Current issues in General Insurance

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IFRS 17 – Insurance Contracts

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Agenda for today

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Background and IFRS timetable 1	Overview IFRS 17 requirements 2
IFRS 17 reporting and disclosures 3	IFRS 17 operational and system impacts 4

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Overview and IFRS timetable

IFRS timetable

IFRS Standard	2017	2018	2019	2020	2021 onwards
Financial instruments (IFRS 9)		Mandatory effective date of 2018*			Deferral ceases 1 Jan 2021
Revenue (IFRS 15)		Mandatory effective date 2018			
Leases (IFRS 16)			Mandatory effective date 2019		
Insurance contracts (IFRS 17)	Final standard May 2017				Mandatory effective date 1 Jan 2021

FASB decided to only make targeted amendments for long duration contracts for US GAAP (additional disclosures only for short duration contracts)

Not confirmed if, how and when IFRS 17 would be incorporated for UK GAAP

In Europe subject to EU endorsement

In APAC, many countries' local GAAP is already aligned with IFRS

IFRS 17 applies to insurance contracts only, so investment contracts (e.g. unit-linked pensions) are not impacted

* A number of transitional options exist for insurers including full deferral to 1 January 2021 for Insurers who meet certain criteria

Group vs local reporting?

Key highlights of IFRS17

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- A more complex measurement model under IFRS 17 introduces **greater levels of system complexity and cost**
- Changes to financial statement presentation will drive **new key performance indicators** and MI requirements
- Enhanced disclosures requirements will **increase transparency of reserve adequacy and quality of earnings**
- Capacity to **leverage Solvency II** (although not applicable to every territory)

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Overview of IFRS 17 requirements

IFRS 17 measurement models

Overview

	General model / Building Block Approach (BBA)	Premium allocation approach (PAA)	Variable fee approach
Why is it needed?	Default model for all insurance contracts	To simplify for short term contracts with little variability	To deal with participating business where payments to policyholders are linked to underlying items like assets
Types of contract	• Long-term and whole life insurance, protection business • Certain annuities • US style universal life • Certain reinsurance written • Certain general insurance contracts	• General insurance • Short-term life and certain group contracts	• Unit-linked contracts, US variable annuities and equity index-linked contracts • Continental European 90/10 contract • UK with profits contracts
Mandatory?	Mandatory	Optional	Mandatory

IFRS 17 measurement models

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	Current IFRS/GAAP	BBA	PAA
Unexpired risk / Liability for remaining coverage	UPR less DAC	Contractual Service Margin Risk adjustment Discounting Best estimate of fulfilment cash flows	Premium (less acquisition costs) unearned
Expired risk / Liability for incurred claims	Undiscounted reserves for past claims (including IBNR)	Risk adjustment Discounting Best estimate of fulfilment cash flows	Risk adjustment Discounting Best estimate of fulfilment cash flows

Qualifying for the PAA

Automatically available for contracts with coverage period twelve months or less.

Inwards and reinsurance contracts are required to be considered separately, but mixed measurement models within a reportable segment could make results difficult to interpret.

Drivers of profit

Changes to yield curves will require better asset liability matching to manage income statement volatility.

No prescribed method for measuring the risk adjustment but entity required to disclose methodology and expected to be consistent year on year.

* Size of blocks are for illustrative purposes only

Optional model for short term contracts
Premium Allocation Approach (PAA)

- Optional simplified model for future cover based on premiums.
- Permitted for short duration contracts (period of cover <= 1 year) or where “would not differ materially” from the BBA (LFRC only).
- ‘would not differ materially’ does not apply when entity expects significant variability in the pre claim cash flows.
- Incurred claims liability (including IBNR) calculated in the same way as for the BBA approach*.

