3rd Capacity Building Seminar on IFRS 17
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Ind-AS-117 Transition – Fair Value Measurement Approach

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Agenda

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A) IFRS 17 – Fair value approach for Transition
- Transition Date and Overview
- Permitted modification for FV
- Retrospective Vs Fair Value approach

B) Introduction to IFRS 13
- Definition
- Framework
- Input Heirarchy
- Measurement techniques

C) Practical issues in applying IFRS 13 for Fair value calculations
- CSM under fair value appraoch
- Disclosures

IFRS 17 – Fair value approach for Transition

Applying IFRS 17 for the first time

Global - 01 Jan 2021	Global -01 Jan 2022
India - 01 Apr 2019	India - 01 Apr 2020*

Transition date

Beginning of the annual reporting period immediately preceding the date of initial application

Date of initial application

Beginning of the annual reporting period in which an entity first applies IFRS 17

*** Initial Application date in India is uncertain as it stands today**

IFRS 17 – Fair value approach for Transition

Transition - Overview

Decide transition method by group of contracts

Full retrospective approach (FR)

If impracticable

OR

Fair value approach (FV)

- When full retrospective approach is impracticable
- Only option if historical information about cash flows is NOT available to calculate the CSM/LC

Modified retrospective approach(MR)

- Modifications available if necessary given reasonable and supportable information
- Maximises use of available information

Examples of transition variations (Illustrative)

Prior periods			IFRS 17 Effective date
Fair value	Modified retrospective	Fully retrospective	Transition CSM #1
Fair value	Modified retrospective	Fully retrospective	Transition CSM #2
Fair value	Modified retrospective	Fully retrospective	Transition CSM #3

IFRS 17 – Fair value approach for Transition

Modifications permitted for fair value approach

Following determinations may be **applied at transition date** rather than inception date, if sufficient information is not available at inception date

Grouping of Contracts	Identification and grouping of insurance contracts based on “similar risks and managed together“ and “Profitability“ based on information at transition date
Measurement model	Determination of whether an insurance contract is eligilbe to use the VFA based on information at transition date
Discount rate	Determination of Discount rates at the transition date and lock them for future use
Yearly cohorting	Grouping together contracts that are more than one year apart

IFRS 17 – Fair value approach for Transition
Retrospective vs Fair Value approach

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Challenge is to find an optimised approach

Operational transition efforts

Profitability after transition

	Retrospective Approach	Modified Retrospective Approach	Fair Value Approach
Principles / Judgement	Least Complex	Less Complex	Complex
Application	Most Difficult	Less Difficult	Least Difficult
Relative value of CSM	Highest	Can't Say	Least
OCI and Loss component at balance sheet date	OCI and Loss component Built up	OCI and Loss component Built up	OCI can be accumulated or set to zero

Introduction to IFRS 13

Fair Value approach - Definition

- Definition – IFRS 13 defines fair value as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date
- Fair Value = as determined by IFRS 13 ('**exit price on going concern basis**')

Other Fair Value definitions – e.g. Solvency II

The amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction ?

Description

It did not specify whether an entity is buying or selling the asset
It specifies that the entity is selling the asset

It was unclear about what "settling" meant because it did not refer to the creditor
It refers to the transfer of a liability

It is not a forced or distressed sale

It was unclear about whether it was market-based
It is clear it is market-based

It did not state explicitly when the exchange or settlement takes place
It states explicitly when the sale or transfer takes place

IFRS 13 "Fair Value" definition

… the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

FV measurement framework (Only IFRS 17)

