7th Seminar on Current Issues in General Insurance

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Key Accounting Policy Choices for IFRS17

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Key Features

Key Features of IFRS17

IFRS 17 framework comprises of 12 key components

Define the accounting policy

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Expected cash flows
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Interaction with other standards:

| IFRS 9 *Financial instruments* | IFRS 13 *Fair value measurement* | IFRS 15 *Revenue from contracts with customers* | *Relevant standards and local regulations* |

Policy Choices

Grouping of Insurance Contracts

Portfolio of Insurance Contracts

Similar risks & managed together

Group of Insurance Contracts

- Onerous at initial recognition
- no significant possibility of becoming onerous subsequently
- Others (non-onerous)

Cohort

Contract issued not more than one year
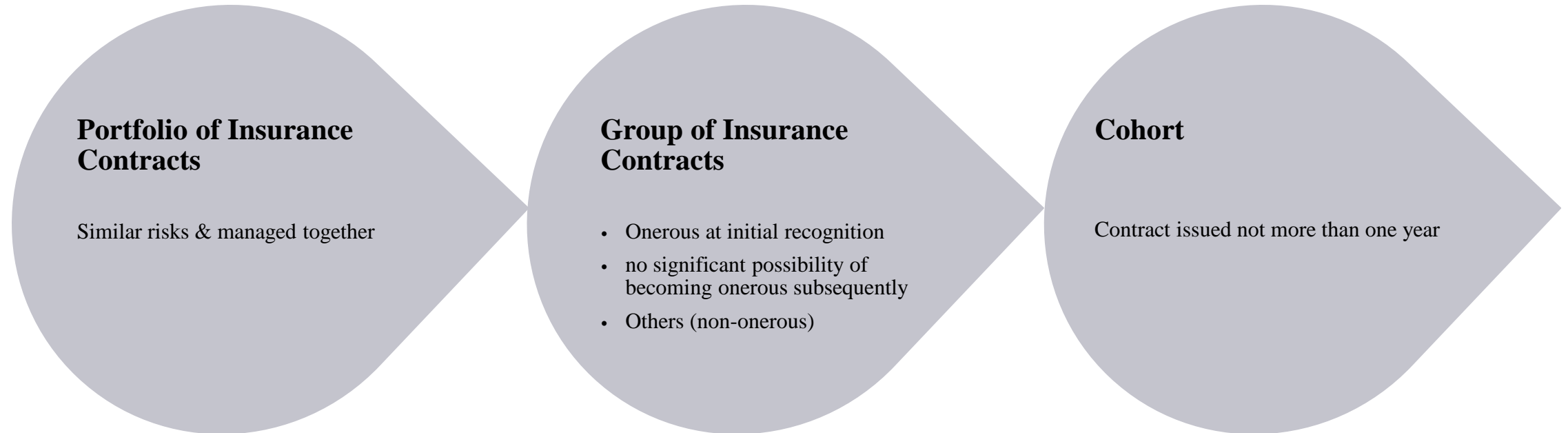
- ► In the European region, most companies created the portfolios at a very aggregated level
- ► Portfolios are in line with Lines of Business as per regulatory reporting
- ► Occasionally, there may be a split or combination of Lines of Business based on specific company circumstances, but this is not widespread.
- ► Insurers have opted to use grouping – either onerous or non-onerous; in a few cases, insurers have splitted
- ► Category for "no significant possibility of becoming onerous subsequently" is often not used

Grouping of Insurance Contracts

Similar Risk – Can these be grouped under single Portfolio?

▶ Is Group Health / Individual Health – similar risk?

▶ What about Indemnity health contracts versus Critical Illness contracts?

▶ What about Health with Co-pay and without co-pay?

▶ Does risk differ between Urban vs Rural health plans?

▶ What about Travel & Health? Personal Accident & Health?

▶ Similarly – Motor OD with zero dep / without zero dep ?

▶ Motor OD & Motor TP?

▶ Motor and Personal Accident?

What about **multiple risk coverage** – for eg a rural policy covering house, livestock, crop, two wheeler – all in a single policy with single premium?

Grouping of Insurance Contracts

Managed Together?? Are these managed together?

