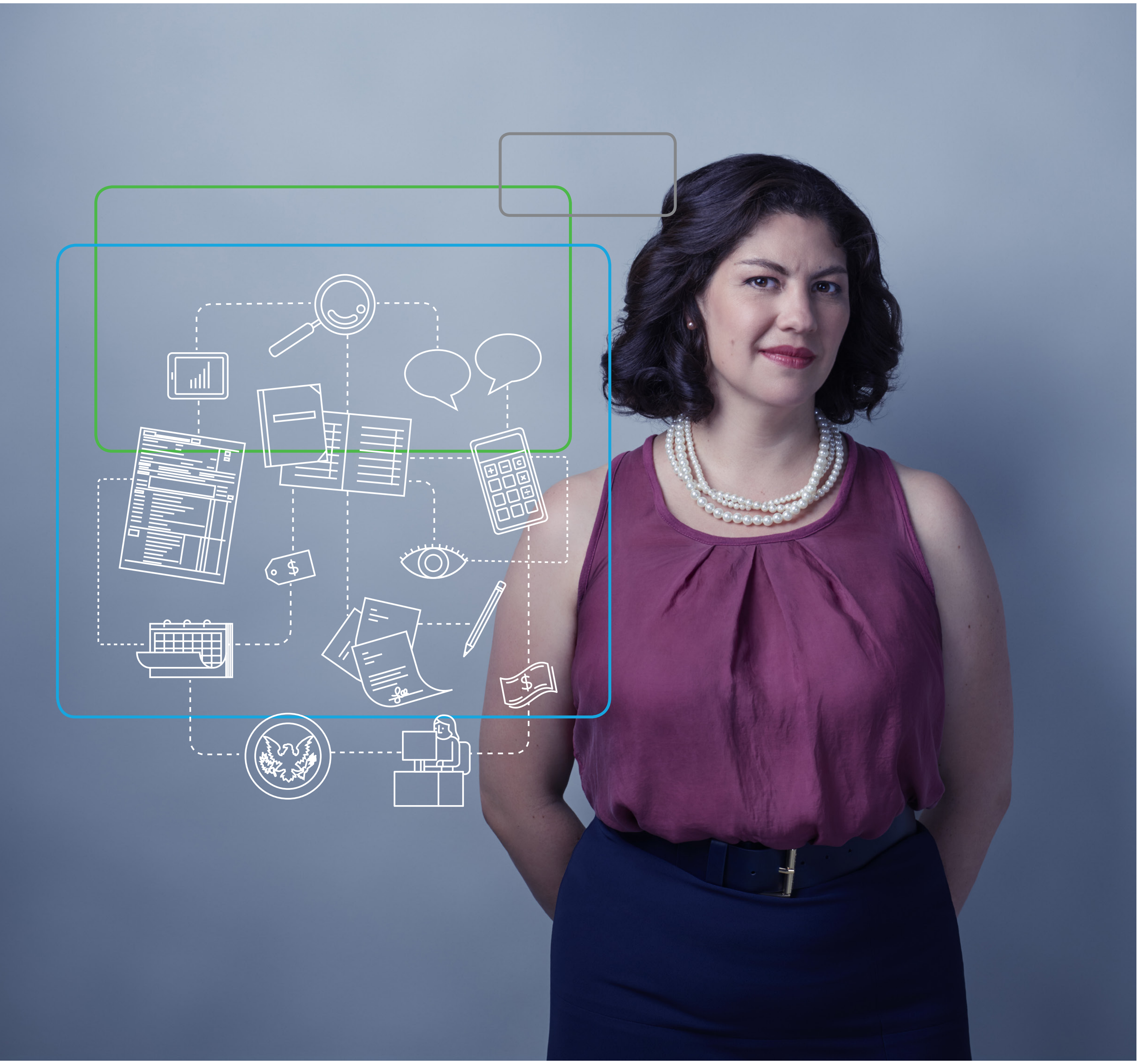


IFRS 17 *INSURANCE CONTRACTS*: STRATEGIC AND OPERATIONAL IMPACTS

Ifrs 17 insurance contracts: strategic and operational impacts

After decades in the making, IFRS 17 is reaching the final stages of completion with the new exposure draft published in June 2019. Management needs to be prepared that the standard is not only a compliance issue – it may also impact the business strategy of insurance companies.

IFRS 17 measurement requirements have direct impacts on the timing, disclosure and presentation of profit emergence during each reporting period. Changes to financial reporting and accounting processes, actuarial models, data and systems architecture will require end to end solutions.

