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Insurance Accounting Alert

May 2017

IASB issues IFRS 17 - the new Standard for insurance contracts

What you need to know

- The IASB issued IFRS 17, a comprehensive new accounting standard for insurance contracts covering recognition and measurement, presentation and disclosure.
- The IFRS 17 model combines a current balance sheet measurement of insurance contract liabilities with the recognition of profit over the period that services are provided.
- Certain changes in the estimates of future cash flows and the risk adjustment are also recognised over the period that services are provided.
- Entities will have an option to present the effect of changes in discount rates either in profit and loss or in OCI.
- The standard includes specific guidance on measurement and presentation for insurance contracts with participation features.
- IFRS 17 will become effective for annual reporting periods beginning on or after 1 January 2021; early application is permitted.

Background

After a very long journey, the International Accounting Standards Board (IASB or the Board) issued IFRS 17 *Insurance Contracts* (IFRS 17). IFRS 17 will be mandatorily effective for annual reporting periods beginning on or after 1 January 2021. Once effective, IFRS 17 replaces IFRS 4 *Insurance Contracts* that was issued in 2005. The overall objective of IFRS 17 is to provide a more useful and consistent accounting model for insurance contracts among entities issuing insurance contracts globally.

In response to comments received on the 2013 revised Exposure Draft (2013 ED), the IASB revisited a number of aspects of its proposed model. The re-deliberations resulted in changes to several areas of the model, but the overall objective to measure insurance contracts on a current basis has been retained. The IASB concluded that the changes made in response to feedback received on the 2013 ED did not include any fundamental changes that constituents have not had the opportunity to comment on during development of the standard. The Board also noted that extensive consultations had taken place throughout the project. Therefore, the Board concluded it could issue the final standard without the need for further re-exposure.

This publication provides a summary of the main features of the final standard and highlights main changes compared to the 2013 ED.

Overview of the model

In contrast to the requirements in IFRS 4, which are largely based on grandfathering previous local accounting policies, IFRS 17 provides a comprehensive model for insurance contracts, covering all relevant accounting aspects. The core of IFRS 17 is the General (building block) Model, supplemented by:

- A specific adaptation for contracts with direct participation features (the Variable Fee Approach)
- A simplified approach (Premium Allocation Approach) mainly for short-duration contracts

This is illustrated in Exhibit 1.

The main features of the new accounting model for insurance contracts are:

- A measurement of the present value of future cash flows, incorporating an explicit risk adjustment, remeasured every reporting period (the fulfilment cash flows)
- A Contractual Service Margin (CSM) that is equal and opposite to any day one gain in the fulfilment cash flows of a group of contracts, representing the unearned profitability of the insurance contract to be recognised in profit or loss over the service period (i.e., coverage period)
- Certain changes in the expected present value of future cash flows are adjusted against the CSM and thereby recognised in profit or loss over the remaining contract service period
- The effect of changes in discount rates will be reported in either profit or loss or other comprehensive income (OCI), determined by an accounting policy choice
- A presentation of insurance revenue and insurance service expenses in the statement of comprehensive income based on the concept of services provided during the period
- Amounts that the policyholder will always receive regardless of whether an insured event happens (non-distinct investment components) are not presented in the income statement, but are recognised directly in the balance sheet
- Insurance services results (earned revenue less incurred claims) are presented separately from the insurance finance income or expense
- Extensive disclosures to provide information on the recognised amounts from insurance contracts and the nature and extent of risks arising from these contracts

The key aspects of the model are further explained below:

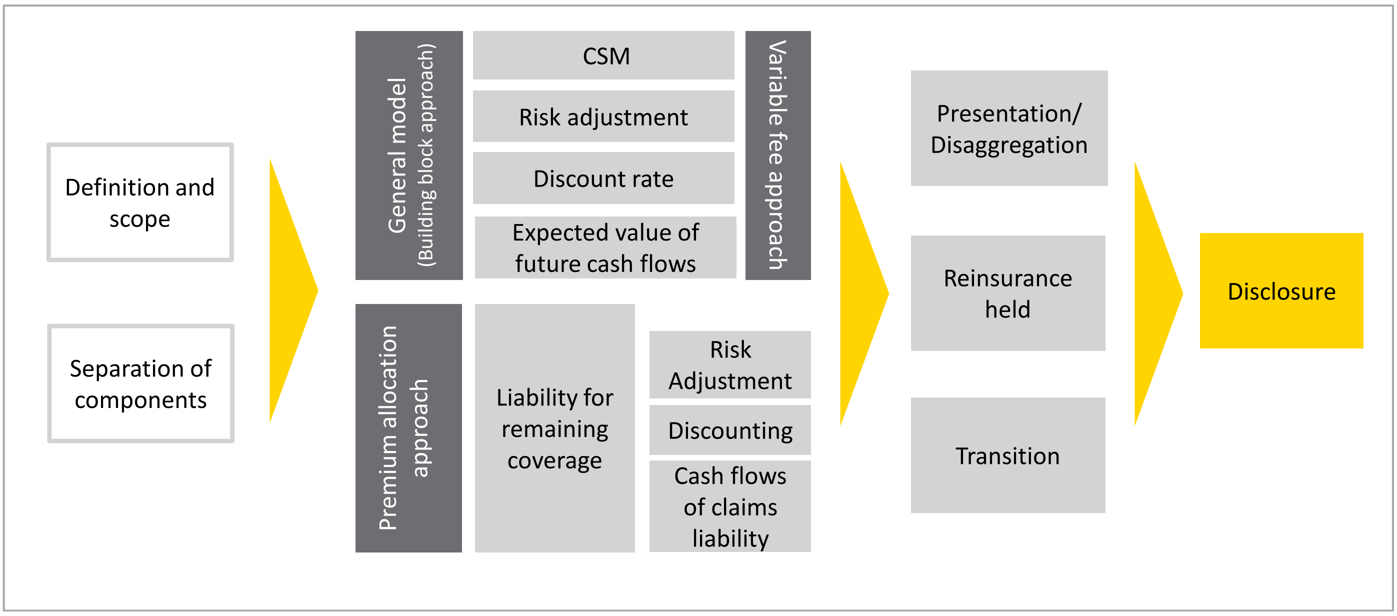
Scope

IFRS 17 applies to all types of insurance contracts (i.e., life, non-life, direct insurance and re-insurance), regardless of the type of entities that issue them, as well as to certain guarantees and financial instruments with discretionary participation features. A few scope exceptions will apply.

Separation of components

The term 'unbundling' is no longer used. Instead, the new standard refers to 'separating components from an insurance contract'. It requires entities to separate the following components from insurance contracts: (i) embedded derivatives, if they meet certain specified criteria; (ii) distinct investment components; and (iii) distinct performance obligations to provide non-insurance goods and services.