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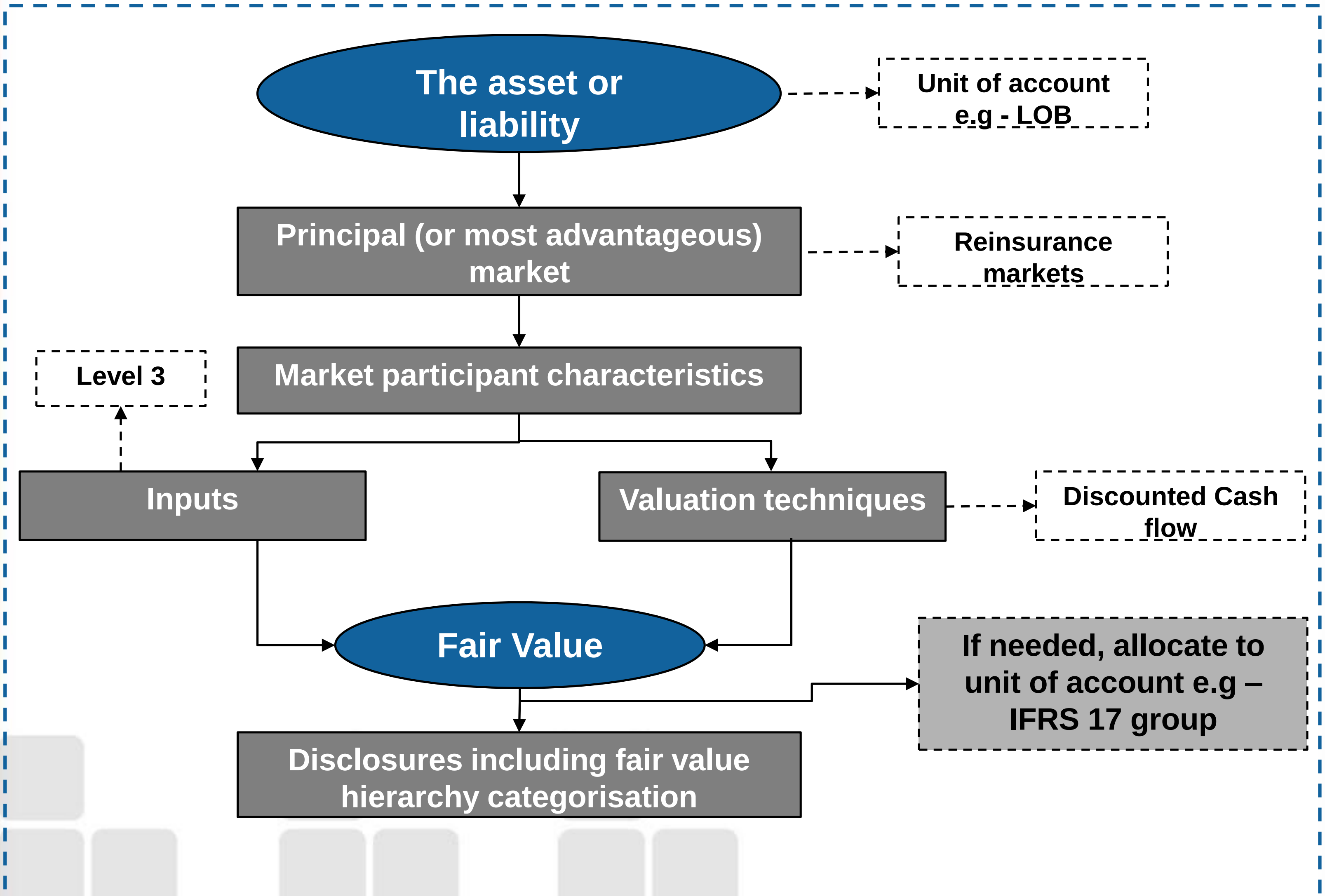

Introduction to IFRS 13
Input Hierarchy

	Level 1	Level 2	Level 3
Definition	Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date	Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly	Unobservable inputs to valuation techniques

- IFRS 13 does **<u>not specify the measurement model</u>** to use but requires to:
  - **Maximize the use of level 1 inputs (i.e. Directly observable inputs)**
  - **Minimize the use of Level 3 inputs**
- For disclosure purposes, the fair value measurement must be categorized in its entirety based on the <u>lowest level input</u> that is <u>significant</u> to the entire measurement
- Fair value measurement of insurance contracts would usually require level 3 inputs; specially with respect to non markets variables.
- Likely to be characterized as **level 3**