Premiums less acquisition costs

Risk adjustment

Discounting *

Expected value of future cash flows**

Expired risk = Liability for incurred claims (LIC)

Unexpired risk = Liability for remaining coverage (LFRC)

*** Additional simplification excludes discounting where cash flows are expected to be paid or received in one year or less.**

**** Probability weighted, essentially an unbiased mean.**

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PAA eligibility

Tougher than it looks…

Factors to consider	Decision tree	Impact on lines of business
Contract boundaries under IFRS 17 (different to current standard and Solvency II)	Is the coverage period one year or less? Yes → PAA is automatically applicable. No ↓	All (re)insurance contracts with coverage period of one year or less
Variability in your expectation of the present value of future cashflows	At inception, would the PAA differ materially from the BBA (LFRC only)? No → May be possible to construct an argument that PAA is applicable	Property damage type multi-year policies of 2 to 3 years, some reinsurance contracts (e.g. risk attaching)
No definition of "material" or "significant"	Is significant variability in the fulfilment cashflows expected (which may affect the measurement of the liability for remaining coverage during the period before a claim is incurred)? ? → More difficult to construct an argument that PAA is applicable	Construction, energy, engineering, A&H, D&O, credit, surety and long duration property damage type multi-year policies

An approach to assessing PAA eligibility

Premium Allocation Approach (PAA)

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At inception, would the PAA differ materially from the BBA (LFRC only)?

Is significant variability in the fulfilment cashflows expected (which may affect the measurement of the liability for remaining coverage during the period before a claim is incurred)?

May be possible to construct an argument that PAA is applicable

Using contract boundaries:

Pros:

- Allows for a quick analysis
- Can take account of contract wording, such as re-rating clauses and cancellation terms

Cons:

- Need to look through binders and risk attaching during ("RAD") policies
- Cannot provide definitive "proof"

Using actuarial modelling:

Pros:

- Provides definitive proof
- Can allow for a range of scenarios and assumption sensitivities

Cons:

- Time intensive
- Requires specialist resource

Profit and Loss Recognition - PAA

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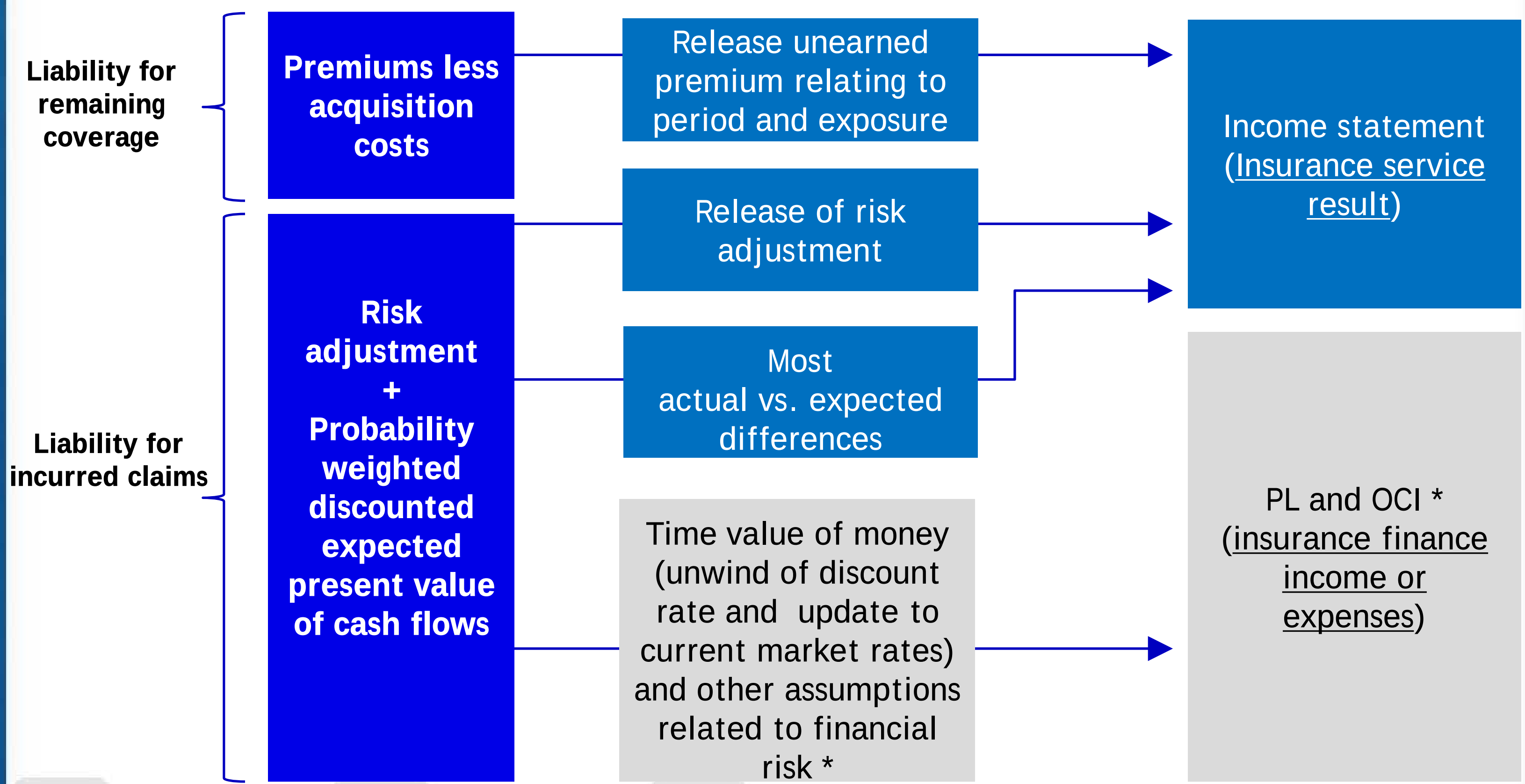

