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Health Insurance Technical - IFS09 - Impact Assessment for IFRS17 in Health Insurance

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CASE STUDY:Impact Assessment for IFRS 17 in Health Insurance

While many countries across the globe have transitioned into IFRS 17 reporting, it is quite abuzz now that India will also move into the same for all insurance companies sometime soon. Given that you are the Appointed Actuary of one of the biggest health insurers in the country, prepare an impact assessment presentation, highlighting the impact of transitioning from the current accounting regime to the IFRS 17 accounting regime. This should cover the following:

- Financial impact assessment – A high level impact of the key changes that could impact the financials. You could use publicly available information of any health insurer or pseudo numbers for the purpose of presentation.

- Operational impact assessment – How will the data, systems and processes be impacted and what will be some of the key decision-making areas which could impact the choice of the company due to cost implications and complexity of implementation keeping in mind existing systems and processes.

Background and IFRS17 For Health Insurance

- Existing Products in Indian Health insurance market can be divided into the following categories:
  - Indemnity Products:
    a. Retail: Minimum Term 12 months and maximum Term 36 months
    b. Group:
      - Term of 12 months
      - Credit Linked: Minimum Term 12 months and maximum Term 60 month
  - Fixed Benefit Products like Personal Accident/Critical Illness:
      - Retail: Minimum Term 12 months and maximum Term 36 months
      - Group:Term of 12 months, Personal accident Policy can be less than 12 Months
      - Credit Linked: Minimum Term 12 months and maximum Term 60 months
  - Travel Insurance Product can be less than 12 months and can be up to 3 years

IFRS17 Overview

- **Insurance Contract Definition**
  - While the definition of an insurance contract has not changed much from IFRS 4, the consequences of qualifying as an insurance contract have changed.
  - IFRS 17 requires the assessment of whether a contract transfers significant insurance risk to be made only once at inception
  - Under IFRS 17, separate identification of investment components, embedded derivatives, and non-insurance services is required only when they are distinct from the insurance component within the insurance contracts

- **Aggregation of Insurance contracts**
  - Contracts that are subject to similar risks and managed together
  - Contracts should not be issued more than one year apart
  - Contracts issued in each UW year to be analyzed in three portfolio groups: Onerous, might become Onerous and Profitable
  - The aggregation has to be consistent with internal reporting
  - If law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, the entity may include those contracts in the same group

IFRS17 Overview

- **Portfolio Groups Onerous/Might become Onerous/Profitable**
  - Under IFRS 17, onerous contracts are more transparently identified, as they are placed in a separate group.
  - The standard mandates disclosure of losses from these contracts issued during the reporting period, along with the changes in the loss component for all such contracts.
  - IFRS 17, through its specified level of aggregation, aims to restrict cross-subsidization in the insurance industry, minimizing situations where profits from certain contracts offset anticipated losses from others

- **Contract boundary**
  - Contract boundary refers to the timeframe in which substantive rights and obligations exist under an insurance policy.
  - It encompasses the period when the entity can enforce premium payments from the policyholder or has an obligation to deliver services to the policyholder

- **Initial recognition**
  - Many companies that currently defer and amortise acquisition costs present DAC as assets, separately from insurance contract liabilities
  - Under IFRS17 the treatment could vary depending upon the measurement model

IFRS17 Overview

- Premium Allocation Approach (PAA):
  - Recognize insurance acquisition cash flows in Liability for Remaining Coverage (LRC).
  - Amortize insurance acquisition cash flows as insurance service expenses.
  - Exception for Contracts with One-Year Coverage or Less:
  - Alternatively, recognize insurance acquisition cash flows as an expense when incurred for contracts with one year coverage or less
- General measurement model (GMM) and the variable fee approach (VFA):
  - Insurance acquisition cash flows decrease the CSM and are thus implicitly deferred within the CSM
  - leading to a lower amount of CSM amortisation recognised in revenue in future reporting periods as services are rendered

- **Investment Component**
  - An investment component is the amount of an insurance contract that requires to repay to the policyholder even if insurance event does not occur

IFRS17 Overview

- **Separation of Insurance and Reinsurance results**
  - IFRS 17 treats reinsurance contracts held and underlying insurance contracts separately
  - This would result in the differences arising between the value of reinsurance recoverable and the ceded insurance liability impacting the contract boundaries for reinsurance contracts

- **Recognise Profits as it delivers insurance services**
  - Under IFRS 17, insurance revenue no longer aligns directly with premiums received in the period.
  - It represents the consideration the insurer expects for services provided on an earned basis.

