IFRS 17
A simplified approach?

Understand the detail and make it work for you.

Background

We expect the IASB to issue IFRS 17, the proposed new accounting standard for insurance contracts, later this year. If this happens, the new standard is likely to be effective from 2021.

IFRS 17 will include a simplified approach to the measurement of liabilities for remaining coverage (the premium allocation approach, 'the PAA'). The PAA may be applied to groups of contracts if:

- the coverage period is one year or less, or
- the PAA is expected to provide a measurement of the liability for remaining coverage that is not materially different to that produced by the IFRS 17 general measurement model.

The PAA is intended to be simpler to apply than the standard's general measurement model and may appear similar to current accounting in some jurisdictions.

However, while it might initially seem that little will change, a look below the surface reveals some challenges for insurers expecting to apply the PAA to most contracts.

Executive Summary

As general insurers emerge from their year-end reporting, they are starting to think seriously about IFRS 17 to understand better the road to implementation that lies ahead.

For many, the first step is getting to grips with the eligibility criteria for the PAA, understanding any work required to demonstrate eligibility and getting an early view of any business to which the PAA won't be applied.

Even where insurers apply the PAA, they will still face challenges. In most cases IFRS 17 will require them to account for losses on insurance business at a more granular level, and accounting for incurred claims will be more complex and transparent.

In this short briefing paper, we present our latest thinking on the key challenges the general insurance industry faces in implementing IFRS 17. We focus on nine key areas that could have the biggest impact on finance systems, processes and operations:

1. Eligibility for the PAA
2. Increased granularity of accounting
3. Packaged products and contracts with different rights and obligations
4. Acquisition costs
5. Claims reserving: alignment with Solvency II
6. IFRS 17 OCI option and IFRS 9
7. Presentation and disclosure
8. Accounting for a CSM on acquired claims liabilities
9. Increased governance driving accelerated processes

1. Eligibility for the PAA

Many insurers issue multi-year contracts, which won't qualify for the PAA based solely on duration. This applies particularly to those writing risks covering industries such as construction, shipping and energy, and those with inward reinsurance business written on a risk attaching basis.

Insurers wishing to apply the PAA to these contracts will need to demonstrate that they meet the other eligibility criteria.

Operational considerations
For any such multi-year contracts, it might be necessary to model on transition to determine whether the PAA will provide no material difference in valuation to the IFRS 17 general measurement model.

BAU processes will also be needed to confirm continued eligibility year-on-year for new business. If insurers design these correctly at the outset, a top-down approach focused on key elements of change may make the process easier.

2. Increased granularity of accounting

Under the PAA, insurers must immediately recognise losses on groups of contracts that are onerous at inception in the income statement. Although this is conceptually similar to some existing practices, it's likely that insurers will need to identify and account for onerous business at a more granular level, with IFRS 17 limiting the extent to which profitable contracts can offset loss-making ones.

Specifically, they will need to divide contracts into portfolios (comprising contracts that are subject to similar risks and managed together as a single pool) and then further into at least three groups:

- contracts that are onerous at inception
- contracts with no significant risk of becoming onerous
- other 'profitable' contracts.

There is an exemption from the requirement to divide contracts between these groups where profitability differences are due to regulatory or legal constraints on pricing contracts based on specific characteristics, such as gender or age.

In addition, insurers cannot group together contracts issued more than 12 months apart.

Operational considerations – identifying onerous contracts
Most general insurers will not be able to identify groups of onerous contracts at the level of detail required by IFRS 17 through current reserving processes, as reserving typically takes place by peril or risk type rather than by 'portfolios' or groups of contracts.

Possible solutions to this include:

- Using pricing data to identify onerous contracts. Insurers would need to base this on a robust understanding of the differences between reserving and pricing loss ratio data, to identify onerous contracts according to IFRS 17 measurement principles. They would also need to formalise this process, backed up by documented evidence, and could bring pricing information into the scope of audit.
- A detailed reserve allocation process whereby insurers apportion risk-adjusted, present value cash flows calculated at a higher level to more granular groups of contracts. This may be achievable by using data on the distribution of different groupings of policies around mean loss ratios. This would also probably be reliant on underlying pricing data.

3. Packaged products and contracts with different rights and obligations

Some insurers may enter into:

- multiple contracts, with one premium covering the whole 'package', or
- individual contracts containing separate rights and obligations, managed by the customer.

In both cases, IFRS 17 may require insurers to consider the business in a new way to identify any onerous elements that they need to account for separately.

Operational considerations
New processes and methodologies may be needed to allocate premiums between either different components of individual contracts or different contracts sold to customers as a package. Insurers might have to develop new processes to capture the required system tagging data at source.

