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SPRING MEETING

May 7–10, 2023
The Westin Boston Seaport District
Boston, MA

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What is IFRS 17 and Why Should You Care

Presenters

Philippe Grégoire – Willis Towers Watson

Ralph Blanchard – retired (formerly Travelers)

Audience Poll #1

Where do you work?

- U.S.
- Canada
- Europe
- Asia
- Other

Why should I care about IFRS 17?

- An affiliate requires IFRS 17 reporting (e.g., Canada)
- Employer owned by an IFRS 17 filer
- Need to review financial reports of an IFRS 17 filer (competitor? reinsurer?)
- May want to work in the future for one of the above
- IF ALL YOU DO IS RATEMAKING, maybe you don't care, but if you want to see what all the fuss is about …

Audience Poll #2

What is your predominate responsibility area?

- Pricing/ratemaking
- Reserving
- ERM
- Financial Reporting
- Other

IFRS 17 Brief History – part 1

- IFRS 17 is the 17th International Financial Reporting Standard (IFRS) issued by the International Accounting Standards Board (IASB)
- Project began in late 1990s by the IASB predecessor (IASC)
- Tried to meet an EU deadline of 2005 – failed – so issued a placeholder (IFRS 4)
- IFRS 4 – keep doing what you were before, but with min stds (rqrd liability adeq. test, no cat reserves.)

IFRS 17 Brief History – part 2

- After two decades, finally issued IFRS 17.
- Original effective date – 1/1/2021 (with one year of “comparables”)
- Later changed to 1/1/2023.
- But not really effective until adopted by local authorities.
  - Canada – effective 1/1/2023 for GAAP and regulatory reporting (all insurers and branches)
  - EU – effective 1/1/2023 for publicly owned*
  - Effective date differs by jurisdiction, and publicly owned vs. privately owned, shareholder reports vs. regulatory reports.

IFRS 17 Brief History – part 3

- Major themes affecting IFRS 17 development
  - “One model” for all insurance (*like Solvency II*).
    - *Eventually added a “simplification” for short duration insurance*.
  - Belief that life ins. accounting was inconsistent, non-comparable across the globe.
    - *So a focus on fixing life insurance accounting. P&C an afterthought.*
  - Present value of future cash flows, plus risk “adjustment”.
  - How should “revenue” be calculated for life insurance?
  - No gain at issue – shouldn’t show a profit until service is provided.
    - *As opposed to Solvency II, where you can recognize profit immediately*.

Major Implementation Issues

- IFRS 17 Financial Statements
- Portfolios & Groups
- General Model (GM) vs. Premium Allocation Approach (PAA)
- PAA eligibility
- Risk Adjustment
- Discount
- Expenses
- Reinsurance
- Onerous Contracts

An Excel workbook providing a series of examples / additional information is attached to this presentation. You are welcome to ask questions during or after the meeting but note that the Excel material won't be covered during the presentation.

IFRS 17 Financial Statements

IFRS 17 introduces the terminology of Insurance Contracts Issued and Reinsurance Contracts held.

Type of Contracts	IFRS 17
Insurance Contracts issued directly to the policyholders by the insurer & Reinsurance Contracts issued by a reinsurer to the insurer / ceding company.	Insurance Contracts Issued
Reinsurance contract held by a ceding company with a reinsurer (reinsurance or retrocession)	Reinsurance Contracts Held

Liabilities *(or assets)* from Insurance Contracts Issued are shown separately from Assets *(or liabilities)* from Reinsurance Contracts Held on the financial statements.