Insurance contract portfolios (IFRS 17 (14–24))

To assess the impact of IFRS 17 on profitability and capital, the first step is to identify the unit of measurement. While IFRS 4 Insurance Contracts set out presentation and disclosure requirements, IFRS 17 additionally sets out new measurement requirements. The accounting concept of the insurance contract portfolio is introduced and defined as contracts subject to similar risks and managed together. Contract groups within portfolios are identified as the unit of measurement. Although three types of contract groups are defined by the standard, insurers are choosing the onerous contract group; and the other contracts group for measurement (Figure 1). The third group, no significant possibility of becoming onerous has been found to have limited applicability in discussions with IFRS 17 industry working groups.

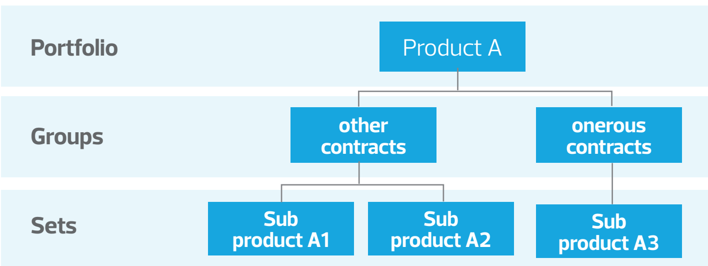


Figure 1: Profitability of insurance contracts may be assessed at the group, set or contract level. Portfolios are comprised of Groups. Groups can be considered composed of contract sets.

Assessing and separating insurance contracts into portfolios and groups may present operational challenges. For example, multiple separate annually dated Groups will likely be required in a portfolio, assessed on a continuing basis because the standard requires that entities should not include contracts issued more than one year apart in the same group. The data needed to measure multiple annual onerous and profitable groups (or "cohorts") and aggregate them into portfolios may not currently exist within an insurance company's systems. Expansion of data storage capacity could impact on the data management strategy. Operationally, new processes may be needed to process new data and transfer the data into actuarial measurement systems and processes for measurement. Governance processes over model change management may become a focal point for risk management.

Strategic impacts could also be felt due to requirements to separately disclose onerous contracts. For example in the past insurers looking to price products at a discount may have been able to offset loss making contracts with profitable books of business. However under IFRS 17 onerous contract groups cannot be offset against other contract groups in the financial statements disclosures, which in turn may require more explanation to stakeholders and users of financial statements.

Acquisition costs

Another strategic impact could arise from acquisition costs. The new standard requires acquisition costs to be deferred under the General Measurement Model (GMM) and provides an accounting policy choice of deferral or expense under the Premium Allocation Approach (PAA). The June '19 exposure draft introduces guidance allowing deferral of acquisition costs beyond the current coverage period for insurance contract renewals instead of amortizing within the current period. (see RSM IFRS 17 Fact sheet) Insurers who have a growth oriented strategy may benefit in the current period from deferring significant acquisition costs to future renewal periods.

Additionally, new types of costs may need to be included in acquisition costs because IFRS 17 defines insurance acquisition costs for the first time compared to IFRS 4. For example, selling costs, a new requirement in some IFRS 17 jurisdictions, are included in the IFRS 17 definition of acquisition costs (IFRS 17 Appendix A). Systems and processes may need to be updated to pass new types and amounts of acquisition costs into the accounting systems and actuarial measurement models. Additionally these new types of acquisition costs and amortization periods will need to be allocated into new periods, portfolios and groups.

The accounting policy choice for acquisition costs may also have a significant impact on the profitability and capital of insurers. IFRS 17 requires an insurer to defer or immediately recognize acquisition costs as an expense under the PAA (IFRS 17 (59a), while deferral is required under the GMM (IFRS 17(38b). The PAA and GMM are discussed further below.

Claims and policy administration expenses (IFRS 17 (Appendix B para. 65))

Claims and operating expenses are crucial inputs into the valuation of insurance contracts. Similar to IFRS 4, IFRS 17 includes policy administration and maintenance expenses within measurement of insurance contracts but develops the concept of claims costs as payments to the policyholder (IFRS 17 (B65b-c) and claims handling costs (IFRS 17 (B65f). Similar to current practices of allocation overheads, IFRS 17 also includes an allocation of fixed and variable overhead costs into the measurement of the insurance contracts (IFRS 17 (B65(l)). However IFRS 17 introduces more restrictive criteria for which cash flows are allowed within the measurement of the liability by only allowing expenses that relate directly to the fulfilment of the contract (IFRS 17 (B65).