Balance sheet measurement

* Use of OCI is an accounting policy choice

Flow to income or equity

General measurement model in IFRS 17
Building Block Approach (BBA)

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- General model for all insurance contracts.
- Based on discounted best estimate of future cash flows (in and out).
- Explicit margins:
  - Contractual service margin to prevent gain on policy inception.
  - Risk adjustment.
- Day 1 loss recognised in income statement.
- Cash flow approach for all liabilities: past claims (including IBNR) and future cover.

Contractual service margin	Unearned profits recognised over coverage period.
Risk adjustment	Reflect compensation entity requires for uncertainty. Quantifies the value difference between certain and uncertain liability.
Discounting	Discounting future cash flows using 'top-down' or 'bottom-up' approach for discount rates to reflect characteristics of the liabilities.
Best estimate of fulfilment cash flows	Best estimate cash flows – explicit, unbiased and probability weighted estimate of fulfilment cash flows.

Expired and unexpired risk

Similar to SII* but with the additional contractual service margin

Profit and Loss Recognition - BBA

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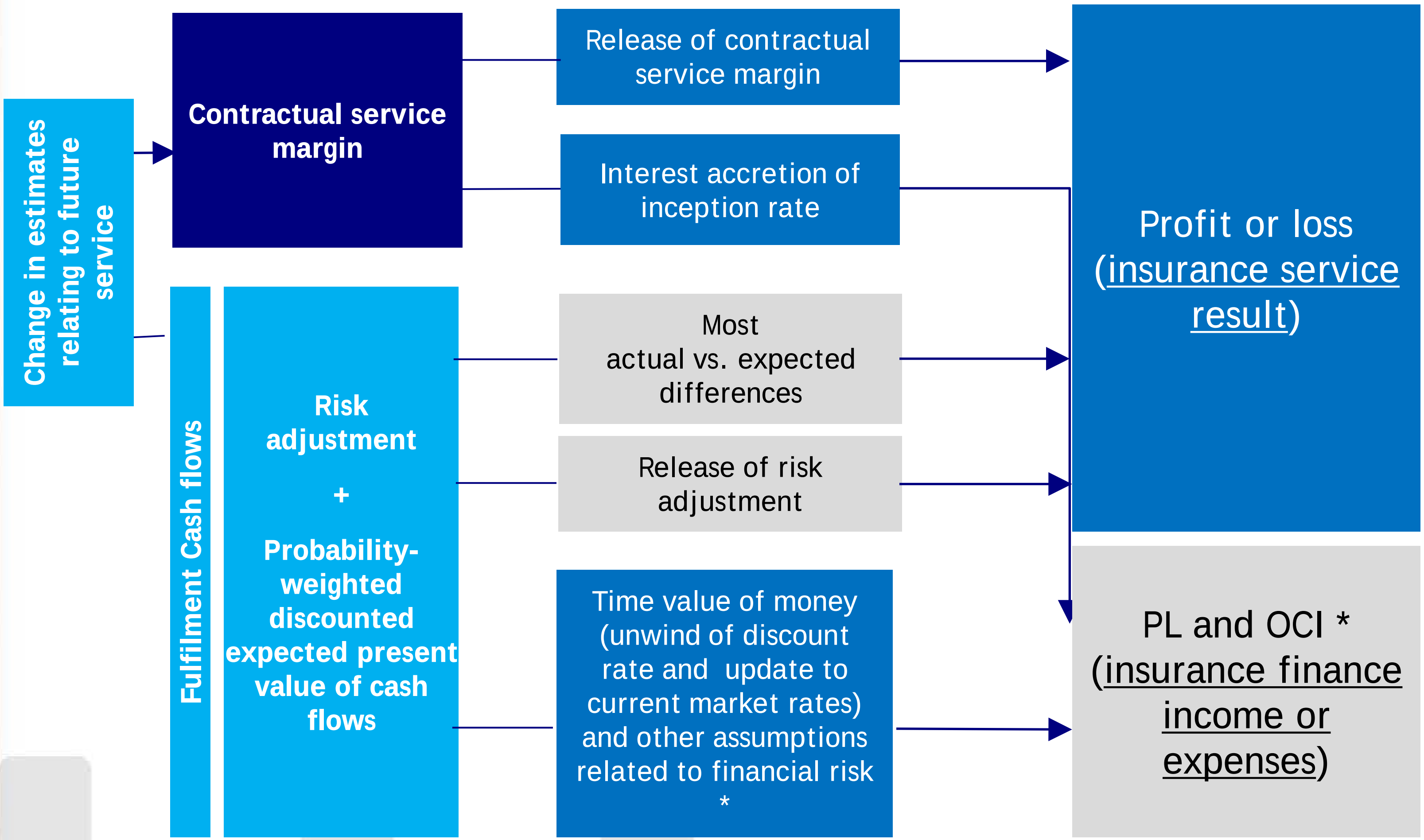

Balance sheet measurement * Use of OCI is an accounting policy choice **Flow to income or equity**

Level of aggregation
Summary

1. Objective

Profitable vs onerous contracts

No CSM at the end of coverage period

2. Aggregation requirements

Top-down approach:
Start at portfolio level (similar risks, managed together)

3 groups at inception:
- Onerous;
