CHANGES IN LIABILITIES



1. Changes in estimates of future cashflows related to future coverage, i.e. assumption changes on the best estimate cashflows and Risk Adjustment (other than the discount rate), are absorbed in the CSM.

PREMIUM ALLOCATION APPROACH

The Premium Allocation Approach is an optional alternative measurement to the General Model for contracts which:

- Have no significant expected changes in estimates before the claims are incurred
- Have a coverage period of approximately one year or less

The measurement is a simplified calculation based on the unearned premium reserve approach and is not expected to pose a challenge for companies.

VARIABLE SERVICE FEE APPROACH

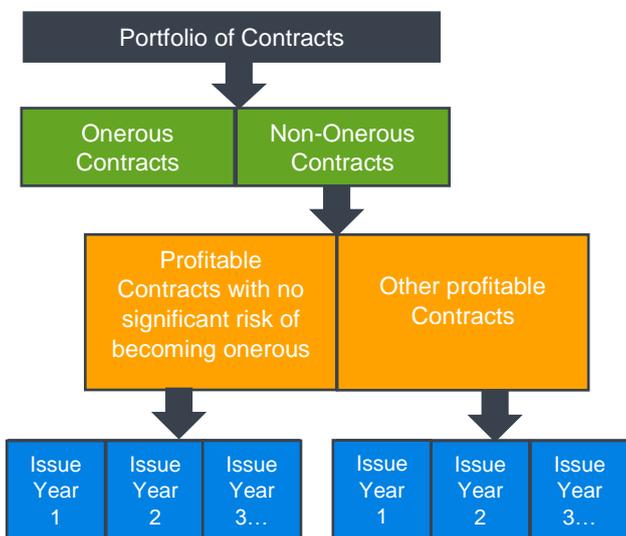
The Variable Service Fee approach applies for contracts with direct participation features (e.g. unit linked contracts). The direct participation feature (also known as Variable Service Fee) is the insurer’s share in investment returns on the contract. There are two differences with this approach compared to the General Model:

- Changes in the estimate of the variable service fee due to market variables are absorbed in the CSM.
- The discount rate used to determine the interest on the CSM can be unlocked so there is no need to track and maintain the locked-in yield curves from inception.

LEVEL OF AGGREGATION

Grouping of contracts is permitted but companies will need to identify contracts which are onerous (loss-making) at inception and group these separately to non-onerous contracts. For onerous contracts a loss is immediately recognised in the P&L. The group of non-onerous contracts will need to be split further into at least two groups – one group with no significant risk of becoming onerous and one group with other profitable contracts. Companies are also only permitted to group contracts written in the same year.

FIGURE 5: LEVEL OF AGGREGATION



Practical Challenges

- The grouping of contracts and the need to track and maintain the different groups of contracts may require significant systems updates.

Presentation of Results

Presentation of results in the Income Statement and Balance Sheet will change significantly. The new Income Statement will be fundamentally different and should look similar to the following illustration in Figure 6 from the IASB March 2015 project update: *Insurance Contracts without Participation Features*:

FIGURE 6: STATEMENT OF COMPREHENSIVE INCOME

Statement of Comprehensive Income		20XX
Insurance contracts revenue		X
Incurred claims and expenses		(X)
Underwriting result		X
Investment income*		X
Interest on insurance liability		(X)
Investment result		X
Profit or loss		X
Gains and losses on financial assets measured at fair value through OCI*		
Effect of discount rate changes on insurance liability (optional)		(X)
Total comprehensive income		XX

* Amounts recognised, measured and presented in accordance with IFRS 9 Financial Instruments

A big challenge in preparing the Income Statement lies in the way changes in the Fulfilment Cashflows and CSM at subsequent valuation dates are recognised in the Income Statement as outlined in the **Subsequent Valuation** section above.