4. Acquisition costs

Under the PAA, for contracts with a coverage period of one year or less, insurers can choose whether to effectively defer acquisition costs that are directly attributable to portfolios of contracts. This is narrower than the definition currently used by some insurers, who may also defer costs that are not directly attributable to portfolios.

Ability to identify acquisition costs that are directly attributable to portfolios
On transition, insurers may need to make a potentially significant effort to develop the processes required to identify acquisition costs in accordance with the IFRS 17 definition – and then allocate these to IFRS 17 groups of contracts on an ongoing basis.

Will losses for onerous contracts be higher if acquisition costs are deferred?
Under the PAA, the loss on a group of onerous contracts to be recognised in the income statement is measured as the difference between:

- the liability for remaining coverage (which is net of any deferred acquisition costs)
- the contract's fulfilment cash flows.

As deferring acquisition costs reduces the liability for remaining coverage, it may increase the loss recognised in the income statement for onerous contracts.

Other financial considerations
Other financial considerations will influence the decision on whether to defer acquisition costs, including the impacts on reported profits, taxable profits and net assets.

5. Claims reserving: alignment with Solvency II?

For some insurers, measuring incurred claim liabilities under the IFRS 17 PAA approach will become more like the valuation under Solvency II. This may provide opportunities to align aspects of the two valuation bases, although insurers should weigh up any benefits of doing so against other financial and operational considerations.

The extent of any alignment will be an important design decision in insurers' implementation programmes. There are key considerations for policy decisions relating to the discount rate and the risk adjustment.

Discount rate
Under the PAA, insurers must discount claims liabilities not expected to be settled in the next 12 months using a rate that reflects the characteristics of the liability, although the specific rate is not defined. Under Solvency II, technical provisions must also be discounted to take account of the time value of money, but the regulator prescribes the risk-free interest rate curve to use, with no allowance made for illiquidity.

General insurers may feel that an allowance for illiquidity in the IFRS 17 discount rate is appropriate in some cases, particularly for longer tail liabilities. This could provide a more realistic valuation of insurance liabilities compared to Solvency II, although insurers would need to build the ability to apply multiple discount rates into year-end reporting processes.

Composite insurers might also want to consider whether to adopt a consistent approach to discounting both life and non-life business.

Risk adjustment
Under IFRS 17, insurers must apply an explicit risk adjustment (for non-financial risk) to claims liabilities, although the method by which this adjustment is calculated is not prescribed.

Even if alignment with the Solvency II risk margin is technically acceptable under IFRS 17, insurers may prefer to adopt a methodology that allows management to use its own internal models to capture more accurately the specific and complex risks faced, rather than using the prescribed Solvency II risk margin calculation.

Given the income statement impact of the IFRS 17 risk adjustment and required disclosure in the report and accounts, management might require more detailed risk adjusted claims liability data than they do for Solvency II. The ability to meet this demand within financial statement reporting timeframes will probably depend on the approach taken to the risk adjustment:

- A risk adjustment that is independent of the Solvency II SCR could be calculated at the level of detail required off-cycle, thereby reducing on-cycle production timeframes.
- However, a risk adjustment that is dependent on a hard-close standard formula SCR may not be ready until relatively late in the year-end close process based on current Solvency II processes, so it might become necessary to accelerate these processes.

6. IFRS 17 OCI option and IFRS 9

Under IFRS 17, insurers will be permitted to recognise in Other Comprehensive Income (OCI), the impact on insurance liabilities of changes in discount rates in the period. For insurers with significant long-tail liabilities this may represent an opportunity to take some volatility out of reported profit or loss, if used in combination with the 'fair value through OCI' financial asset classification under IFRS 9, the forthcoming financial instruments standard.

Insurers should consider the IFRS 17 OCI option together with the accounting for financial assets under IFRS 9, as both have related financial and tax implications, and potentially large operational consequences.

Operational considerations
Using the IFRS 17 OCI option could have significant implications for data, systems and processes supporting claims liabilities, with insurers possibly needing to be able to:

- store discount rates applicable at the date each claim is incurred, which could be particularly complicated for IBNR claims
- calculate the impact of changes in discount rates at each reporting date
- record the cumulative impact of discount rate changes for each claim over time.

The operational impacts to consider in relation to IFRS 9 primarily arise for any assets which are not accounted for at 'fair value through profit or loss', for which it might be necessary to perform potentially complex testing relating to asset classification and impairment.

7. Presentation and disclosure

IFRS 17 will transform the presentation of insurers' income statements and bring disclosure requirements that will be new to many, including:

- detailed analyses of movements in insurance liabilities during the period
- reporting of 'investment components' separately from insurance contract revenue and insurance contract expense
- disclosure of the confidence level that the total insurance liabilities represent.