- ► Pricing of Motor OD is dependent on Motor TP rates
- ► Travel premium is also evaluated whenever health premium is evaluated/revised
- ► MIS identifies Travel and Health separately; decisions like re-pricing, underwriting, closing channel/geography etc are independent of each other
- ► OEM channel statistics are reported separately, its priced separately, even add-ons are different, all decisions around this channel are independently taken

Profitability Buckets – Extreme Loss making ($<-25\%$), Moderate Loss making ($-25\%<x<-10\%$), Marginal Loss making ($-10\%<x<0\%$), marginal profit making ($0\%<x<10\%$), moderate profit making($10\%<x<25\%$), no possibility of loss making ($25\%<x$)

Cohorts – quarterly, yearly, Apr-Dec and Jan-Mar, etc.

Coverage Unit

Para B119 –

The contractual service margin at the end of the period (before recognising any amounts in profit or loss) is allocated equally to each coverage unit provided in the current period and expected to be provided in the future. Amount allocated for the coverage units provided during the period is recognised in P&L.

The number of coverage units in a group is the quantity of insurance contract services provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage period.

There is no specific definition of coverage unit as per IFRS17, however are the possible methods for determining the quantity of benefits provided under an insurance contract, if they are reasonable proxies for insurance coverage provided in each period :

| 1 | Straight line allocation over the passage of time |

| 2 | A method based on the maximum contractual coverage each period – sum insured method |

| 3 | A method based on the amount the entity expects the policyholder to be able to claim in each period if an insured event occurs |

▶ Majority of the insurers have opted for the straight line allocation over the passage of time except in case of non-uniform risks like engineering
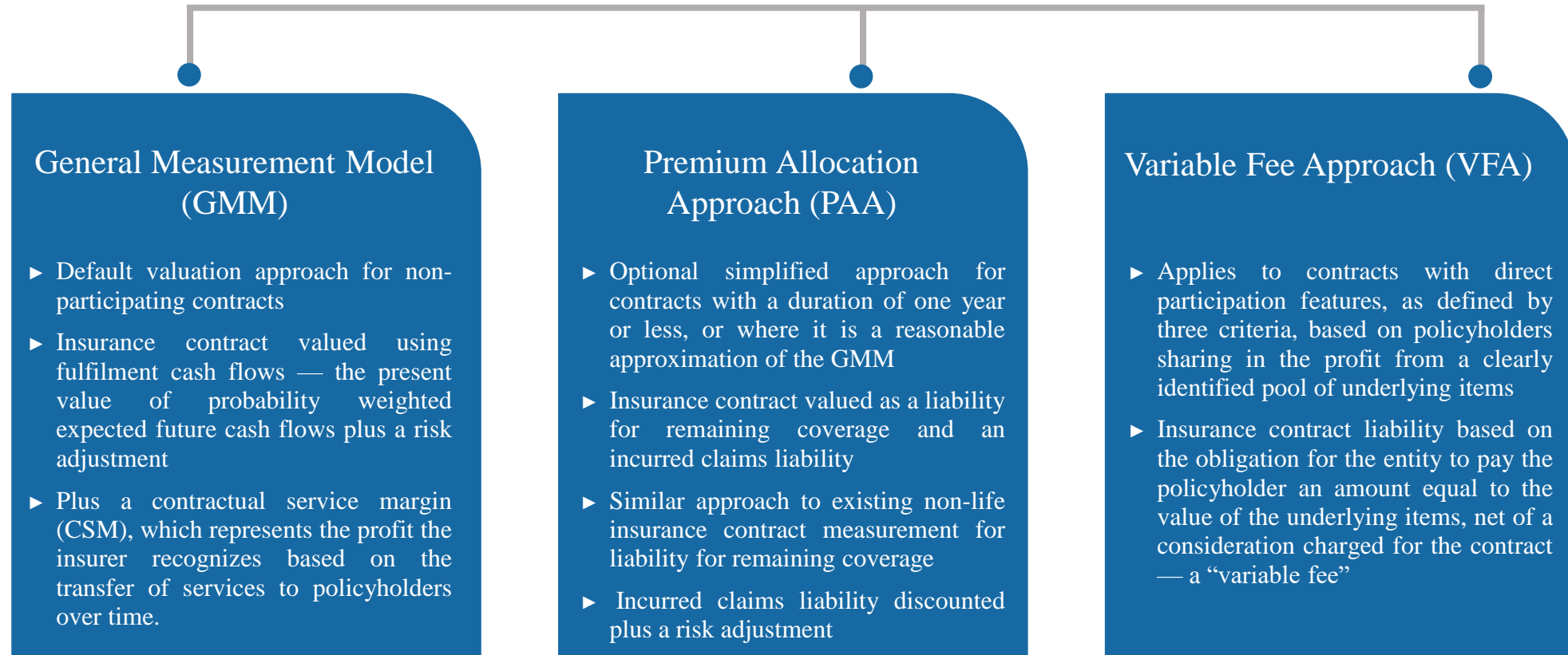
Coverage Unit