Introduction to IFRS 13
Measurement Techniques

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Market Approach (Price and other relevant information)

- Transaction price paid for an identical or a similar instrument
- Comparable company valuation multiples

- Prices for insurance contracts are rarely observable
- Secondary markets for insurance products exist in UK
- But do not exist in developing markets
- Fair value of insurance contracts needs to be estimated

Income Approach (Discounted future cash flows)

- **Discounted cash flow method (DCF) – Consistent with IFRS 17 FCF measurement**
- Dividend discount model
- Option Pricing models

- The fair value of a group of insurance contracts can be seen as the fulfilment cashflows adjusted to take into account the perspective of market participants (i.e. move to an exit price)
- **Fair value = BEL_{MP} + RA_{MP} + adjustments**
- **CSM/LC = Fair Value – BEL_{IFRS17} – RA_{IFRS17}**

Cost Approach

- Replacment Cost of asset

- Amount that would be required currently to replace the service capacity of an asset
- This method is not applicable to insurance liability valuation

Measurement Techniques – when there is no replicating asset

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Two possible ways to approach it:

1. Use the future cash flows that a market participant would expect to incur in fulfilling the obligation, including the compensation that a market participant would require for taking on the obligation.

Such compensation includes:

- the cost to fulfil the obligation plus a return for undertaking the activity; and
- a risk premium to compensate for the risk that actual cash flows might differ from expected cash flows.

2. Use the amount that a market participant would receive to enter into or issue an identical liability or equity instrument

Practical issues in applying IFRS 13 for Fair value calculations of Insurance Liabilities- 1/3

Requirements - IFRS 13	Notes / allowance as per IFRS 17
The price is based on a hypothetical transaction in the principal market /most advantageous market	Market participants are limited to other insurers/reinsurers that would be able to complete a transaction
An estimate of future cash flows for the asset or liability	GPV + adjustment to expense assumptions and cashflows outside IFRS 17 contract boundaries to reflect the view of market participants
Market participant's expectations about possible variations in the amount and timing of the cash flows- representing the uncertainty and including diversification benefit	Market participant will have a different view of uncertainty- Different Risk Adjustments

Practical issues in applying IFRS 13 for Fair value calculations of Insurance Liabilities- 2/3

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Requirements - IFRS 13	Notes/ allowance as per IFRS 17
Discount rates consistent with nature and timing of contract's cash flows	IFRS 17 discount rates adjusted for - entity's own credit risk - market participant view in illiquidity premium.
Include compensation that a market participant would require for taking on the obligation	Allowance for shareholder required returns on backing capital
Apply demand deposit floor on the fair value of financial liabilities	IFRS 17 does not require demand deposit floor to apply when calculating fair value

Practical issues in applying IFRS 13 for Fair value calculations of Insurance Liabilities- 3/3

Requirements - IFRS 13	Notes/ allowance as per IFRS 17
When price is not observable, measure fair value using other valuation techniques	Embedded value gives the combined fair value of assets and liabilities Suitable for - Business combinations Not Suitable for transition - we need only fair value of liability

CSM under Fair Value Approach

Fulfilment Cashflow (FCF) = Best Estimate Liability (BEL) + Risk Adjustment (RA)

Fair Value (FV) = BEL* + RA* + Cost of Capital (CoC)

CSM = FV – FCF ~ **CoC**

* Adjusted

Additional Disclosures required by IFRS 13

Contracts under scope of IFRS 13	Separate disclosures are required for insurance contracts to which the fair value approach was applied at transition
Modifications adopted	What transition modifications were used for fair value measurement at transition date
Measurements models	Explain how insurance contracts were measured at the transition date
Initial and subsequent measurement	Fair value measurement takes place at transition date only and therefore the disclosure requirements may have limited applicability.

Thank you