Exhibit 1: Overview of the IFRS 17 model



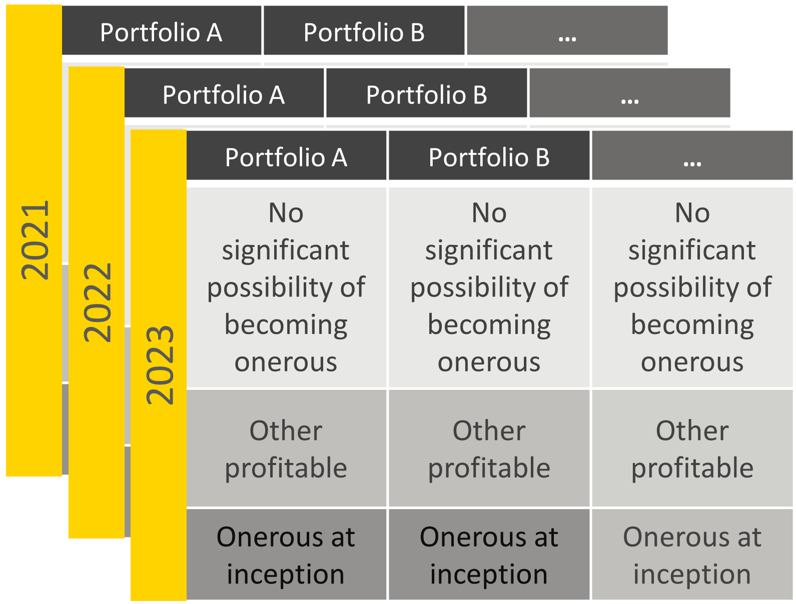
Level of aggregation

The standard defines the level of aggregation to be used for measuring the insurance contract liabilities and the related profitability. When deciding how contracts should be grouped for determining the CSM at inception, the level of aggregation must be determined, as follows:

- The starting point would be a portfolio of contracts. A portfolio comprises contracts that are subject to similar risks and are managed together. Contracts within a product line would be expected to have similar risks and, thus, would be in the same portfolio if they are managed together. Contracts in different product lines (for example, single premium fixed annuities as opposed to regular-term life assurance) would not be expected to have similar risks and would be in different portfolios.
- The entity should divide a portfolio, at a minimum, into the following three 'buckets' referred to as groups:
    - Contracts that are onerous at inception (i.e., initial recognition)
    - Contracts that have no significant possibility of becoming onerous subsequently
    - All remaining contracts in the portfolio.
- An entity is prohibited from grouping contracts issued more than one year apart.

If an entity has reasonable and supportable information to conclude that all contracts in a set of contracts will be in the same group, it may perform the classification based on a measurement of this set of contracts ('top-down'). If the entity does not have such reasonable and supportable information, it must determine the group to which contracts belong by evaluating individual contracts ('bottom-up'). Exhibit 2 provides an example of grouping of contracts under the standard.

Exhibit 2: Example of grouping of contract



An entity is permitted to subdivide the above groups into further groups based on information from its internal reporting, if that information meets certain criteria.

These aggregation requirements for the CSM represent a significant change in the new standard compared to the proposal in the 2013 ED. The 2013 ED only included a portfolio definition that referred to similar risks being priced similarly, and did not provide any other specific requirements on the aggregation level for the CSM.

Entities should consider whether the cash flows of insurance contracts in one group affect the cash flows to policyholders of contracts in another group. In practice, this effect is referred to as 'mutualisation'. Contracts are 'mutualised' if they result in policyholders subordinating their claims or cash flows to those of other policyholders, thereby reducing the direct exposure of the entity to a collective risk. The standard includes guidance on how to take the corresponding effects into account when determining the future cash flows for the affected groups. In contrast, the 2013 ED did not include any specific guidance on mutualisation.

General Model

The General Model applies to all contracts that do not have direct participation features and that are not accounted for under the Premium Allocation Approach (PAA). The General Model is based on the following 'building blocks':

- Estimates of future cash flows
- Adjustment for the time value of money (i.e., discounting) and the financial risks related to the future cash flows
- Risk adjustment for non-financial risks
- CSM

The expected future cash flows included in the measurement of the insurance liability should be explicit and reflect in a neutral way the range of possible outcomes, based on conditions at the measurement date.

The discount rate will be updated at the end of each reporting period, based on the principle that the rate should reflect the characteristics of the liability. As the discount rate will have to incorporate the time value of money for longer-dated future cash flows, it is expected that it typically will be a rate curve rather than a single rate.

The risk adjustment embodies a measurement adjustment to the expected cash flows based on the compensation the entity would require for bearing the uncertainty about amount and timing of the cash flows stemming from non-financial risks as it fulfils the insurance contract.

These first three building blocks are referred to collectively as the fulfilment cash flows of the insurance liability.