Should reflect the quantum of insurance service & investment service

► Crop Insurance contract for 3 years ?

► NDIC component in Crop Insurance ?

► NDIC in other products – how to allow for coverage unit?

Measurement Approaches

General Measurement Model (GMM)

- ▸ Default valuation approach for non-participating contracts
- ▸ Insurance contract valued using fulfilment cash flows — the present value of probability weighted expected future cash flows plus a risk adjustment
- ▸ Plus a contractual service margin (CSM), which represents the profit the insurer recognizes based on the transfer of services to policyholders over time.

Premium Allocation Approach (PAA)

- ▸ Optional simplified approach for contracts with a duration of one year or less, or where it is a reasonable approximation of the GMM
- ▸ Insurance contract valued as a liability for remaining coverage and an incurred claims liability
- ▸ Similar approach to existing non-life insurance contract measurement for liability for remaining coverage
- ▸ Incurred claims liability discounted plus a risk adjustment

Variable Fee Approach (VFA)

- ▸ Applies to contracts with direct participation features, as defined by three criteria, based on policyholders sharing in the profit from a clearly identified pool of underlying items
- ▸ Insurance contract liability based on the obligation for the entity to pay the policyholder an amount equal to the value of the underlying items, net of a consideration charged for the contract — a "variable fee"

- ▸ 8 out of 12 insurers have applied PAA >=99% of the non-life insurance business
- ▸ Remaining insurers have applied PAA for short term (<=1 year) business while GMM for the remaining contracts in non-life business

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Measurement Approaches

What about PAA for Longer duration – 2 years? 5 years? 10 years?

LFRC – similar between GMM & PAA - What about tolerance limit?

No choice on contract boundary – But interpretation issue exists for example

Yearly renewable individual indemnity health policy sold of a newly launched product?

Options while applying PAA

How Should DAC be amortized ?

Para 59 - In applying the premium allocation approach:

1

DAC

► an entity may choose to recognise any insurance acquisition cash flows as expenses when it incurs those costs, provided that the coverage period of each contract in the group at initial recognition is **no more than one year**.

2

Discounting

► the entity is not required to adjust future cash flows for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received in **one year or less** from the date the claims are incurred.

► We have observed the majority of the insurers are opting to defer the insurance acquisition cashflows

► For the simplification purposes, some of the insurers have opted to use the undiscounted liabilities for short tail lines like health

Attributable Expenses

IFRS 17.B65 provides examples of cash flows that would be included in an insurance contract valuation, including expense cash flows. Expenses specifically addressed in B65 include claims handling costs, policy administration costs, costs of paying benefits, acquisition costs, allocation of overhead directly attributable to fulfilling insurance contracts, etc.

IFRS 17.B66 then provides examples of the types of cash flows that would not be included in insurance contract valuation. Specific exclusions addressed in B66 are expenses outside of the contract boundary, expenses not directly attributable to the fulfilment of insurance contracts, expenses from abnormal amounts of wasted labour, income tax payments and receipts on behalf of policyholder, product development, training, cash flows that arise under reinsurance contracts held, cashflows that arise from non-insurance business.

IFRS 17.B65(e): an allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.

o Appendix A: "Insurance acquisition cash flows" are defined as "Cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts that are directly attributable (emphasis added) to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.