XYZ Insurance Company Ltd – Product Portfolio

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Product	Maximum Term	Premium for the year	Claim expected	Acquisition expenses	Other Attributable Expenses	Portfolio	Onerousness
Retail Health Indemnity	1 year	100	50	20	20	Retail Health Indemnity	Non onerous
Group Health Indemnity	1 year	100	100	7.5	10	Group Health Indemnity	Onerous
Group Health Indemnity	1 year	100	80	7.5	10	Group Health Indemnity	Non Onerous
Retail Personal Accident	3 years	50	20	10	10	Retail PA	Non Onerous

PAA Eligibility Testing

Is the duration less than or equal to 1 year?

No

Would the Liability for Remaining coverage be materially same in PAA and GMM model?

No

GMM Approach

If the answer for either of the question is the Yes, then we need to follow PAA method

In the case of XYZ Insurance Company Limited, the following methods would be applied for measurement

Product	**Measurement Model**	**Reason**
Group Health Indemnity	PAA	Duration less than equal to 1 year
Retail Health Indemnity	PAA	
Retail Personal Accident	PAA	No material difference between PAA and GMM

Financial Impact of PAA method

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Particulars	IFRS-17	IGAAP	Remarks
Loss Component of onerous contract in GHI	17.5	8.75	Note 1

Note 1: Loss Component of onerous contract in GHI
We have identified and grouped the onerous contracts in GHI separately. As per the IFRS-17 standard, we need to provide for the losses on initial recognition itself. However, in the current IGAAP, the losses would be identified as the claims get reported and premium is earned

Assumptions:
1. Premium is written uniformly throughout the year
2. Premium is earned using straight line method (1/365th method)

Financial Impact of PAA method

Particulars	IFRS-17	IGAAP	Remarks
Liability for Incurred Claim for all products under PAA method – Best Estimate	60.42	62.5	Note 2
Liability for Incurred Claim for all products under PAA method – Risk Adjustment	6.04		Note 2

Note 2: Liability for Incurred claims – PAA method

The best estimates of liability for incurred claims are discounted using an appropriate discount rate. As a result of this, the liability would reduce. However, the standard suggests for Risk Adjustment which is calculated as 10%. As per IGAAP, the insurer is not expected to hold any Risk Adjustment. In this case, we have assumed that the IGAAP figures are best estimates. Further, the benefit is discounting is an added benefit in IFRS.

Assumptions:

1. 50% of all the incurred claims are paid and 50% of the incurred claims are outstanding as case reserves and IBNR
2. Outstanding claims reserves and IBNR claims are expected to be paid in the next financial year.
3. They are discounted using 7% discount rate for half a year
4. Risk adjustment at 75^{th} percentile came out to be 10%

Financial Impact of PAA method

Particulars	IFRS-17	IGAAP	Remarks
Deferred Acquisition Cost – PAA Method	18.75		Note 3

Note 3: Deferred Acquisition Cost – PAA Method
As per IGAAP, the cost of acquisition was written off in the year of incurring the same. They were not allowed to be carried forward by the regulator. However, in IFRS-17, the choice is provided to the insurer to defer the cost of acquisition or expense it out in the initial year itself.

Assumptions:
1. The entity has chosen to defer the cost of acquisition
2. The cost of acquisition has been deferred in the same pattern as the premium has been recognised.