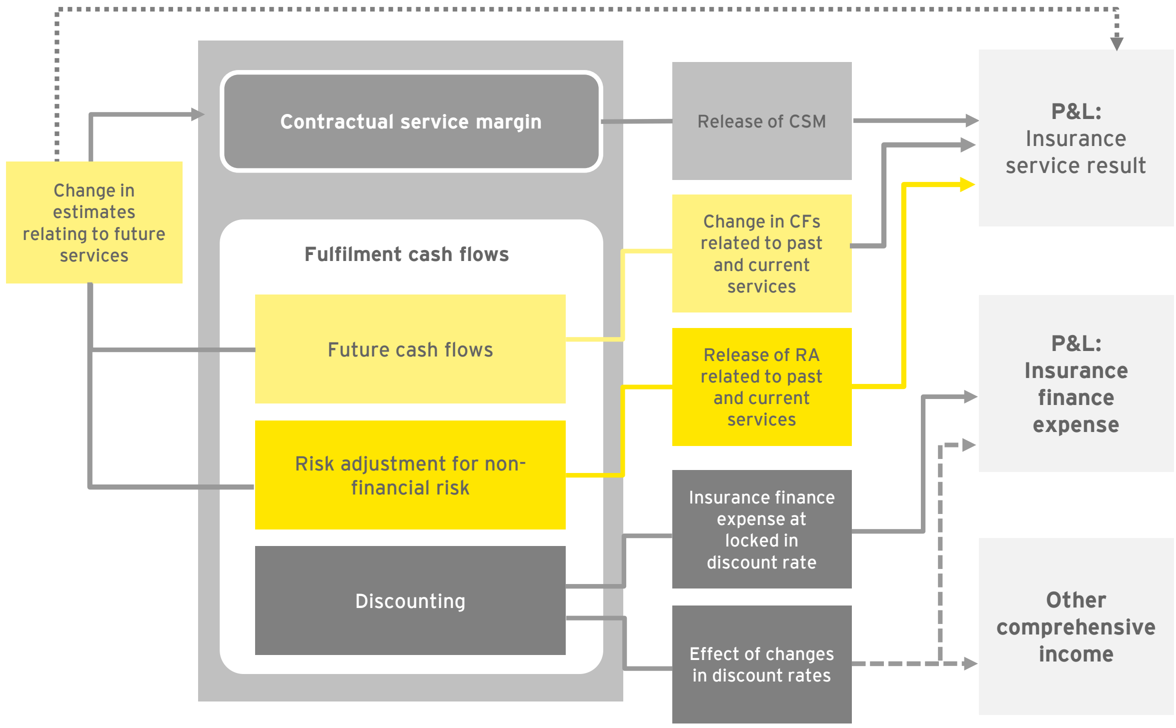
In addition to the fulfilment cash flows, the insurance liability includes a CSM; the CSM represents the unearned profit for a group of insurance contracts. The entity will recognise the CSM as it provides services under the group of contracts over time. At inception, the CSM will be equal and opposite to the fulfilment cash flows plus any pre-coverage cash flows (e.g., acquisition costs) provided that a group of contracts is not onerous. The CSM cannot be negative at inception; any net negative amount of the fulfilment cash flows at inception will be recorded in profit or loss immediately. Interest will accrue on the CSM over time, based on the discount rate used at inception to determine the present value of the estimated cash flows. The CSM will be released into profit or loss based on coverage units, reflecting the quantity of the benefits provided and the expected coverage duration of the remaining contracts in the group. The CSM is adjusted subsequently for certain changes in estimates of future cash flows and the risk adjustment. The adjustment is referred to as 'unlocking' (see below).

All fulfilment cash flow assumptions will be updated each reporting period. Changes in fulfilment cash flows that relate to future services will be added to or deducted from the remaining CSM (i.e., unlocking of the CSM). Examples of such effects are changes in assumptions causing a change in the estimate of the future cash flows of the liability for remaining coverage. Changes relating to past and current services (e.g., differences between actual and expected claims incurred in the current period, and changes in estimates of fulfilment cash flows of the liability for claims incurred in previous periods) should be recognised in profit or loss as part of the insurance service expenses for the period. The CSM cannot become 'negative' subsequently. If the CSM has become nil, any further unfavourable changes in estimates of the present value of future cash flows are recognised in profit or loss. The 2013 ED did not include specific guidance on the treatment of experience adjustments. However, the final standard is more specific on how an entity should determine the effects of experience and how to account for those effects.