IFRS 17.B65(l): "an allocation of fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent, and maintenance and utilities) directly attributable (emphasis added) to fulfilling insurance contract
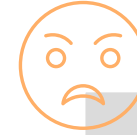
Attributable Expenses

Attributable
- Pricing/uw
- Issuance/renewal
- Sales/distribution
- Claim settlement cost
- Maintenance cost
- Customer service cost
- Commissions
- Premium tax

Non attributable
- Non-insurance business (pension)
- Investment return
- Reinsurance contract held
- Income tax
- Shareholder exp
- Cost associated with future insurance contract

Grey
- Investment exp
- Corp Governance
- Reg/statutory reporting, Sh relations
- Generic marketing, sales conference, events
- ALM expenses
- Risk function / Internal Audit etc

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Discounting Approaches

- ► reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts
- ► consistent with observable market prices for financial instruments with similar characteristics
- ► exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance contracts

Top-Down

- ► the appropriate discount rates for insurance contracts based on a yield curve that reflects the current market rates of return implicit in a fair value measurement of a reference portfolio of assets
- ► adjust that yield curve to eliminate any factors that are not relevant to the insurance contracts
- ► Market rate of return – Credit Risk

Bottom-Up

- ► discount rates derived by adjusting a liquid risk-free yield curve to reflect the differences between the liquidity characteristics of the financial instruments that underlie the rates observed in the market and the liquidity characteristics of the insurance contracts
- ► RFR + Illiquidity Premium
- ► Illiquidity premium reflects the difference between the liquidity characteristics of the group of insurance contracts and the liquidity characteristics of the assets used to determine the yield curve

- ► 10 out of 12 insurers have opted for bottom-up approach

Illiquidity Premium

► reflect the liquidity characteristic of the contract

► Motor OD / Health – liquidity characteristics ?

► How to measure ? – Corporate yield – less credit risk ?

Risk Adjustment Techniques

Para 37: An entity shall adjust the estimate of the present value of the future cash flows to reflect the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk (B86-B92)

Principles: low freq high severity, longer duration, wider prob distribution, less information,

How do we measure the same??

Risk Adjustment Techniques

Value at Risk (VaR)

▶ Easy to compute for companies already using a stochastic reserving approach

▶ Bootstrapping, Mack Method are easy to implement in reserving tools

▶ Risk Based Solvency regime would indicate capital loadings and confidence level. Can be re-engineered to provide loadings for the selected confidence level

Tail Value at Risk (TVaR)

▶ Probability weighted average of losses in excess of the selected confidence level

▶ The selected risk adjustment is then the difference between the TVaR and mean

▶ Translation methodology to estimate the equivalent percentile is required here as well similar to cost of capital approach

Cost of Capital (CoC)

▶ Linked to solvency capital requirements;

▶ Difficult to establish confidence level for the existing RSM approach

▶ Economic capital framework or the incoming risk-based capital framework can be leveraged

▶ Restate the confidence level for the estimated risk adjustment

▶ Majority of the insurance companies are using Cost of Capital (CoC) approach ~ leveraging the calculation of risk margin under Solvency II while a few of them have selected VaR approach

▶ >90% of the insurers have disclosed the confidence level above 70th percentile

▶ ~50% of the insurers are using 70-79th percentile; ~25% opted for 80-89th percentile while remaining have chosen above 90th percentile

# Transition Approaches

Fully Retrospective Approach (FRA)

► identify, recognise and measure each group of insurance contracts as if IFRS 17 had always applied

► identify, recognise and measure any assets for insurance acquisition cash flows as if IFRS 17 had always applied

Modified Retrospective Approach (MRA)

► use reasonable and supportable information.

► maximise the use of information that would have been used to apply a fully retrospective approach, but need only use information available without undue cost or effort

Fair Value Approach (FVA)