IFRS 17 Financial Statements

How insurance component of Balance Sheet might look like (prior to recognizing ceded reinsurance)

Balance Sheet - Current GAAP	**20XX**
Deferred Acquisition Costs (DAC)	30
Premium Receivable	10
Total Assets	**40**
Unearned Premium Reserve (UPR)	60
Provision for Claims	80
Total Liabilities	**140**

Balance Sheet - IFRS 17	**20XX**
Total Assets	-
Liability for Remaining Coverage (LRC)	20
Liability for Incurred Claims (LIC)	80
Total Liabilities	**100**

Key Takeaways

- DAC and Premium Receivable no longer shown separately on the balance sheet, but rather embedded in the Liability for Remaining Coverage (i.e., the balance sheet is "compressed" under IFRS 17).
- New terminology introduced: LRC for premium liabilities and LIC for claim liabilities.

Caveat: This is a simplified example where underlying assumptions remain the same. Focus is on terminology and geography. In some cases, the balance sheet would be different and the breakdown between the two liabilities (i.e. LRC and LIC) might not be available on the balance sheet – but rather rolled-up into a single line item called ***Insurance Contract Liabilities****.*

IFRS 17 Financial Statements

Ceded Portion (reinsurance contracts held) – how Balance Sheet might look like

Balance Sheet - Current GAAP	20XX
Reinsurance Claim Recoverable	40
Reinsurance Unearned Premium	30
Total Assets	**70**
Premium Payable	5
Unearned Ceded Commission	15
Total Liabilities	**20**

Balance Sheet - IFRS 17	20XX
Asset for Incurred claims (AIC)	40
Asset for Remaining Coverage (ARC)	10
Total Assets	**50**
Total Liabilities	-

Key Takeaways
• Balance sheet is also compressed with premium payable and unearned ceded commission netted out of the Reinsurance Unearned Premium to form the Asset for Remaining Coverage (ARC). • New terminology introduced: ARC for and AIC.

*Caveat: This is a simplified example where underlying assumptions remain the same. Focus is on terminology and geography. In some cases, the balance sheet would be different and the breakdown between the two assets (i.e. ARC and AIC) might not be available on the balance sheet – but rather rolled-up into a single line item called **Reinsurance Contract Assets**.*

IFRS 17 Financial Statements

How the income statement might look like

Income Statement - Current GAAP	20XX
- Gross Earned Premiums	60
- Ceded Earned Premiums	(30)
Net Earned Premiums	30
- Gross Incurred Claims	30
- Ceded Incurred Claims	(15)
Net Incurred Claims	15
Investment Income	20
- Amortized Acquisition Cash Flows	10
- Amortized Ceded Commission	(5)
- Other expenses	5
Total Expenses	10
Income	25

Income Statement - IFRS 17	20XX
Insurance Revenue	60
Insurance Service Expense	36
Net Expense for Reinsurance Contracts	12
Insurance Service Results	12
Investment Income	20
Finance Expense	2
Net Financial results	18
Other Expense (Income)	5
Income	25

Key Takeaways

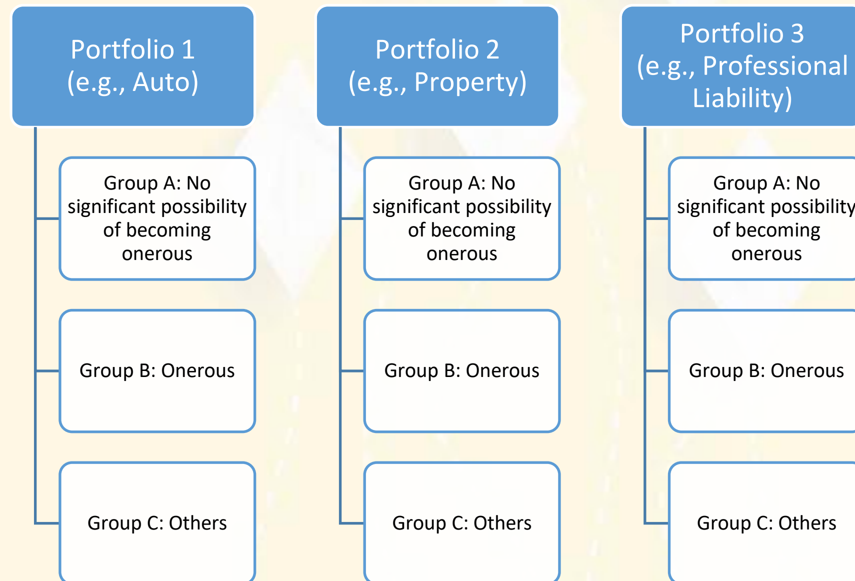
- Insurance Revenue and Insurance Service Expense are both shown before ceded reinsurance.
- Ceded reinsurance premiums, claims and commissions are all shown under one line* item: Net Expense for Reinsurance Contracts.
- Interest cost on reserves (e.g., unwinding of present value) is carved out of the incurred claims and shown under Finance Expense.
- Insurance Service Expense includes claims and all expenses attributable to insurance contracts.
- Expenses not considered directly attributable are shown in Other Expenses.
- New terminology introduced.