The discount rate assumptions for the fulfilment cash flows should also be updated every reporting period. Entities will be able to choose whether the effect of changes in discount rates (and any other changes in assumptions that relate to financial risk) are recognised in profit or loss or in OCI, based on an accounting policy choice applied to portfolios of contracts, considering for each portfolio the assets it holds and how it accounts for those assets. If an entity elects to report changes in discount rates in OCI, the interest expense accrued on the insurance liability in profit or loss will be at the inception discount rate over the entire contract period. The 2013 ED did not have any such option and required the effect of the change in the discount rate to be reported in OCI.

Under the General Model, specific requirements for the presentation of insurance finance income or expense apply to indirect participating contracts (i.e., participating contracts that are not in scope of the Variable Fee Approach described below). Exhibit 3 below summarises how to treat subsequent changes in estimates:

Exhibit 3: Overview of subsequent changes in estimates



Variable Fee Approach (VFA)

The VFA is an adaptation of the building block approach applied under the General Model, specifically designed to account for contracts with direct participation features (also referred to as 'direct participating contracts'). A contract has a direct participation feature if it meets all three requirements below:

- The contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items (e.g., financial assets or a pool of contracts)
- The entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns from the underlying items

And

- The entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items

This assessment of whether the contract meets these criteria is made at inception of the contract and not reassessed subsequently.

The Board's rationale for including this approach is that the CSM under the General approach did not appropriately reflect the economics that a direct participating contract creates. Specifically, the difference between the fair value of the underlying items and the amount the entity is obligated to pay to the policyholder is viewed as the consideration for managing the underlying items. The consideration is referred to as the variable fee. At inception, this fee comprises the entity's expected share of the fair value of underlying items to which the participating contracts have a participation right, less any expected cash flows that do not vary based on the underlying items (e.g., fixed death benefits and minimum return guarantees). As such, this variable fee represents the CSM under the VFA.

The CSM under the VFA will be updated subsequently for:

- Changes in the entity's share in the fair value of the underlying items
- Changes in the fulfilment cash flows that do not vary based on the underlying items relating to future services, arising from:
  - Discounting and financial risks (e.g., minimum interest guarantees), unless the entity meets certain criteria for risk mitigation and decides, in order to reflect the economic offset of this risk mitigation, to report the effects of changes due to the related financial risks in profit or loss
  - Non-financial risks

If the entity actually holds the underlying items, it will have to make an accounting policy choice between:

- Disaggregating insurance finance income or expense (i.e., accretion of investment returns to both the fulfilment cash flows and the CSM) by including in profit or loss for the period an amount that eliminates accounting mismatches with income or expenses included in profit or loss on the underlying items held. This is sometimes referred to as the 'current period book yield approach'

Or

- Including all insurance finance income or expenses for the period in profit or loss

If the entity does not hold the underlying items, it determines insurance finance income and expense in the same way as contracts that are within the scope of the General Model.

Exhibit 4 below illustrates the application of models within the continuum of insurance contracts and summarises the measurement differences between the General Model and the VFA.

The accounting for participating contracts in the 2013 ED included a proposal that would have required entities to separate cash flows for measurement purposes. The VFA therefore represents an important change compared to the 2013 ED, as it reflects a model that is specifically designed to deal with direct participating contracts in their entirety rather than splitting them into components.