- Profitable with no significant risk of becoming onerous; and
- Other profitable contracts

Risk of contracts becoming onerous:
- Internal reporting
- Sensitivity of fulfilment cash flows

Requires that a group shall not include contracts issued more than one year apart

=> Effect of regulation

Some laws or regulations prevent insurers from pricing for certain risk indicators (e.g. gender)

If a law or regulation specifically constrains
- insurer's practical ability to set a different price or level of benefits for policyholders with different characteristics…
- then ignore that characteristic for grouping (e.g. male or female drivers)

3. CSM allocation

Based on coverage units, reflecting the expected quantity of benefits and expected coverage duration of the contracts in the group

Level of aggregation

Group illustration for a portfolio

Portfolio 1

Motor insurance

Entity divides each portfolio into groups

- contracts issued within the same year
- information about the contracts' resilience
- consistent with internal reporting
- exemption for regulatory pricing
- group not reassessed after initial recognition

Profitable contracts	Group A	Contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any	Unearned profit is recognised as part of the liability and is released as insurance services are provided
	Group B		
	Group C	Other profitable contracts, if any	
Onerous contracts	Group D	Contracts that are onerous at initial recognition, if any	A loss is recognised in P&L

Initial recognition

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Earliest of when

- Coverage period starts
- First payment from policyholder is due or actually received
- A group of contracts becomes onerous