► an entity shall determine the CSM or loss component of the LFRC at the transition date as the difference between the fair value of a group of insurance contracts at that date and the fulfilment cash flows measured at that date
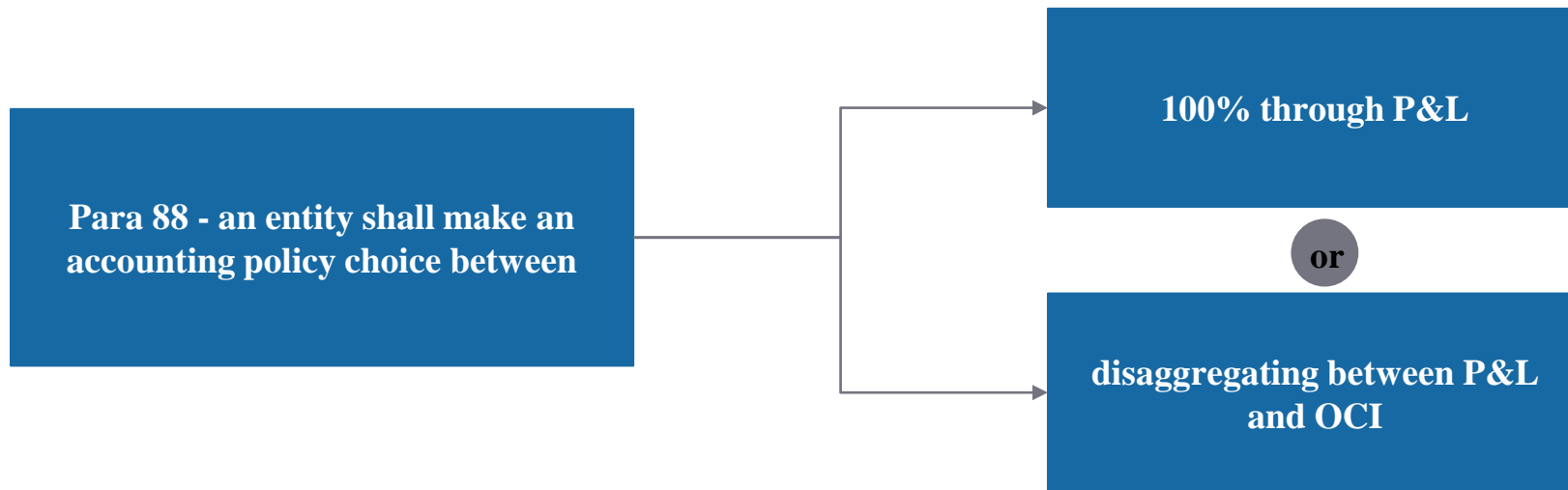
Is it impractical to use a (FRA)?

No → **Full Retrospective**

Yes → **Modified Retrospective Approach (MRA), If possible**

Fair Value Approach (FVA)
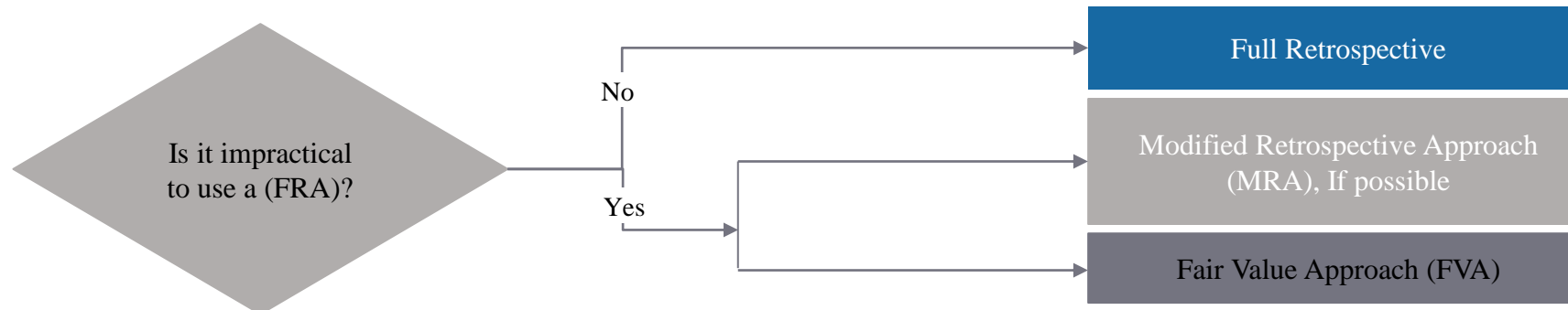
► Most of the insurers have applied retrospective approach (dominantly MRA)
► Partial use of FVA <=~25% business where the historical information is not available

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P&L vs OCI Approach

Para 87 - Insurance finance income or expenses comprises the change in the carrying amount of the group of insurance contracts arising from:
- ► the effect of the time value of money and changes in the time value of money; and
- ► the effect of financial risk and changes in financial risk