Exhibit 4: Application of measurement models and differences

	Continuum of insurance contracts		
Type of contract	Non-participating	Indirect participating	Direct participating
Measurement	General Model		Variable fee model
Subsequent measurement - Financial variables	PL or OCI, following the General Model		CSM, if risk-mitigated PL
Accretion of interest on CSM	Locked-in rate		Rate included in balance sheet measurement

Premium Allocation Approach (PAA)

A simplified approach based on a premium allocation could be applied to the liability for the remaining coverage if a group of contracts meets the following eligibility criteria:

- The coverage period, as determined by the contract boundary definition in IFRS 17, is one year or less

Or

- The use of the PAA would produce a measurement of the liability for remaining coverage that would not be materially different from (i.e., would be a reasonable approximation of) the outcome that would follow from applying the building block measurement under the General Model. The standard describes examples of circumstances in which the PAA would not be a reasonable approximation of the General Model

For contracts accounted for under the PAA, the criteria for determining the aggregation level have been adapted to reflect its simplified nature: an entity should assume no contracts in a portfolio are onerous at inception unless there are facts and circumstances that indicate otherwise. The entity should identify contracts with a significant possibility of becoming onerous after inception based on the likelihood of subsequent changes in facts and circumstances.

In addition to the liability for remaining coverage, an entity needs to set up a liability for incurred claims. The liability for incurred claims is based on the fulfilment cash flows (expected discounted value of claim payments, including a risk adjustment).

The overall accounting concept under the PAA plus the liability for incurred claims would be fairly similar to today's accounting models for non-life contracts (often based on unearned premiums and incurred claims), although some aspects, like the discounting of claims and an explicit adjustment for risk, will result in changes compared to today's accounting for non-life contracts.

Exhibit 5 summarises the main elements of PAA.

Reinsurance held

The standard requires that a cedant measures the reinsurance contract it holds at the fulfilment cash flows, adjusted for the risk of non-performance by the reinsurer, and a CSM. The cedant should estimate the present value of the future cash flows for the reinsurance contract in the same manner as the corresponding part of the present value of the future cash flows for the underlying insurance contract. The cedant determines the risk adjustment for non-financial risk in a manner that represents the amount of risk being transferred through the reinsurance contracts it holds.

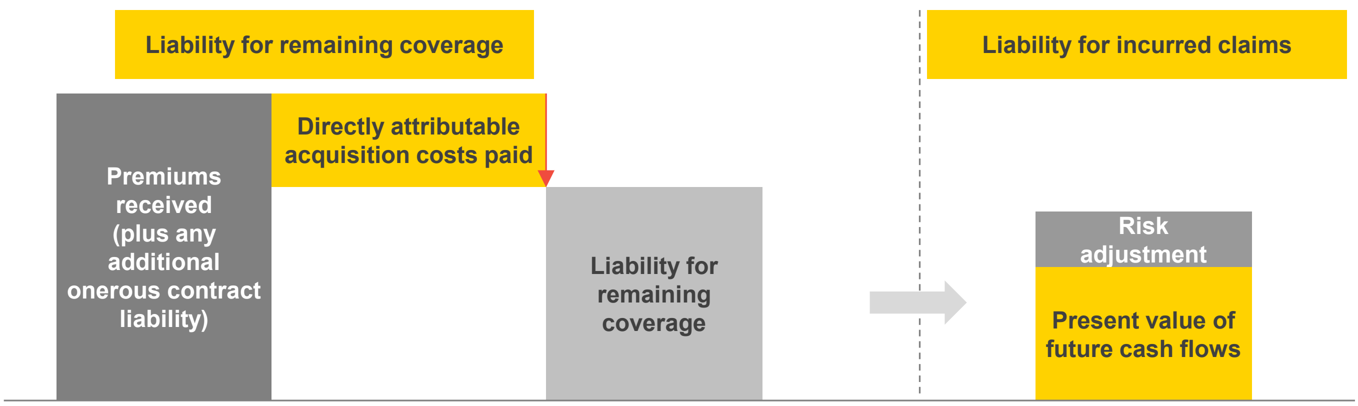
In contrast to the model for underlying direct contracts, the CSM at inception can also be negative. However, if a reinsurance contract reimburses a cedant for liabilities incurred as a result of past events (i.e., retroactive reinsurance), a negative contractual service margin (i.e., the cost to purchase insurance, which the Board refers to as a loss) would be recognised in profit or loss immediately. Also, in a change from the proposals in the 2013 ED, specific requirements apply for subsequent measurement of reinsurance contracts held: any changes in estimates of the fulfilment cash flows relating to future services (i.e., coverage received) should be recognised in profit or loss immediately if those changes are allocated to measurement changes of underlying direct insurance contract that are recognised in profit or loss.