Financial Impact of PAA method

Particulars	IFRS-17	IGAAP	Remarks
Liability for Remaining Coverage for all products under PAA method	151.05	175	Note 4

Note 4: Liability for Remaining Coverage
The liability for remaining coverage is calculated on gross premium less acquisition cost and is discounted. Since, the entire gross premium less acquisition cost is discounted and the loss component has been recognized separately, there is no need for best estimate liability and risk adjustment as in the case of liability for incurred claims

Assumptions:
1. The entity has chosen to defer the cost of acquisition
2. The unearned premium would be earned immediately in the next year.
3. Discount rate is 7%

Reinsurance Ceded Arrangements

Particulars	Premium Ceded	Commission	Products Covered / Portfolio	Reinsurance Type
Obligatory Treaty	4%	Ceding @ 5% + Profit (50%)	All Products	Proportional – Quota
Risk cum CAT XOL (Occurrence year wise)	₹5	None	Retail Personal Accident	Risk cum CAT XOL

Obligatory Treaty to be grouped under Miscellaneous Portfolio as the profit commissions are dependent on the line of business

Reinsurance Overview

- IGAAP – Balance Sheet and P&L were provided on Net basis
- IFRS 17 - Insurance and Reinsurance Service results are shown separately
- Reinsurance held does not have to be measured with the same model as related insurance contracts.
- Contract boundary of the reinsurance contract held can be different that the contract boundary of the related insurance.
- Reinsurance contracts held can follow different grouping that do not map one-to-one with the related insurance contracts groups.
- There are different reinsurance held recognition rules comparing to the related insurance contract recognition.
- Treatment of onerous group contract (net off)

Reinsurance Financial Impact

- Reinsurance cashflows to be more prudent to allow for probability of default. Risk adjustment factor may remain the same as the underlying contract
- Recognizing expected profit commission in the financial statements would lead to better financial performance
- Separation of reinsurance service results and reinsurance finance income / expenses would provide an assessment of burden of timing impact for insurance recoverable and pure reinsurance service results
- Fixed Reinsurance commission is treated as a financial asset and may be shown as a deduction from reinsurance ceded amount

Difference between current accounting Standards and IFRS17

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- Revenue recognition is different for IFRS contracts than current method.
- Measurement and recognition of Expenses
- Profits are not recognized at inception, and will be recognized as the service period passes.
- CSM (Contractual Service Margin) quantifies the unearned profit the insurer expects to earn as it fulfils contract.
- Ensures no gain at initial recognition.
- CSM is allocated over the service period.
- CSM cannot be negative.
- Loss is recognized immediately.
- The Actual total profit from the contract remains the same, the Standard effects the timing of the profit.

IFRS 17 Insurance contract Liability - GMM

Total IFRS Insurance Liability

Block 4:
Contractual Service Margin ("CSM")

'Fulfilment cash flows'

Block 3:
Risk Adjustment

Block 2:
Time Value of Money

Block 1:
Expected Future Cash Flows (unbiased probability weighted mean)

Illustrative Example for GMM

Single Premium product with Premium Rs.90000

Commission Rate : 10%

Discount rate : 5%

Expected Claim : As in table below

Attributable Expense : 80% of Administrative Expense

Actual Claims : As in Table below

Reinsurance : 30%

RA : Arbitrary value

Illustrative Example for GMM

Direct contract	Year 0	Year 1 (end)	Year 2 (end)	Year 3 (end)
An insurance contract with coverage period of 3 years				
Premium received	90,000			
Commission @10%	(9,000)			
Administration expenses (80% assumed as attributable)		(1,000)	(1,000)	(1,000)
Expected claims (settled immediately)		(17,000)	(20,000)	(22,000)
PV of claims @ discount rate of 5%	(53,336)			
PV of Attributable expense @ discount rate of 5%	(2,179)			
Risk adjustment	(1,200)			
CSM at initial recognition	**24,286**			
Actual claims incurred and reported		(18,000)	(20,000)	(22,000)
Claims incurred are settled one year after the date of incurrence				

IFRS 17 Insurance contract Liability

Total IFRS Insurance Liability

Block 4:
Contractual Service Margin (“CSM”)

‘Fulfilment cash flows’

Block 3:
Risk Adjustment

Block 2:
Time Value of Money

Block 1:
Expected Future Cash Flows (unbiased probability weighted mean)

