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Navigate the new world of IFRS 17 Insurance Contracts

In May 2017 the IASB issued the long awaited IFRS 17 Insurance Contracts – after some 20 years of discussion, several exposure drafts and discussions. IFRS 17 replaces IFRS 4, which currently permits a wide variety of practices. IFRS 17 does not only introduce a new measurement model for insurance contracts but will give users of financial information a whole new perspective on insurance companies' financial statements. What does a member of the board of directors has to expect?

A short overview on the new measurement models

Applying the general model (Building Block Approach "BBA") on initial recognition, the liability of a group of insurance contracts is made up of the following components.

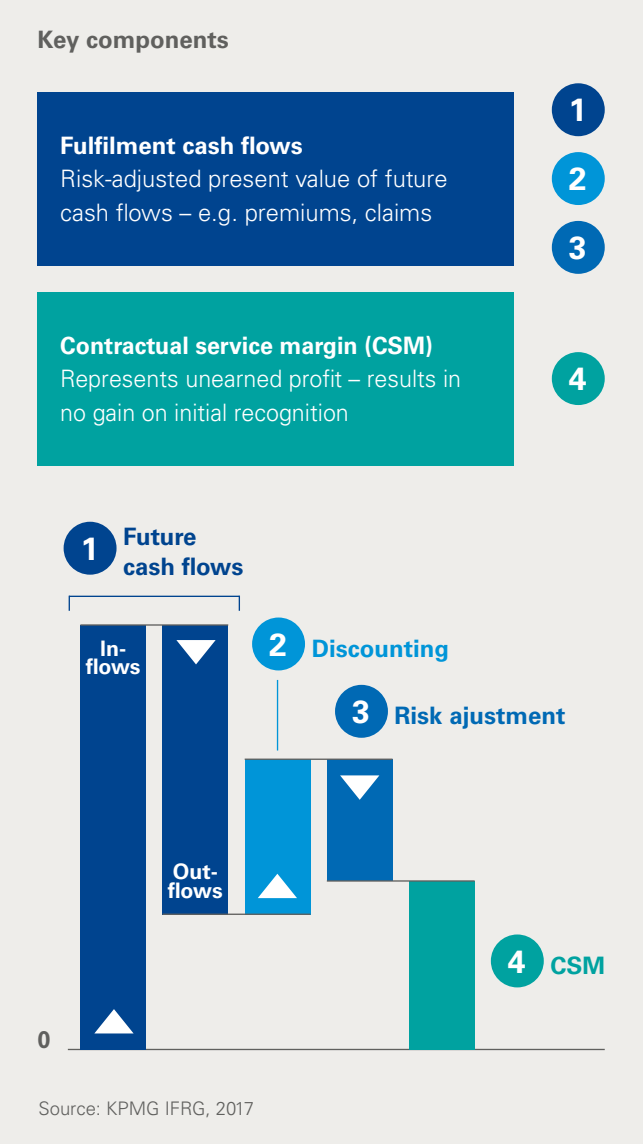
a. The fulfilment cash flows, which represent the risk-adjusted present value of the entity's rights and obligations to the policyholders, comprising:
   - current, explicit, unbiased and probability-weighted estimates of future cash in- and outflows (e.g. premiums, payments to policyholders; insurance acquisition, claims handling, policy administration and maintenance costs etc.);
   - discounting to reflect time value of money (consistent with observable market prices and reflecting the cash flows' characteristics and the contracts' liquidity); and
   - an explicit risk adjustment for non-financial risk.

b. The contractual service margin (CSM), which represents the unearned profit the entity will recognise as it provides services over the coverage period. A loss at inception would be recognised immediately in profit or loss.

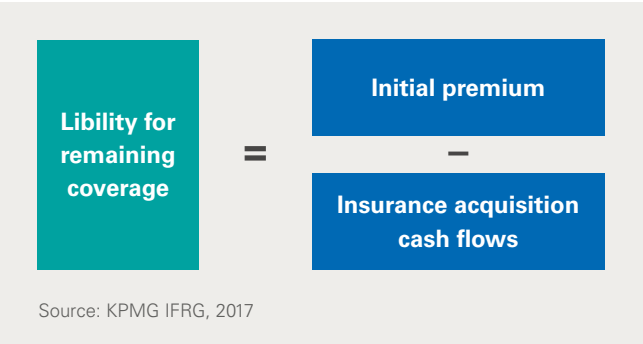
The general model represents a current measurement model, where estimates are remeasured in each reporting period. Changes in cash flows related to future services should be recognized against the CSM. Changes in discount rate and other financial risk related assumptions are recognised either in profit or loss or in other comprehensive income.

An insurance company is allowed to apply the Premium Allocation Approach ("PAA") (a simplified model) if the coverage period for the contracts in the group is one year or less or if the PAA represents a reasonable approximation to the general model. The PPA measures the liability for the remaining coverage as the amount of premiums received net of acquisition cash flows paid, less the amount of premiums and acquisition cash flows that have been recognised in profit or loss over the expired portion of the coverage period on the passage of time.