IFRS 17 also specifically disallows costs related to product development and training (IFRS 17(B66(d)). If these costs are currently included in the valuation of insurance contracts, existing systems and processes will need to be updated to remove and process them as other expenses outside the boundary of the insurance contracts. Certain expenses related to future contracts not yet written should also not be included in the measurement of the liability under IFRS 17 (IFRS 17(B66(c)). For example expenses related to strategic planning and preparing business plans are not required to fulfill the current insurance obligation. This is a difference with current practice, where some of the strategic and business planning are often included in policy administration or claims expenses.

Insurance measurement models

The assessment of profitability and capital requires an understanding of the IFRS 17 measurement models. The GMM (IFRS 17 (32-52) is the main measurement model of IFRS 17 and is required to be applied to measure all insurance contracts unless the criteria for application of the PAA are satisfied (IFRS 17 (53).

The GMM liability is comprised of three parts: the Contractual Service Margin (CSM) (IFRS 17 (32b, 38 ,43) Risk Adjustment (RA, see section below) (IFRS 17(32a (iii), 37), and the LFIC (IFRS 17(40b). The CSM is a new type of actuarial liability representing unearned profit the entity will recognize as it provides services under the insurance contracts in the group. The CSM is earned into income using coverage units, a measure of how much coverage is provided during the period.

The Variable Fee Approach is a variant of the GMM and is applicable when the insurer 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 (B104(b)).

The PAA is a simplified accounting approach that uses a separate methodology to measure the LFRC. Under the PAA, the LFRC represents the amount of premium received that is not yet earned. The PAA LFRC does not include a CSM or require a risk adjustment to be calculated. The Liability for Incurred Claims (LFIC) is the same between the GMM and PAA (Figure 2).

Assessing the strategic impact of adopting the GMM and PAA should one of the early business impact assessments undertaken by insurers in their IFRS 17 transition projects.

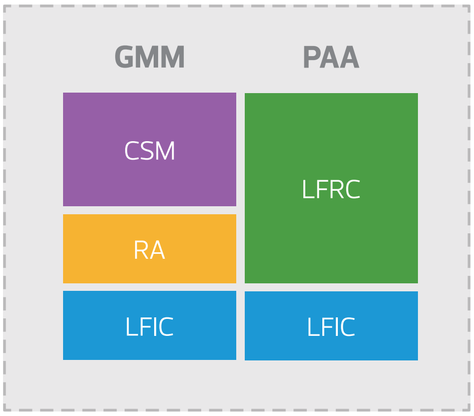


Figure 2: GMM and PAA liabilities. Both GMM and PAA models differ in the treatment of the LFRC. In the GMM the LFRC is comprised of the CSM and RA. The PAA LFRC is calculated according to the PAA methodology and does not contain a RA. The impact of discounting is not shown.

The GMM and PAA accounting models may impact reported profit previously reported under IFRS 4. For example:

- Certain types of term products exhibit different profit emergence patterns when measured under the GMM compared to the current methodology under IFRS 4.
- Depending on how the RA is modelled, the release of the RA into the statement of income could differ under IFRS 17.
- Changes in the amounts and types costs included as inputs (e.g. acquisition costs, claims and policy expenses) can impact direct and reinsurance contributions to profit emergence over time.
- The IFRS 17 requirement to recognize onerous contract groups separately from other contract groups under both the GMM and PAA can accelerate the timing of loss recognition.

In summary, management should re-examine the profit emergence patterns created by IFRS 17 implementation early in the conversion process to determine if any immediate pricing changes are required.

Risk adjustment (IFRS 17 (32a (iii), 37)

The RA is part of the insurance liability and contributes to profits. The RA calculation is a new IFRS requirement compared to existing measurement methods and represents the compensation an entity requires for bearing the uncertainty about the amount and timing of non-financial risk cash flows. The calculation of the RA is complex and may require new actuarial models and processes to be built. Methods to calculate the RA include the percentile method, cost of capital method and PfADs.