Para 88 - an entity shall make an accounting policy choice between

100% through P&L
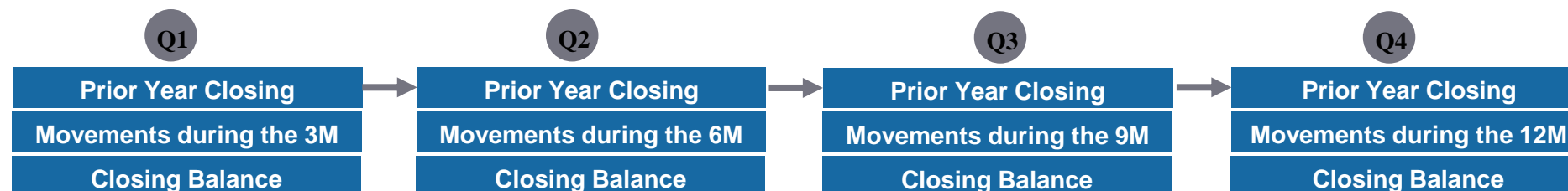
or

disaggregating between P&L and OCI

- ► Para B130 - cumulative amount recognised in other comprehensive income at any date is the difference between the carrying amount of the group of contracts and the amount that the group would be measured at when applying the systematic allocation

- ► Almost all the insurers have opted for OCI approach (disaggregation) which will help reduce the P&L volatility on account of changes in discount rates
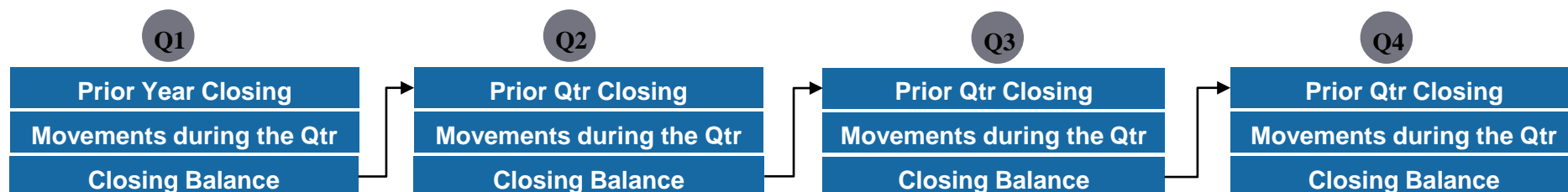
Interim Financial Reporting

YTD Approach

The CSM is calculated every quarter, based on the YTD movements since the beginning of the annual period. The results of an interim quarter are defined as the difference between the cumulative results of the current quarter, prepared on a YTD basis minus the cumulative results for the previous quarter, prepared on a YTD basis. This means that changes relating to previous quarters will impact the current quarter's result.

Q1

| Prior Year Closing |
| Movements during the 3M |
| Closing Balance |

Q2

| Prior Year Closing |
| Movements during the 6M |
| Closing Balance |

Q3

| Prior Year Closing |
| Movements during the 9M |
| Closing Balance |

Q4

| Prior Year Closing |
| Movements during the 12M |
| Closing Balance |

PTD Approach

The CSM is calculated based on movements in the discrete quarters from the beginning of the current quarter without going back to the previous quarters. The results of the current quarter will therefore not be affected by revising any accounting estimates of previous quarters. The cumulative results for the annual period to date are determined by the sum of the results of the four individual quarters.

Q1

| Prior Year Closing |
| Movements during the Qtr |
| Closing Balance |

Q2

| Prior Qtr Closing |
| Movements during the Qtr |
| Closing Balance |

Q3

| Prior Qtr Closing |
| Movements during the Qtr |
| Closing Balance |

Q4

| Prior Qtr Closing |
| Movements during the Qtr |
| Closing Balance |

Implications

KPI computation: CSM will become a key indicator; the combined ratio will be based on GEP

Combined Ratio

Mostly planned to be presented based on gross earned. This ratio is to improve (decrease) due to the discounting of the liability for incurred claims

Contractual Service Margin

This will become a key performance indicator representing the present value of profit element for the future services.