Caveat: The above IFRS 17 presentation is a suggestion of what the income statement might look like. In practice, some items may be presented differently.

** Alternatively, allowed to show ceded reinsurance impact on two lines, one for ceded premium and another for ceded losses/expense. But in any event the ceded reinsurance premium impact is shown as part of insurance service expense, not revenue.*

Portfolios & Groups

Insurance and reinsurance contracts need to be divided between portfolios and groups.



Key Takeaways

- A portfolio is comprised of contracts subject to similar risks and managed together.
- An entity shall divide a portfolio of insurance contracts into a minimum of 3 profitability groups (i.e. onerous, no significant possibility of becoming onerous, others).
- Moreover, groups should not include insurance contracts more than 12-months apart (i.e. annual groups).
- Under the PAA approach, an entity should assume that there are no onerous contracts unless "facts and circumstances" indicate otherwise.
- Common to use only one group per issue year, with the other two required groups being null sets.

General Model (GM)

also known as the *Building Block Approach*

LRC = sum of 4 building blocks

1. Future “fulfilment” cash flows *(including DAC amortization)*
2. Discounted
3. Plus “risk adjustment”
4. Plus Contractual Service Margin (CSM)

CSM = plug to avoid a gain at issue.
(wrongly) labeled “future profit”

LIC = parts 1 thru 3 above. (No CSM)

General Model (continued)

- CSM is amortized in proportion to the provision of "service" described as "coverage units" (undefined but frequently discussed – typically pro rata amortization for P&C)
- CSM is also recalculated each reporting period as a group runs off, acting as a limited shock-absorber as estimates of future cash flows change.
- **This need to recalculate CSM adds tremendous complexity**.
- Special rules for "onerous" contracts (discussed later)

Premium Allocation Approach (PAA)

Meant to be a simplification of the GM

LRC =

- Initially - Premiums received to-date, less DAC
- Subsequently – initial LRC
  - plus additional premiums received
  - plus amortized DAC
  - Minus premium recognized (earned)

TRANSLATION:

LRC* = UPR – unamortized DAC – Premiums receivable

* accrue for interest if a "significant financing component" exists.

Premiums are earned based on "*expected pattern of release of risk*", typically pro rata.

Advantages of the PAA

- No CSM – totally avoids CSM complexity
- "*shall assume no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise*".
- Income statement and disclosures are simpler.
- In short – simpler, less work, easier to understand, closer to prior accounting.

PAA eligibility requirement

- Coverage period is 12 months long or less for all policies in the group, OR
- The insurer "reasonably expects" ***at inception*** that the PAA LRC "would not differ materially from the one that would be produced" under the GM.
- ALSO,

  "*not met if at the inception of the group an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the liability for remaining coverage during the period before a claim is incurred.*"
- HUGE INCENTIVE TO MEET THESE TESTS

PAA eligibility testing

- Identify whether any contracts over 12 months
- Is this volume material (to the group)
- Model the LRC for the GM and PAA for those that are material.
  - Issue is not whether they can differ, but whether you "reasonably expect" that they will be similar. (reasonably expect ≠ reasonably possible)
- Get auditor approval
- Risk if things change in the future?
  - Modeling, systems, and tracking for GM is not trivial
  - Many find all or essentially all P&C qualifies.
  - Some with large life operations insisted on GM – one model for all.