IFRS 17 Business Impacts		
Key areas	**Impacts**	**How RSM can help**
Profits	■ Profit profiles may change due to introduction of CSM ■ Transition approach may impact future profitability	■ Actuarial modeling and profit emergence ■ Capital impact assessment ■ Training and workshops ■ Transition options
Financial Reporting	■ Same themes as IFRS 4 but higher level of detail ■ CSM new component of disclosure tables ■ Requirement to disclose onerous contracts ■ Risk adjustment confidence l evel disclosure	■ Gap analysis to identify accounting gaps ■ Financial statement impact assessment and drafting ■ Accounting policy choices checklist ■ Disclosure options guidance
Operational complexity	■ Increased data requirements and potentially storage requirement ■ Major impact on actuarial and financial reporting processes ■ Tight regulatory timeframes for inter-disciplinary design of prototypes and implementation	■ Understand the business processes and systems ■ Evaluate opportunities for improvement / alignment with IFRS 17 requirements ■ Vendor evaluation ■ Project management

Discount rates (IFRS 17(36), B72-85))

Discounting insurance liabilities to their present value also has a significant impact on the profitability and capital of insurers. For insurance contract claims that are expected to be settled in more than 12 months, IFRS 17 generally requires claims to be measured at the discounted value, similar to current practice. However, IFRS 17 introduces a fundamentally different approach to the calculation of the discount rate applied to insurance liabilities. The standard requires application of either the top down (IFRS 17 (B81) approach or the bottom up IFRS 17 (B80) approach to calculate the discount rate (Figure 3).

The top down approach requires the insurer to initially create a reference portfolio of financial assets available on the market that matches the characteristics of the insurance liability cash flows. Reference portfolio characteristics that do not match the underlying insurance cash flows are removed. New credit risk models may need to be developed to remove for example the credit risk from the asset portfolio to more closely match the insurance liability characteristics.

The Bottom up approach starts with the risk free rate and adds an illiquidity premium to derive the discount rate.

IFRS 17 Discount Rate – simplified bottom up approach

Top down discount rate	%
Actual or expected reference portfolio rate	6.0
Duration mismatches	0.2
Market risk premium for unexpected credit losses	(0.9)
Market risk premium for expected credit risk losses	(0.5)
Risk free rate of return	**(3.5)**
Illiquidity premium	1.3
Bottom up discount rate	
Illiquidity premium	1.3
Risk free rate of return	3.5
Insurance contract discount rate	**4.8**

Figure 3: The bottom up approach adds the illiquidity premium to the risk free rate to derive the IFRS 17 discount rate.

Reinsurance (IFRS 17 (60–71)

Another important driver of profit emergence and capital is reinsurance. Although the measurement themes are similar for reinsurance held compared to direct insurance issued, IFRS 17 modifies the GMM and PAA measurement models for reinsurance contracts held (IFRS 17 (60–71). For example reinsurance contracts held are required to be aggregated into their own separate portfolios and groups for measurement that may not necessarily align with the underlying insurance contracts. (IFRS 17(61). Additionally the ED introduces new requirements to recognize gains on proportionate reinsurance held when the underlying insurance contracts are initially issued as onerous (RSM Fact sheet). Applying the requirements for reinsurance measurement may be further complicated by the number of legacy reinsurance contracts that are held and the diversity of types of reinsurance arrangements. It's not uncommon for insurers to have to look back decades to determine what reinsurance portfolios and groups exist under IFRS 17.

Asset liability matching strategy

The asset liability matching strategy is of critical importance when managing the profitability and capital of an insurance enterprise. IFRS 17 and IFRS 9 Financial Instruments have a combined and related impact on the statement of income and financial position. For example the new IFRS 17 discount rate for discounting insurance liabilities may no longer sufficiently match the directionality or magnitude of the change in the value of the assets held that fund the insurance liability. This can cause a mismatch or disconnect between investment income and insurance finance expenses. This can be further complicated by complex investment classifications under IFRS 9.

Depending on the insurer's financial objectives, accounting policies may need to be chosen that better align insurance accounting with investment accounting. For example IFRS 17 introduces a new OCI accounting policy choice that can be used together with the fair value through Other Comprehensive Income (FVTOCI) investment classification to offset the movement in asset valuations and discounting of liabilities in Other Comprehensive Income (OCI) (IFRS 17 (88)). Another possibility is classifying the investments held as fair value through P&L (FVTPL) together with re-measuring insurance liabilities entirely through the statement of income to match investment value movements with changes in insurance liabilities in the statement of income.

Capital and strategy

The capital plan often restrains strategic objectives. Due to the reductions in opportunities for offsetting profitable and onerous contracts, changes to the timing of profit recognition for onerous contracts and changes to the liability discount rate, insurers may experience increased sensitivity to adverse events and require more capital under IFRS 17. Management assesses capital adequacy and the resiliency of the financial plan using a forward-looking approach that leverages various risk management techniques (e.g. stress testing, scenario analysis, sensitivity testing, and stochastic modeling). Insurance portfolios that were otherwise expected to be profitable in the company's financial plan may become unprofitable in an adverse scenario, resulting in the immediate recognition of losses and reduction in available capital. Furthermore, the new discount rate calculation approach under IFRS 17 is likely to increase required capital as the mismatch between interest rate-sensitive assets and liabilities increases. Insurers should consider the potential increased sensitivity to adverse scenarios as they adapt their capital adequacy assessment processes and capital management policies to the new standard.