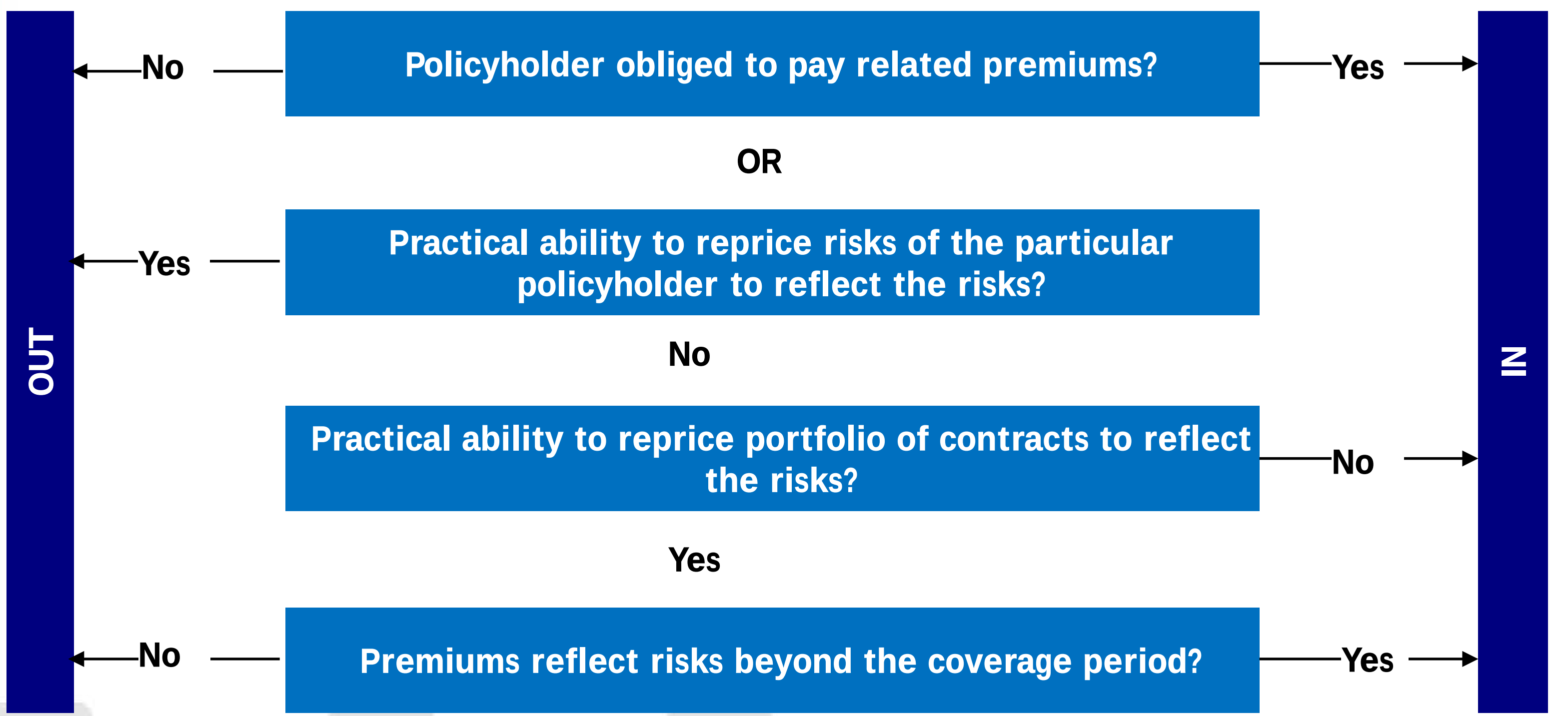
Binders

Reinsurance

Recognition

Contract boundaries

Is the cash flow in the boundary of an insurance contract?