PAA eligibility testing common concerns

- Misc. contracts over 12 months – usually not material
- E&O/D&O – 3 year policies are common
- Contract Surety – various mix of project lengths.
- Warranty – may be problematic (but may not be).
- Retroactive covers (loss portfolio transfers) – problematic?
- How is “release from risk” measured for these? Pro rata?

Hypothetical PAA eligibility test

LRC for a group? policy?				
time	GM	PAA	diff	% diff
0	100	100	0	0%
1	81	80	1	1%
2	62	60	2	3%
3	43	40	3	7%
4	24	20	4	17%
5	0	0	0	
sum	310	300	10	3%

- Is materiality based on $ or %, or a mix of both?
- Materiality relative to the product, or the entire book?
- Interpretation is that the test is for each period of runoff.

Risk Adjustment

- For “*non-financial risk*”
  - Financial risk = e.g., interest rate movement, financial instrument price movement, credit rating
- “*compensation the entity [not the market] requires for bearing the uncertainty about the amount and timing of the cash flows*”
- Main approaches:
  - Cost of capital
  - Confidence interval
- Regardless – must disclose the overall confidence interval of entity’s risk adjustments

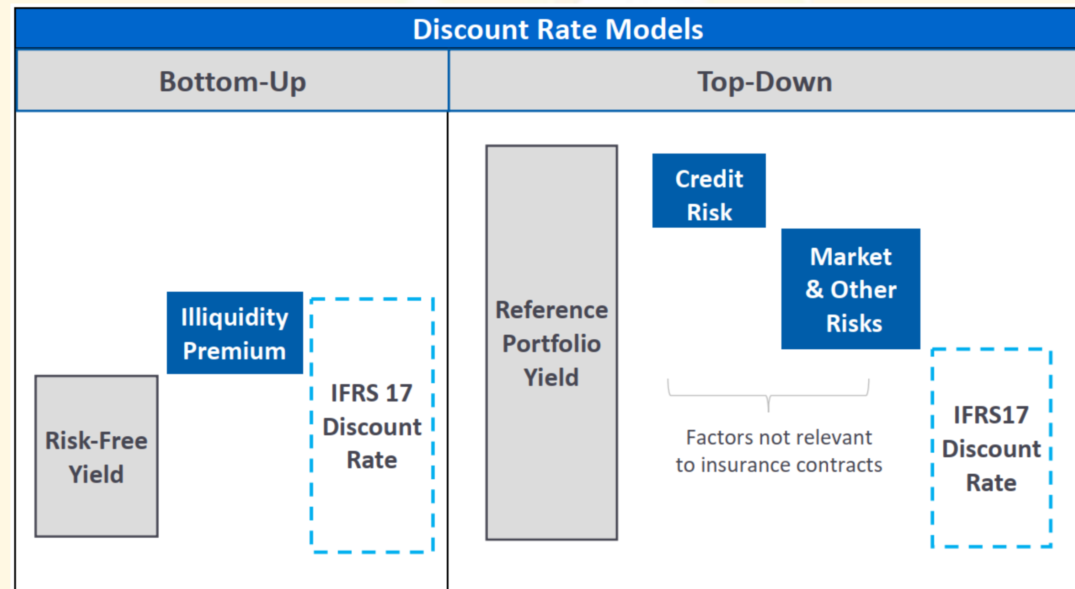
Risk Adjustment (continued)

- Applied at all times of the runoff.
- Some may apply it as a factor times present value of fulfilment cash flows
- Use logic similar to pricing models?
- Reflect diversification across entity? Across insurance group?
- Hard for auditor to second-guess what the insurer requires – but should be consistent.
- Confidence interval – comparability issue across lines
    - (high freq/low severity vs. low freq./high severity)

Also included in onerous contract calculation

Discount Rate

Discount Rates applied to the estimate of the future cash flows shall reflect 1) time value of money, 2) the characteristics of the cash flows, and 3) the liquidity characteristics of the insurance contracts.