Presentation and disclosure

The general theme of presentation and disclosure is continued in IFRS 17 compared to IFRS 4 however IFRS 17 requires a more condensed balance sheet presentation and a higher of level disclosures. New disclosures contain new measurement concepts :

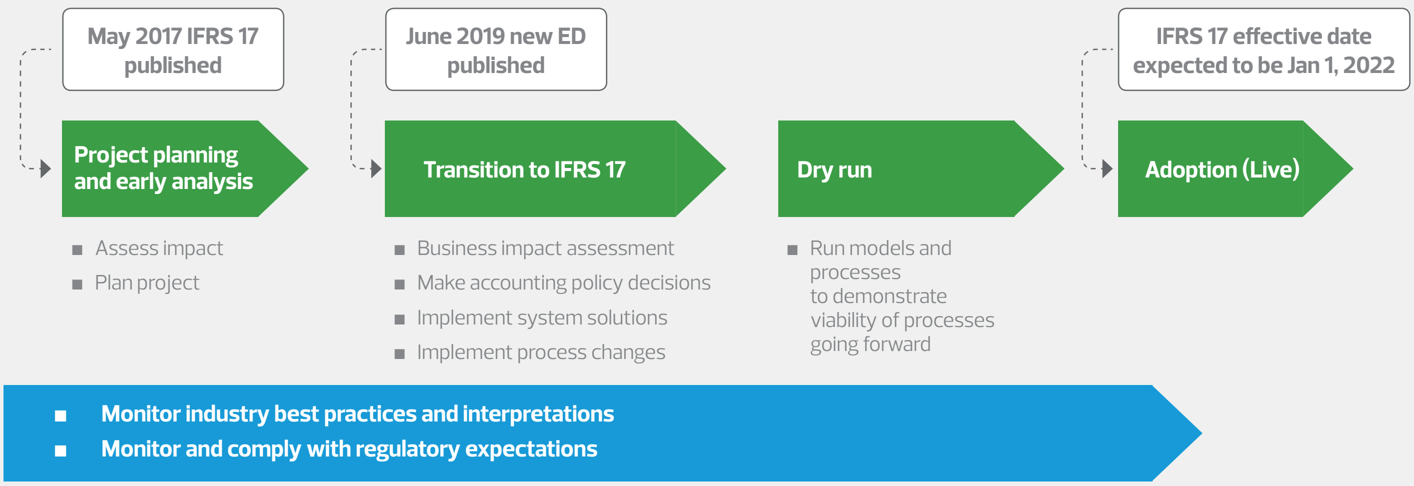
Concepts of written and earned premium are no longer included in the statement of income and are replaced with insurance service revenue and insurance service expense (IFRS 17 ((80).

The statement of financial position is more condensed under IFRS 17, with portfolios of insurance contracts that are assets presented separately from portfolios of insurance contracts that are liabilities (IFRS 17(78). Reinsurance portfolios that are assets are separately presented from reinsurance portfolios that are liabilities (IFRS 17(78).

Actuarial models, processes and accounting systems will need to be updated early in IFRS 17 projects to accommodate the financial statements disclosure requirements as detailed components of the GMM and PAA liabilities are required to be disclosed in the notes to the financial statements (IFRS 17 (93-132).

IFRS 17 Timeline

With the IFRS 17 effective date expected to be Jan 1, 2022, companies are currently planning and implementing the new standard before dry run



Transition (IFRS 17 Appendix C)

The approach to transition may also impact profitability and capital. Depending on the transition approach, the measurement of the insurance liability could be different. IFRS 17 outlines three transition approaches, applicable depending on the circumstances of the insurer. The full retrospective approach (IFRS 17 (C3) requires a full restatement under IFRS 17 as if the standard has always been applied. The modified retrospective (IFRS 17 C6) and fair value (IFRS 17 (C20)) approaches can be used where the full retrospective approach cannot be applied.

Further considerations

Adoption of IFRS 17 will require greater interaction between actuarial and accounting systems and functions and involve significant challenges around data, modeling, processes governance and business integration. RSM can help you take advantage of the opportunities arising from changing requirements. Our experienced teams of actuaries, consultants, IT and other professionals can help you empower your business to deliver its potential and embrace the possibilities.

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