Presentation and disclosure

The statement of comprehensive income will be based on the presentation of insurance revenue (based on an earned premiums concept) and insurance service expenses (based on an incurred claims concept) for all types of contracts. These revenue and expense amounts exclude any non-distinct investment component. An investment component is defined as the amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur, for example, amounts payable on maturity or surrender of an insurance contract.

Insurance contract revenue will be reported in the statement of comprehensive income as the entity's consideration for providing services under the contracts in the period. Entities will have to present insurance service results (i.e., the net of insurance revenue and insurance service expenses) separately from insurance finance income or expenses.

Exhibit 5: Overview of the PAA



IFRS 17 contains extensive disclosure requirements to provide information on the recognised amounts from insurance contracts and the nature and extent of risks arising from these contracts. The requirements include, for example, reconciliations from the opening to the closing balance of the aggregate carrying amounts of insurance contracts. The reconciliations seek to show the linkage between the movements on the statement of financial position and the amounts recognised in the statement of comprehensive income, and have to be provided both according to:

- *Type of liability*: the net liability (or asset) remaining coverage, any additional loss components and the liability for incurred claims
- *Building block component*: the expected present value of future cash flows, the risk adjustment and the CSM.

Effective date and transition

IFRS 17 must be first applied for reporting periods starting on or after 1 January 2021, with comparative figures being required. Early application is permitted, provided the entity also applies IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers* on or before the date it first applies IFRS 17.

The Board decided on a retrospective approach for estimating the CSM on the transition date (i.e., the beginning of the annual reporting period immediately preceding the date of initial application). However, if full retrospective application, as defined by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for a group of insurance contracts, is impracticable, an entity must choose one of the following two alternatives:

- *Modified retrospective approach:* based on reasonable and supportable information available without undue cost and effort to the entity, certain modifications are applied to the extent full retrospective application is not possible, but still with the objective to achieve the closest outcome to retrospective application possible
- *Fair value approach:* the CSM is determined as the positive difference between the fair value determined in accordance with IFRS 13 and the fulfilment cash flows (any negative difference would be recognised in retained earnings at the transition date)

Both the modified retrospective approach and the fair value approach contain modifications for determining the grouping of contracts.

If the entity cannot obtain reasonable and supportable information necessary to apply the modified retrospective approach, it must apply the fair value approach. Exhibit 6 summarises the use of the transition approaches.

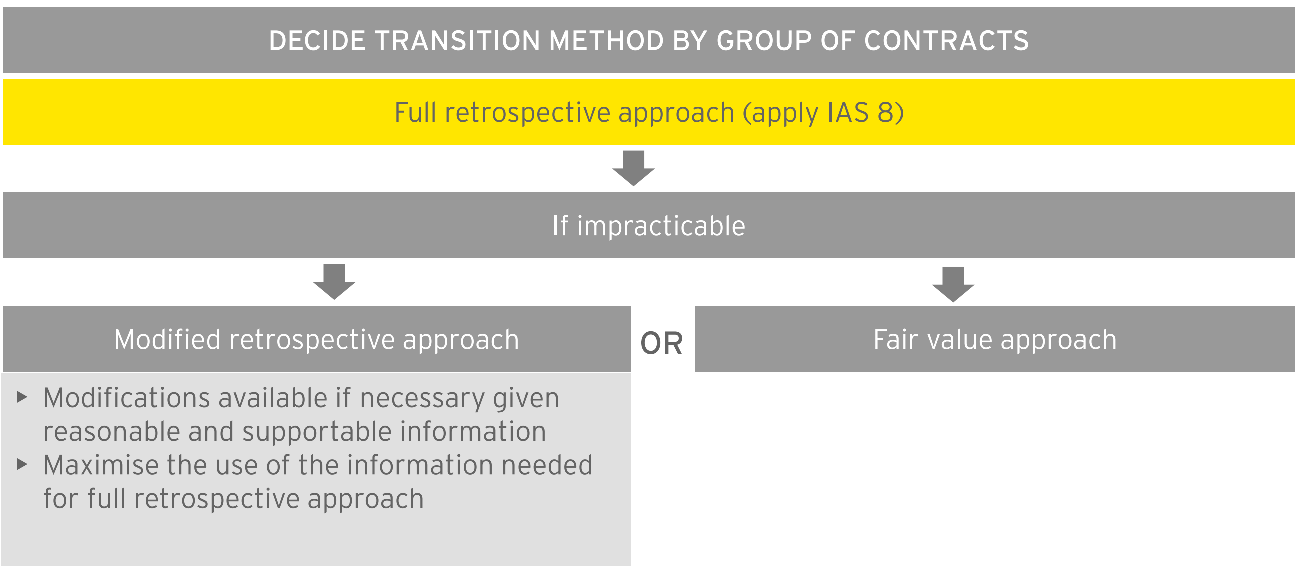
The Board aims to balance complexity, comparability and usefulness for estimating the CSM when transitioning to the new standard where there are limitations to a full retrospective application. As such, determining the CSM on transition will be key to the profitability of insurance contracts reported in the years following transition. The transition requirements in the 2013 ED already contained certain simplifications, but the transition alternative based on fair value in IFRS 17 is new compared to the 2013 ED.