Total IFRS Insurance Liability

Block 4:
24286

‘Fulfilment cash flows’

Block 3:
(1200)

Block 2:
(11514)

Block 1:
Premium 90000
Claims (42000)
Commission (9000)
Expense (2000)

Illustrative Example for GMM

Reinsurance contract	Year 0	Year 1 (end)	Year 2 (end)	Year 3 (end)
A reinsurance contract with 30% proportionate coverage purchased				
Premiums	(27,000)			
Ceding commission@10%	2,700			
Expected claims recovery (settled immediately)		5,100	6,000	6,600
PV claims recovery @ discount rate of 5%	16,001			
Risk adjustment	360			
CSM at initial recognition	**(7,939)**			
Actual claims incurred and reported		5,400	6,000	6,600
Claims incurred are settled one year after the date of incurrence				

Profit or Loss reconciliation to Current reporting (GMM) for Year 1

IGAAP	
Gross written premium	90,000
Reinsurance ceded	(27,000)
Net written premium	63,000
Changes in unexpired risk	(42,000)
Net Earned Premium	**21,000**
Claims paid - Direct	-
Less: Reinsurance claims recovery	-
Net claims paid	**-**
Add: claims outstanding at end of year	(12,600)
Less: claims outstanding at beginning of year	-
Net Claims incurred	**(12,600)**
Commission expense	(9,000)
Commission income - ceding premium	2,700
Commission expense	**(6,300)**
Operating expense	(1000)
Profit / (Loss)	**1,100**

Ind AS117 Contracts	
Insurance contract revenue (1)	29,850
Reinsurance contract expense (3)	(7,999)
Insurance service expenses (2)	(21,093)
Reinsurance recoveries revenue (4)	5,143
Insurance service result	5,901
Administrative expenses (5)	(200)
Other income	-
Insurance operating result	5,701
Insurance finance income/(expense) (6)	(2,793)
Investment income	-
Investment expenses	-
Investment result	(2,793)
Financing and other costs	-
Profit (loss) before income tax	2,908
Income tax expense	-
Profit (loss) after income tax	2,908
	-
	-

Financials Comparison

Particulars	Year 1	Year 2	Year 3	Year 4	Total
Net earned premium	21,000	21,000	21,000	-	**63,000**
Net Claims incurred	(12,600)	(14,000)	(15,400)	-	**(42,000)**
Net commission expense	(6,300)	-	-	-	**(6,300)**
Operating expenses	(1,000)	(1,000)	(1,000)	-	**(3,000)**
Profit / (Loss)	**1,100**	**6,000**	**4,600**	-	**11,700**

Particulars	Year 1	Year 2	Year 3	Year 4	Total
Insurance revenue	29,850	33,433	36,044	-	**99,083**
Insurance service expenses	(21,093)	(23,155)	(25,225)	-	**(69,473)**
Net reinsurance expenses	(2,856)	(3,324)	(3,498)	-	**(9,677)**
Finance Income/Expense	(2,793)	(2,612)	(1,793)	(733)	**(7,632)**
Administrative expense	(200)	(200)	(200)	-	**(600)**
Profit / (Loss)	**2,908**	**4,142**	**5,383**	**(733)**	**11,700**

IFRS 17 Operational Impact

1. Disclosure Requirements

- Extensive disclosure requirements under IFRS 17 compared to IFRS 4. Challenge for entities to meet these requirements due to data, systems and processes.
- For insurance contracts measured under the PAA, the entity is required to disclose the following:
    - Which of the PAA eligibility criteria it has satisfied
    - Whether it adjusts the LRC and LIC for the time value of money and the effect of financial risk
    - Whether insurance acquisition cash flows are recognized as incurred expenses or are amortized over the coverage period.
    - Reconciliations of opening to closing balances of various components of assets, liabilities and cashflows
- Judgement- to break down the required disclosures into separate LOBs, reportable segment, or geographical areas; in applying the concept of materiality.
- For each type of risk entity must disclose:
    - Exposures to risks and how they arise
    - Objectives, policies and processes for managing risks and methods used to measure them
    - Any changes in the above from the previous period.
- Additional disclosures may be required if the information provided is insufficient to understand the impact of particular transactions, other events and the entity's financial position and financial performance.
- Separate reconciliations for insurance and reinsurance contracts held, such as generation of expenses or reduction in expenses rather than revenue