Portfolio transfer and business combinations

Contracts acquired in the settlement period

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Issuer of insurance policies

One of three options for liability for incurred claims (expired risk)

Expired risk

General model throughout	PAA	PAA and undiscounted* incurred claims
Risk adjustment	Risk adjustment	Risk adjustment
Discounting	Discounting**	Best estimate of fulfilment cash flows
Best estimate of fulfilment cash flows	Best estimate of fulfilment cash flows	

Entity acquiring insurance contracts*

Contract has new coverage period (the settlement period of the liabilities) and CSM has to be set-up

General model

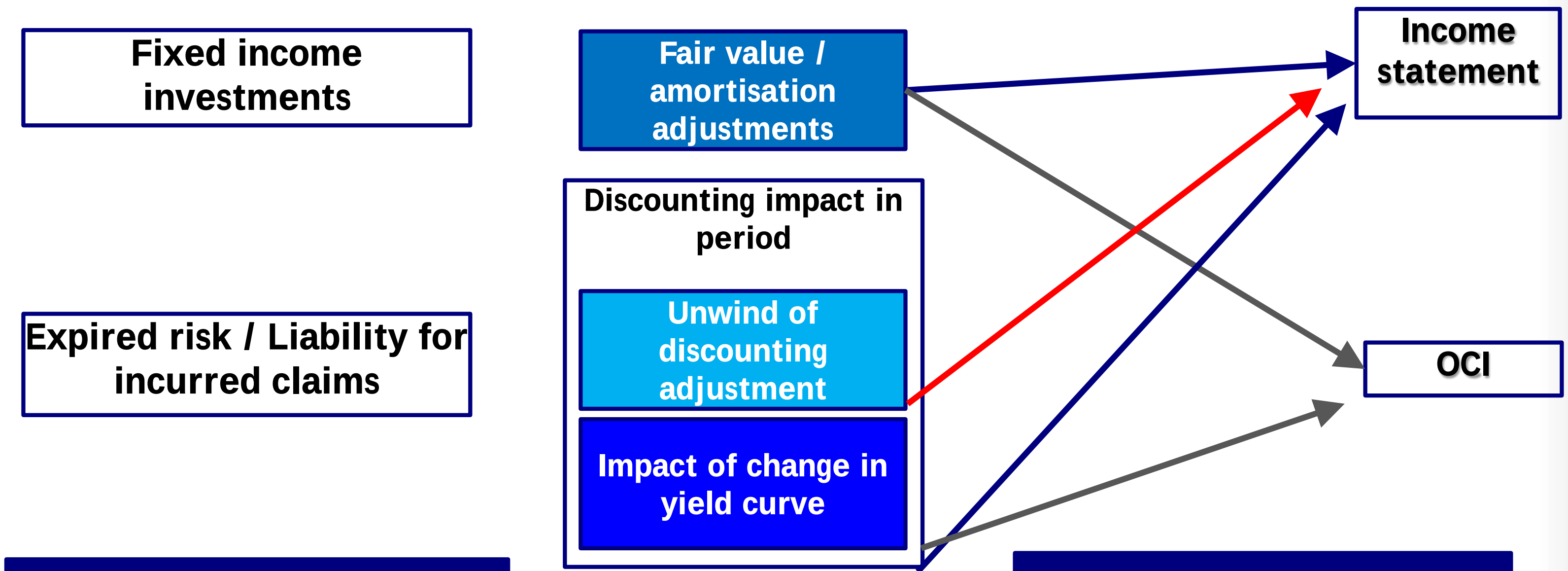
General model
Contractual Service Margin
Risk adjustment
Discounting
Best estimate of fulfilment cash flows

* No discounting is required if cash flows are expected to be received/ paid within one year.

Other Comprehensive Income (“OCI”)
Options under IFRS 17

Option 1
Option 2
Mandatory

IFRS 17 allows you to choose where to recognise the discounting of reserves. Either in the Income Statement or through the OCI. Similarly IFRS 9 allows you to choose, under certain conditions, where to book the fair value movements, either in the Income statement or OCI.



Option 1 - Fair value through profit and loss

Volatility will exist both with duration and currency mismatches.