There will also be some significant changes to the presentation of results in the Balance Sheet, for example there will be:

- A change to the insurance contract liabilities
- The removal of Deferred Acquisition Costs (DAC)
- Intangible assets related to future profits will be deferred as part of the CSM
- A change to Retained Earnings

Practical Challenges

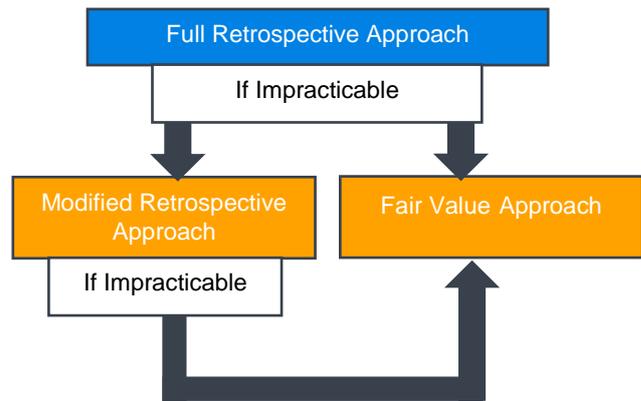
- Updates to accounting systems will be required to produce the new format of Income Statement and Balance Sheet.
- Senior management and other stakeholders will need to be educated on changes to the presentation of results. They will need to understand the initial impact the new standard will have on the profits of the company. In addition, decisions on the choice of methods used in the valuation of liabilities will affect how future profits are released over time so senior management will need to understand this to be involved in the decision making process.
- It is likely that results will need to be reported quickly. Most publicly listed companies present results to their stakeholders within 6-10 weeks of the closing date and preparing the results within these tight time scales may be testing. Industrialisation of system processes may be required.

Transition

First time application of the standard will be a challenge for many companies, in particular in the calculation of the CSM. The IASB have provided a hierarchy of approaches for determining the CSM at the transition date, as illustrated in Figure 7:

- The Full Retrospective Approach should be used unless impracticable. This approach requires relevant pricing and historical data to be available for all in-force contracts in order to estimate the fulfilment cashflows and CSM at the date of initial recognition and to roll them forward to the transition date.
- The Modified Retrospective Approach may be used if the Full Retrospective Approach is impracticable. For this approach information on the actual historical cashflows since initial recognition is required.
- The Fair Value Approach may also be used if the Full Retrospective Approach is impracticable and must be used if the Modified Retrospective Approach is impracticable. This approach involves determining the CSM at the transition date as the difference between the fair value of the insurance contract at that date and the fulfilment cashflows measured at that date.

FIGURE 7: TRANSITION APPROACH



Practical Challenges

- For the Modified Retrospective Approach, and in some cases for the Fair Value Approach, companies will need to estimate the discount rates that applied at inception. This will give rise to a number of practical challenges, such as how often to lock in interest rates, how to estimate past interest rates where there is a lack of historical data.
- If a Fair Value Approach is being used, deciding on an appropriate fair value may be difficult. The fair value may differ from the fulfilment cashflows for a number of reasons, for example fulfilment cashflows exclude overhead expenses not directly attributable to the contracts whereas the fair value should include an allowance for all overhead expenses. The fair value should also reflect non-performance risk whereas this is not the case for fulfilment cashflows. Fulfilment cashflows also include a Risk Adjustment whereas fair value includes a risk premium. Different approaches may be taken to determine both of these items.
- Data storage will also be an immediate issue at the transition date. Yield curves from the inception date of the portfolio will need to be determined and stored.
- There will be an initial impact on opening retained profits at the transition date which will need to be explained and understood by all stakeholders.

How Milliman can help

An IFRS 17 implementation project should be on the agenda now for insurance companies reporting under IFRS. We can assist you across various tasks including:

- Carrying out a gap analysis against the standard to see what changes to systems and data are required;
- Development of a roadmap to successful implementation;
- Adapting/developing actuarial models to be able to calculate the required results, including systems industrialization to produce the results within the required timeframe;
- Assessing the impact on profitability and opening equity;
- Providing training courses for senior management or other staff.



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