Return on Equity

Considered panel of insurers plan to exclude the OCI in the RoE calculation, even though there is a better matching under IFRS 9/17 between the revaluation of investments and insurance liabilities

Leverage Ratio

CSM is added to the denominator of the ratio. It has to be noted that one insurer also plans to include the RA net of tax as part of the denominator

KPI impacts on ratios

Impact

Operating Profit ① ▶ Should be similar or slightly higher compared to IFRS 4, potentially due to the decrease of onerous contracts at transition

Level of Shareholders' Equity (SHE) ② ▶ Expected to go down for most large composite insurers due to the adjustment of OCI; excluding OCI, equity would be more stable. Some mention reduction of equity due to setting up a CSM

RoE ③ ▶ Depending on previous practices, the RoE targets will remain unchanged or will be improved. Indeed, in the past, some insurers were excluding OCI from the RoE calculation where others were not. Since part of the OCI are now included in the CSM, the RoE of these latters will be mechanically improved

CSM ④ ▶ Presented as gross, net of tax or net of tax & projected Non Attributable Expenses (NAE). This latter view provides a more direct view on the net income impact of the release of CSM

Risk Adjustment ⑤ ▶ Could present varying levels of calibration depending on the risk appetite of the groups. Some insurers plan to use cost of capital approach, when others are using value at risk methodology

Release of CSM ⑥ ▶ Indication of pattern of release helps the analysts to anticipate expected future profitability

Appendix

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Appendix

Abb.	Full expression
CSM	Contractual Service Margin
ECL	Expected Credit Loss
FVPL	Fair Value through Profit & Loss
GMM	General Measurement Model
GOC	Group of Contracts
HTCS	Held to collect and sell
IFRS	International Financial Reporting Standard
ILP	Illiquidity Premium
L&H	Life & Health
L&S	Life & Savings
NAE	Non Attributable Expenses

Abb.	Full expression
OBS	Opening Balance Sheet
OCI	Other Comprehensive Income
FVOCI	Fair Value through Other Comprehensive Income
PAA	Premium Allocation Approach
P&C	Property & Casualty
PVEP	Present Value of Expected Premiums
RFR	Risk Free Rate
RA	Risk Adjustment
ROE	Return on Equity
SHE	Shareholders' equity
VFA	Variable Fee Approach

Operational Implications (2/2)

7 **Ledgers**

- Enhance GL Chart of Accounts to capture CSM on the balance sheet and CSM amortization on the profit and loss statement
- Potentially capture product cohorts

8 **Consolidation**

- Update consolidation and group reporting to include additional CSM reporting requirements

9 **Planning, budgeting and forecasting and management information**

- Bring business planning and forecasting models into line with the new external reporting basis
- Update internal and external KPIs to reflect CSM and the levers available to manage

10 **Operational Data Stores**

- Update to capture policy inception date, duration and CSM
- Capture historical amortization of CSM per cohort
- Create link between policies and cohorts
- Capture market and non-market data to update assumptions required for CSM

11 **Master Data Management**

- Update and enhance product hierarchies or product attributes to link to cohort

12 **Governance Risk Compliance**

- Capture business rules / policy used to build homogenous cohorts

Operational Implications (1/2)

1 **Source Systems**

- Policy systems – extract additional information from source including policy inception date and policy duration
- Append/extract data to include CSM value ranges if existing at policy level

2 **Actuarial and risk models**

- Embed CSM methodology in actuarial/risk/capital models based on revised cohort drivers
- Implement assumptions management to allow reconciliation between local GAAP/Solvency II to IFRS 17
- Update modelled results output to reflect IFRS 17 grouping and CSM

3 **Reporting layer**

- Update reporting/disclosure tools based on IFRS taxonomy
- Add new analysis of movement/change steps to capture CSM amortization impacts
- Capture notes to business rules used to build homogenous cohorts and CSM accretion

4 **IFRS 17 calculation engine**

- Require calculation engine to calculate, amortize and adjust CSM, either as a part of actuarial, finance systems or a separate application Build the integration to GL system

5 **Accounting rules engine**

- Update accounting rules to post to new accounts and cohorts

6 **Allocations**

- Change some allocations to be done at cohort level
- Update allocation rules to exclude certain costs such as non-attributable acquisition costs

Thank You!