Option 2 - OCI

The storing of the ‘initial discount rate’ adds complexity

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IFRS 17 reporting and disclosures

New financial statement presentation

General ledger changes: *New primary statement presentation and reconciliations may require amendments to existing chart of accounts and consolidation schedules.*

Impact on KPIs: *Traditional measures such as written premium disappear replaced by a single measure of revenue. Financial KPIs may require redefining as a result of IFRS 17.*

Primary financial statements

- *P&L to comprise insurance contract revenue, incurred claims and other expenses and investment components*
- *Balance sheet to comprise insurance and reinsurance contract assets and liabilities (DAC and UPR disappear)*

Nature and extent of risks

- *Nature and extent of risks*
- *Concentrations of insurance risk and claims development*
- *Relationship between interest on insurance contracts with investment return on related assets*

Reconciliations

- *Liabilities for the remaining coverage period*
- *Liabilities for incurred claims*
- *Premiums received and insurance contract revenue*

Significant judgements

- *Processes to estimate inputs to methods*
- *Effect of changes in methods and inputs*
- *Confidence level for determining risk adjustment*
- *Yield curve(s) used to discount cash flows*

Current IFRS Income statement	**IFRS 17 Income Statement**
Gross written premium	Insurance revenue
Reinsurance premiums	
Change in gross UPR	
Change in reinsurance UPR	
Underwriting and policy acq costs	
Gross claims incurred	Incurred claims and other expenses
Claims recoveries from reinsurers	
Other operating expenses	
Underwriting result	**Insurance service result**
Investment income	Investment income
	Insurance finance expense
	Net financial result
Profit/Loss before tax	**Profit/Loss before tax**
Other Comprehensive Income	Other Comprehensive Income*
Total comprehensive income	**Total comprehensive income**

*** Includes optional presentation of discount rate changes on insurance liability**

Balance Sheet

Balance Sheet format is largely unaffected but Insurance Liabilities are a significant proportion of the Total Liabilities

Assets	Liabilities
Cash and cash equivalents	Derivatives
Derivatives	Liabilities associated with assets held for sale
…	Financial liabilities at FC through PL
Financial assets at FV through PL	Investment contracts
Loans and receivables	Borrowings
…	Other financial liabilities
Investment property	Insurance contracts liabilities
Investments in associates	Insurance component
Insurance contracts assets	Investment component
Insurance component	Reinsurance contracts liabilities
Investment component	Insurance component
Reinsurance contracts assets	Investment component
Insurance component	Employee benefit liabilities
Investment component	Current income tax liabilities
Property and equipment	Deferred income tax liabilities
Intangible assets	Provisions
Current income tax assets	Other liabilities
Deferred income tax assets	**Total liabilities**
Other assets	Share capital
	…
	Total Equity
Total assets	**Total liabilities and equity**

Separate presentation of insurance contracts in an asset and liability position assessed at portfolio level

Ceded reinsurance contracts are presented separately from insurance contracts

DAC / UPR and some intangibles not separate assets but part of fulfilment cash flows

Income Statement

Under the PAA model, insurance contract revenue is determined as the recognition of expected premium receipts allocated to each period of coverage based on passage of time or pattern of risk should this be significantly different.

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Current unbiased probability weighted estimates of present value of future cash flows

Acquisition Costs

Risk adjustment

Contractual service margin

	Insurance revenue	**+**	**Actual experience and interest expense**	**=**	**Profit or Loss**
+	Expected claims and benefits*	-	Actual claims and benefits incurred	+/-	Differences between expected and actual claims and benefits
+	Expected expenses*	-	Actual expenses incurred	+/-	Differences between expected and actual expenses
		+/-	Changes in estimates of past claims	+/-	Changes in estimates of past claims
+	Acq. cost amortization*	-	Acq. cost amortization		
+	Amortization of risk adjustment*			+	Amortization of risk adjustment
+	Amortization of contractual service margin*			+	Amortization of contractual service margin
		-	Other costs (non attributable expenses) and overheads	-	Other costs (non attributable expenses) and overheads
			Investment income less Interest expense on liability		Investment income less Interest expense on liability

* **Including discount unwind**

Applying IFRS 17 for the first time

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Retrospective application

When historical data exists and hindsight is not required

Modified retrospective approach

When not all historical information is available but information about historical cash flows is available or can be constructed

Fair value approach

When no historical information about cash flows is available

Tax implications - profit / tax profile

Tax is driven by legal entity accounts so the impact for tax will depend on what GAAP is adopted in these accounts/territories.

The transitional adjustment is likely to be taxed but it is yet to be determined whether tax law will allow for the smoothing of any opening BS adjustments.