Key Takeaways

• Standard provides two different approaches to calculate the Yield Curve (image on the left):
  • Bottom-up
  • Top-Down
 	
• Liquidity of insurance contracts is not easily observable. Calculating the illiquidity premium might be tricky.
 	
• In practice for P&C products:
  • A yield curve is used to discount the LIC cash flows (vs. a single rate).
  • LIC is often considered illiquid.
  • Under PAA, discounting is not applicable to the LRC unless there is a “significant financing component” – advanced topic not covered here.

Expenses

- All Expenses
  - Directly Attributable Expenses → Included in IFRS 17 liabilities
  - Non-directly Attributable Expenses → Not included in IFRS 17 liabilities

Income Statement - IFRS 17	**20XX**
Insurance Revenue	60
Insurance Service Expense	44
Insurance Service Results	**16**
Investment Income	20
Finance Expense	5
Net Financial results	**15**
Other Expense (Income)	6
Income	**25**

Key Takeaways

- Need to determine which expenses are directly attributable to insurance contracts. Judgement sometimes involved.
- Directly attributable expenses shown under the Insurance Service Expense and considered in the calculation of the loss component (if applicable). Non-directly attributable expenses shown under Other Expense.
- Acquisition cash flows directly attributable to contracts are deferred/amortized over time. Exception: May be "recognized as incurred" for contracts with 12 months or less.

Reinsurance

- Items covered so far (e.g., PAA, Risk Adjustment, Discount Rate) are generally applicable to Reinsurance in a similar fashion (whether it's for Reinsurance contracts Issued or Reinsurance Contracts Held).
- There are however special considerations related to Reinsurance Contracts (most of which are out of scope for this presentation).
- Main difference is the treatment of commission. For instance,
  - Under current GAAP, a flat commission for a reinsurance contract issued (i.e., paid to the ceding company) might be treated as an Acquisition Cash Flows and recognized through Expenses.
  - Under IFRS 17, a flat commission would be treated as a premium and netted out of the Insurance Revenue.

Onerous Contracts

- New name for the liability adequacy test
- "Loss component" = what happens if the CSM would be negative.
- Similar to Premium Deficiency Reserve under US GAAP and old (IFRS 4) Canadian GAAP, except that includes a risk adj.
- Simplified loss component for onerous group =
    1. Calculate combined ratio expected for runoff of current unearned premium
        a. modified for discounting, risk adjustment, expenses in "other income"
    2. Subtract 1.0
    3. Multiply result times the UPR for the group

- Having some expenses in "Other Income" makes Onerous Contracts less likely. The more this happens the less the risk of a group being onerous.

Onerous Contracts (cont.)

- Present value (discounted) risk adjusted combined ratio is for the FUTURE runoff of the coverage
- Does not include incurred losses that have already happened for the group.
- Doesn't include expenses that don't *"relate directly to the fulfilment of the contract"*

Onerous Contracts
Simplified Loss Component Calculation

Next year's earned premium for a portfolio	400	
Portion from policies already issued	200	UPR
Planned combined ratio	110%	
Adjusted for "other income" expense	103%	
Adjusted for discounting	99%	
Adjusted for risk adjustment	102%	
factor	2%	
group UPR	200	
factor	2%	
simplified loss component	4	

Miscellaneous

- Materiality issues – need for an “all other” portfolio?
- Key Performance Indicators (KPIs) – recreate the old KPIs from the new IFRS 17 statements? *(easier under the PAA)*
- Ceded reinsurance (especially quota share) looks very different
- Risk of GM if using PAA exclusively?
- “Significant Financing Component”
- Any value at all to IFRS 17 for P&C? Most say “No”

Questions?