Many entities meeting the eligibility criteria for the temporary exemption from IFRS 9 are expected to elect to defer IFRS 9 until IFRS 17 becomes effective. However, if an entity has already applied IFRS 9 prior to the effective date of IFRS 17, the transitional provisions of IFRS 17 enable the entity to:

- Make designations and de-designations of financial assets under the conditional fair value option and the OCI presentation election for investments in equity instruments under IFRS 9
- Reassess the business model for classification and measurement of financial assets not held in respect of an activity that is unconnected with contracts within the scope of IFRS 17

An entity that adopts IFRS 9 at the same time that it adopts IFRS 17 will be able to apply the transitional provisions of IFRS 9, which include certain designations and de-designations of financial assets.

Exhibit 6: Overview of the transition methods



How we see it

IFRS 17, together with IFRS 9, will result in a profound change to the accounting in IFRS financial statements of insurance companies. This will have a significant impact on data, systems and processes used to produce financial reporting as well as on the people producing it.

The new model requires that insurance contract liabilities are reported on the balance sheet using current assumptions at each reporting date. The profit and loss account, however, will reflect the result from the provision of insurance services in the reporting period. Hence, the model combines a current balance sheet measurement with reporting an entity's performance in profit or loss over time. The new model is likely to have a significant impact on profit and total equity for some insurance companies and groups. Changes to key performance indicators are likely and there could be an increase in volatility in reported equity and earnings compared to today's accounting models.

The effective date of 1 January 2021 will provide entities with an implementation period of around three and a half years. Whilst the IASB noted in a previous meeting that this implementation period is relatively long compared to other standards, the complexity of IFRS 17 is such that companies cannot afford to wait and will need to start preparing for implementation now. Impact assessment studies will be required to plan implementation steps, to identify the extent of effort necessary to achieve compliance, and to understand and explain the financial impacts. In particular, the requirement to restate the opening balance sheet as if the standard had always applied to existing business on the implementation date is expected to require significant effort.

What's next?

The Board acknowledges the need for ongoing support during the implementation period of the new standard. The objective of this support is to encourage understanding of the principles of IFRS 17 and the appropriate interpretation of those principles. The Board plans to provide implementation support through both materials and interactions with constituents. As part of this process, the Board intends to establish a Transition Resource Group (TRG) for IFRS 17 that will be tasked with analysing implementation-related questions on IFRS 17. The TRG will not issue authoritative application guidance or make any formal decisions. In line with the issuance of the standard, the Board announced its intention to establish a TRG over the next few months and published further information on the role of the TRG.

Look out for further publications from EY on IFRS 17, which will be published over the coming months.

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