Profit emergence is likely to change, hence the potential for different tax rates to be applied to the recognition of profit or absorption of deferred tax assets.

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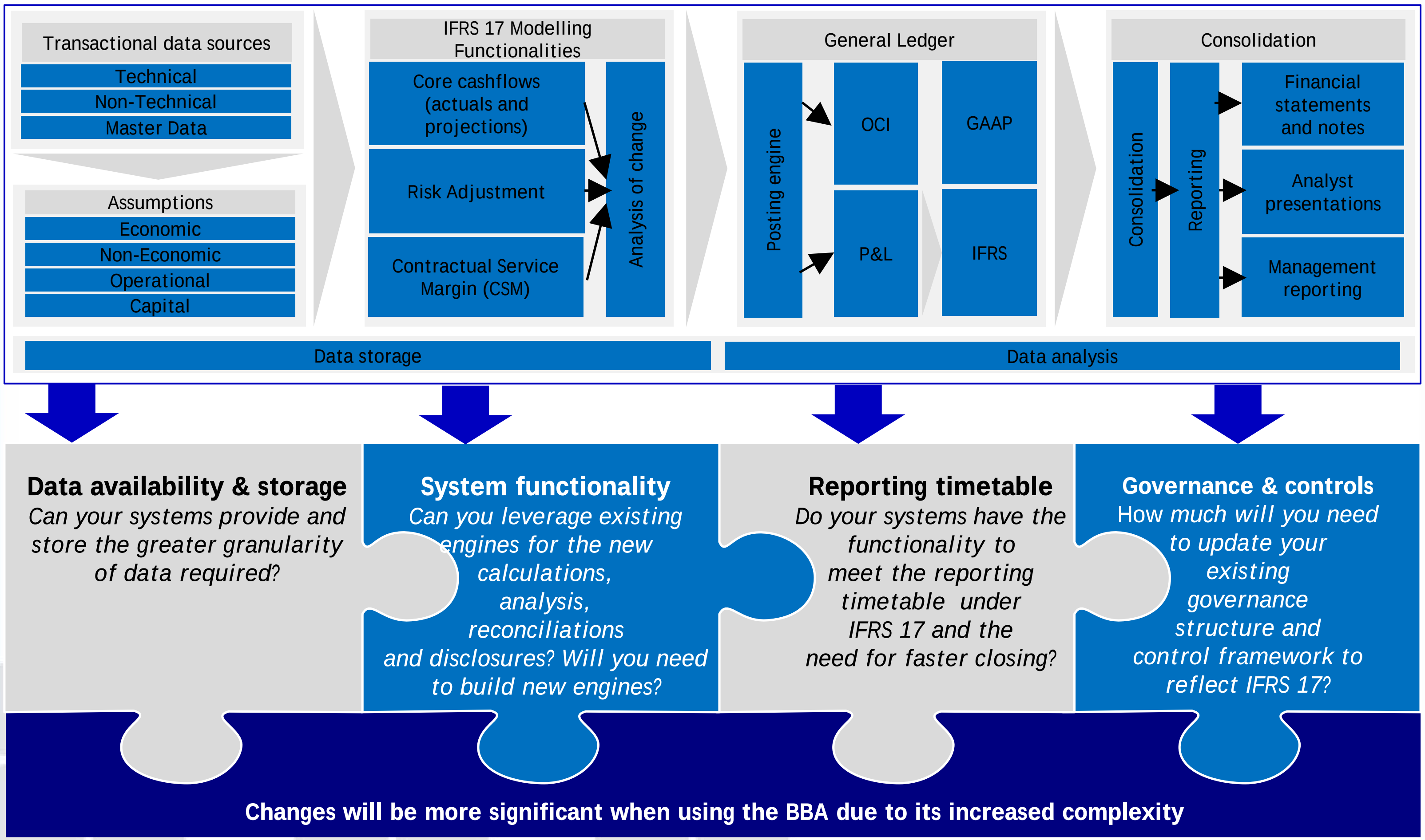
IFRS 17 operational and system impacts

Finance and actuarial systems and processes

Significant change from end to end…



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