IFRS 17 Operational Impact

2. Transition impact-

- Huge reliance on data systems due to retrospective reporting of contracts based on IFRS17 from the transition date- need for historic data at the required level of detail
- Using modified retrospective approach or fair value approach permissible only on provision of reasonable and supportable information.
- Disclosures and reconciliations of CSM and insurance revenue to be provided separately for contracts measured at the transition date when applying

3. Data requirements

- Issues around pre-existing poor data quality, data sourcing from multiple source systems at the required granularity and lack of robust data storing systems
- To disclose inputs, assumptions and estimation techniques used, including processes to estimate inputs.
- Capture changes in methods and processes for estimating inputs, reason for each change, and the type of contracts affected
- Estimates of discount rates and coverage units to be tracked as on reporting date
- Reconciliations of opening to closing balances of the various components
- Confidence level used to determine the risk adjustment for nonfinancial risk
- Yield curves used to discount cash flows that do not vary based on returns from underlying items

IFRS 17 Operational Impact

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4. Risk management systems

- Entity to disclose the nature and extent of the risks- primarily insurance and financial risks. Financial risks typically include, but are not limited to, credit risk, liquidity risk and market risk.
- Robust risk management systems and processes for risk identification, measurement, modelling, monitoring and mitigation.
- Scope and nature of risk reporting or measurement systems, such as internal risk measurement models, sensitivity analyses, scenario analysis, and stress testing.
- Underwriting strategy to ensure appropriate risk classification and premium levels
- Methods employed to limit or transfer insurance risk exposures and avoid undue concentrations of risk, such as retention limits, inclusion of options in contracts, and reinsurance

5. Risk Groupings- level of aggregation

- More granular grouping for measurement purposes compared to many existing practices under IFRS 4
- Practices applied under IFRS 4 for recognizing losses on onerous contracts were based on wider groupings of contracts than those in IFRS 17.
- Earlier recognition of losses as compared with IFRS 4
- Subjective judgements around subdividing groups based on different levels of profitability; or different possibilities of contracts becoming onerous after initial recognition

IFRS 17 Operational Impact

6. Identification of Onerous contacts

- Systems to be able to identify onerous and non-onerous contracts. Need for greater coordination between front and back office; pricing and reserving processes to identify onerous contracts.
- Systems to capture losses arising from onerous contracts issued in the reporting period as well as the movement in the loss component of all such contracts.
- Systems to be able to record the probability of contract becoming onerous. For e.g. a framework where groups of contracts are no onerous if Combined ratio is less than 95%, and

7. Annual Cohorts

- The prohibition on grouping together contracts that have been issued more than one year apart. Practical challenges with tracking the issue date of contracts because the date of issuance is not necessarily the same as the date of initial recognition of a contract.
- Maintaining separate 'cohorts' limit an entity's ability to offset profits and losses (or spread different levels of profitability) arising from different generations of contracts in a portfolio. Need to find practical ways to apply annual cohorts in a suitable manner considering their specific circumstances.

8. Collaboration and communication across multiple teams

The IFRS 17 program requires significant commitments from multiple areas of the insurance industry, e.g., accountants, actuaries, project management, technology data teams, etc

Summary

Reporting	• IFRS 17 requires new reporting process
Budgeting, planning and forecasting External communication Internal control and internal audit	• Budgeting and planning needs to be done according to IFRS 17 metrics • External communication of financial results will be more complex • Materiality thresholds for internal control processes need to be redefined
Reinsurance strategy Risk management Pricing and product development	• Reinsurance impact on income statement will be different • Risk management metrics based on equity or profits need to be adjusted • Product requirements such as payback period and IRR need to be modified

THANK YOU!