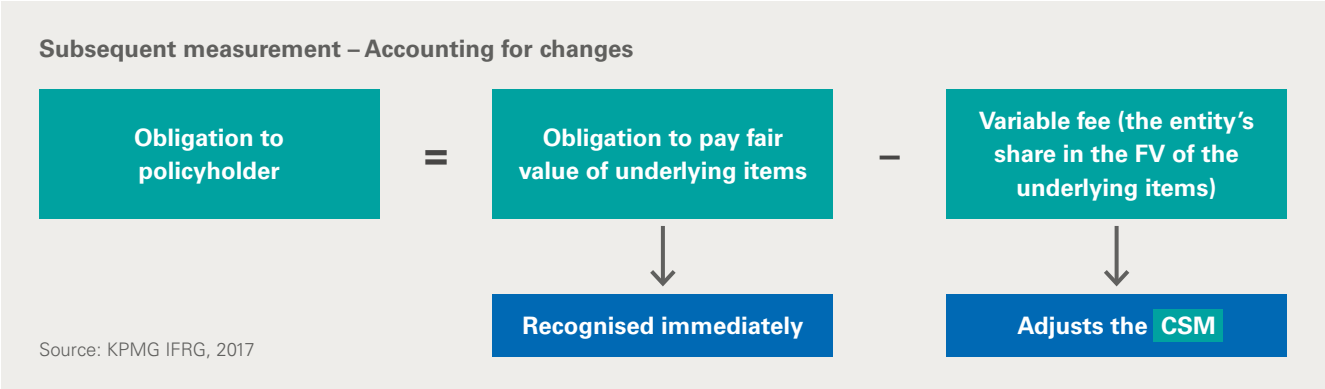
However, claims incurred are measured based on the Building Block Approach (discounted, risk adjusted, probability-weighted cash-flows).



Source: KPMG IFRG, 2017



Source: KPMG IFRG, 2017



The PAA shares some similarities with the current accounting model for short-duration contracts under US GAAP (Unearned Premium Approach) and therefore with models used by many insurers under IFRS 4. Many general insurers are currently assessing if and how their non-life insurance contracts fit under the PAA. We see a clear tendency of insurance companies preferring the PAA over the BBA.

Life insurance contracts will probably be accounted for under the BBA, because their coverage periods are significantly greater than one year. However direct participating contracts (contracts that share returns on underlying items with the policyholder, e.g. group life business in Switzerland) are measured using the Variable Fee Approach ("VFA"), a variation of the general model. The insurer applies the BBA on initial recognition in the same way as applied to other long-term contracts, but for subsequent measurement the CSM is adjusted for an amount equal to the change in the fair value of the underlying items less the change in fulfilment cash flows.

In Switzerland we see a clear tendency whereby the life insurers seek to apply the VFA not only to the group life business where the legal quote applies but also to the individual life business. They argue that also for the individual life business the market forces them to pay the policyholder an amount equal to a substantial share of the fair value returns on the underlying investments and a substantial portion of any change in the amounts paid to the policyholder vary with the change in the fair value.

Key impact of IFRS 17 from a board member's perspective

IFRS 17 introduces major changes to the presentation of profit or loss. The current practice of recognising revenue as written or earned premiums will no longer apply. Investment components do not represent consideration for providing services and are therefore not included in the insurance revenue. Going forward the insurance revenue is the sum of:

- all changes in the liability for remaining coverage in the period that relates to services for which the entity expects to receive consideration;
- the changes in the risk adjustment for non-financial risks relating to the past and current services; and
- the amount of the CSM recognised in profit or loss.

Insurance service expenses consisting of actual claims incurred and of insurance acquisition expenses are recognised when incurred. The resulting insurance service result is distinguished from the insurance finance income and expense which includes the investment income, the unwind of discount and any changes in financial risk assumptions if recognised in profit or loss (accounting policy choice).

IFRS 4	
Premiums	X
Investment income	X
Other comprehensive income	X
Incurred claims	(X)
Change in insurance contract liabilities	(X)
Profit or loss	**X**
Comprehensive income	**X**

IFRS 17	
Insurance revenue	X
Investment result	X
Incurred service expenses	(X)
Insurance finance expenses	(X)
Insurance service result	**X**
Net finance result	**X**
Profit or loss	**X**
Other comprehensive income	X
Comprehensive income	**X**

Source: KPMG IFRG, 2017

The new measurement model results in profits being released over a significantly different pattern than under the old model. The accounting policy choice about where the effects of using current market discount rate will be recognised will increase volatility in profit or loss and equity. Economic mismatches resulting from asset-liability durations will become visible.

The new presentation and disclosures will change the way performance is communicated. Insurance companies will need to design new KPIs and educate internal and external stakeholders.

Further key impacts

The need for new data, updated systems and processes will be challenging considering the long time horizon over which many insurers operate and the legacy systems that many still use.

However, change brings opportunities. Many insurers take the opportunity to revisit their systems and processes and use the IFRS 17 implementation project as a chance to reconsider their finance operating model aiming to streamline processes, centralize und unify to achieve cost reductions.

It is time to get started

The implementation of IFRS 17 will require substantial effort, new systems and processes. An effective coordination between Finance, Actuarial and IT will be essential: actuaries need to speak accounting and accountants understand actuarial! However, IFRS 17 will impact insurers not only in finance, actuarial and IT but insurers might reconsider product design and distribution, their budgeting and business planning, incentives and remuneration etc. It's time to get started – 1 January 2021 is not that far away!

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