Most important may be the new requirement to disclose confidence levels in insurance liabilities. This will bring greater transparency to an area of reporting that has traditionally been opaque and may require significant thought about investor messaging, with margins and releases in reserves becoming more transparent.

Operational considerations
Operational considerations arising from the IFRS 17 disclosure requirements include:

- how and when to perform the modelling and calculations required to produce the required numbers
- data management capabilities and downstream data feeds
- updates to the accounting rules engine and the chart of accounts
- establishing suitable governance procedures, particularly around sensitive disclosures (such as confidence level).

A transformed income statement and new disclosure requirements

An unfamiliar income statement

Insurance contract revenue	X
Insurance service expenses	(X)
Underwriting result (Gross margin)	**X**
Investment income	X
Insurance finance expense (i.e. Interest on insurance liability)	(X)
Profit or loss	**X**
Other comprehensive income:	
Change in insurance contract liability due to changes in discount rate	X
Fair value movements on FVOCI assets	(X)
Total comprehensive income	**X**

Reconciliation of opening and closing liabilities

Liabilities for incurred claims	
Opening balance	**X**
Incurred claims	X
Accretion of insurance investment expense	X
Adjustments to liabilities for incurred claims	X
Release of risk adjustment included in liability for incurred claims	(X)
Claims paid	(X)
Separate lines for other material reconciling items	*(X)*
Closing balance	**X**

8. Accounting for a CSM on acquired claims liabilities

Insurers cannot apply the PAA to acquired claims liabilities such as those acquired in a portfolio transfer or in a business combination. Instead, they should apply the IFRS 17 general measurement model, which means they would need to establish and account for a contractual service margin (or CSM, a type of unearned profit under IFRS 17) where a profit is expected.

Operational considerations
Accounting for a CSM, whether in relation to acquired claims liabilities or otherwise, brings operational complications. Specifically for acquired claims liabilities, operational complexities include the possible need to:

- identify changes in estimated fulfilment cash flows and the associated risk adjustment, to 'unlock' the CSM in each reporting period
- record the discount rate applicable at the acquisition date to accrete interest on the CSM
- track the history of any amounts recognised in profit or loss due to the CSM being exhausted.

The challenge may be greater for acquired claims liabilities with longer settlement periods, with a potentially significant amount of effort required on transition and processes embedded into future M&A activity.

9. Increased governance driving accelerated processes

Under IFRS 17, reported profit will be directly impacted by the risk adjustment and any discounting applied to claims liabilities, and new, more detailed reserving outputs will be disclosed publicly for the first time.

These factors may drive closer management scrutiny and tighter governance over these new public disclosures – especially straight after implementation. Possible process impacts of this are:

- Reserving committees may want to review discounted, risk-adjusted reserves at a granular level early in the year-end close process, which for some insurers could represent a step-change from existing Solvency II processes.
- Any acceleration in the internal governance timetable could increase the importance of performing detailed actuarial reserving work off-cycle, with the year-end close process used to update financial assumptions and check for significant changes in other assumptions, rather than performing a full hard-close bottom-up reserving exercise on cycle.
- Any redesign of the actuarial close process could present an opportunity to introduce or increase automation, removing low level manual data manipulation (often performed by skilled actuarial resource). This may increase capacity to focus on providing timely business insight to support the review of the more granular IFRS 17 accounting disclosures.

Don’t forget the financial implications

As well its operational implications, there will be financial consequences associated with IFRS 17 that CFOs need to get to grips with.

There will be increased transparency of how insurance liabilities are measured, with explicit best estimate and risk adjustment components, and disclosure of the confidence level in total liabilities.

The volatility of reported IFRS profit is expected to change:

- Losses on onerous contracts will be recognised immediately.
- Liabilities will be discounted at current rates, although the impact on profit volatility will depend on whether insurers use the IFRS 17 OCI option and how they account for the related assets.

Although total profit through time will not change, opting not to defer acquisition costs could cause a drag on reported profit and combined ratios for growing businesses.

Insurers can also expect net assets to change on transition to IFRS 17, although the directional impact will depend on each insurer’s specific circumstances:

- Insurers that do not currently discount reserves but are required to do so under IFRS 17 may see a benefit to net assets on transition.
- Only costs that are directly attributable to portfolios of contracts can be deferred under IFRS 17, causing a hit to net assets on transition for insurers that currently defer costs outside of this definition. This hit will be greater if a policy of immediately expensing acquisition costs is adopted under IFRS 17.

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