EFRAG Board - Educational Session

IFRS 17 *Insurance Contracts*

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Agenda paper 07-01

EFRAG
European Financial Reporting Advisory Group

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OVERVIEW

What is insurance

Separating components of insurance contract

Portfolios

Grouping

General Model

Cohorts vs no cohorts – Simplified examples

Recognition of CSM in P&L – Simplified examples

Jargon used

WHAT IS INSURANCE?

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INSURANCE CONTRACT DEFINITION IN IFRS 17

A contract under which one party (the issuer) accepts significant **insurance risk** from another party (the policyholder) by agreeing to **compensate** the policyholder if a specified **uncertain future event** (the insured event) adversely affects the policyholder
(IFRS 17, Appendix A)

WHAT IS INSURANCE?

IN SIMPLE TERMS

An insurance contract is one where, on signing the contract, the insurer has an immediate liability to meet the obligations under that contract.

Insurance business has two key functions:
(a) estimating the amount and timing of claims and other contractual benefits
(b) managing assets and investment returns in order to meet those claims and other contractual benefits

For long-term contracts, the insurer manages reinvestment of assets as they mature.
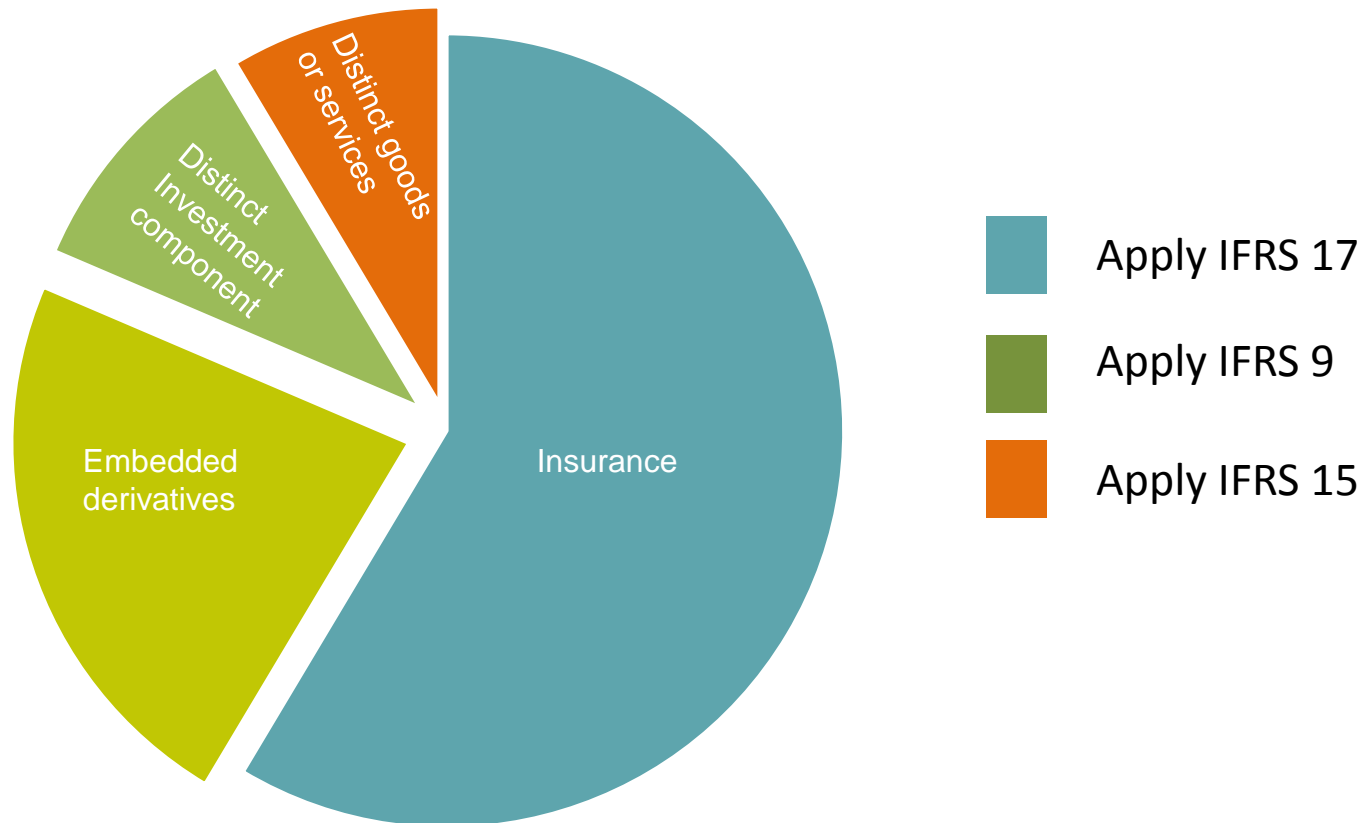
WHAT IS INSURANCE?

SOURCES OF COMPLEXITY

(a) Range of insurance products sold, including short-term insurance through to long-term life insurance contracts

(b) Range and mix of benefits provided – e.g. cover for the insured event(s) and some form of investment return

(c) Uncertainty as to whether the insured event will occur (e.g. burglary insurance) or when the insured event will occur (e.g. death benefit)

(d) Uncertainty about the amount of the claim

(e) Current existence of different practices in accounting for insurance contracts

(f) Asset-liability management

SEPARATING COMPONENTS

SEPARATING COMPONENTS

Distinct goods or services

Distinct Investment component

Embedded derivatives

Insurance

- Apply IFRS 17
- Apply IFRS 9
- Apply IFRS 15

IFRS 17, paragraphs 10-13, B31-B35

SEPARATING COMPONENTS

- Separate components of an insurance contract if they are distinct
- **Investment component:**
    - Is distinct only if both:
        - the investment and insurance components are not highly interrelated
        - a contract with equivalent terms is, or could be, sold separately in the same market or jurisdiction
    - Is not distinct, because highly interrelated, if either:
        - the entity is unable to measure one component without considering the other
        - the policyholder is unable to benefit from one component unless the other is also present

- **Goods or services:**

    - Are distinct only if the policyholder can benefit from the good or service either on its own or together with other readily available resources;

    - Are not distinct if the cash flows and risks associated with the good or service are highly interrelated with the cash flows and risks associated with the insurance components and the entity provides a significant integration service.

INDUSTRY CONCERNS – SEPARATION OF COMPONENTS

Separation of an investment component	IFRS 17, paragraphs 11(b) and B31-B32 For unit-linked contracts with an option of waiving the premium it is unclear whether the investment component can be separated and accounted for in accordance with IFRS 9

Arguments in favour of IFRS 17

- When components of an insurance contracts are highly interrelated, accounting in accordance with IFRS 17 reflects the long-term business model of insurers.

Arguments against IFRS 17

- The requirements for separation may be too strict, in particular the requirement that an investment component is considered highly interrelated with an insurance component when the policyholder is unable to benefit from one component unless the other is also present

PORTFOLIOS

PORTFOLIOS

PORTFOLIO DEFINED AS

Insurance contracts subject to similar risks and managed together (IFRS 17, Appendix A)

Example:
- Contracts in the same product line if managed together
- Appears to be a very broad notion (see paragraph 14 which refers to regular term life assurance as a possible portfolio)
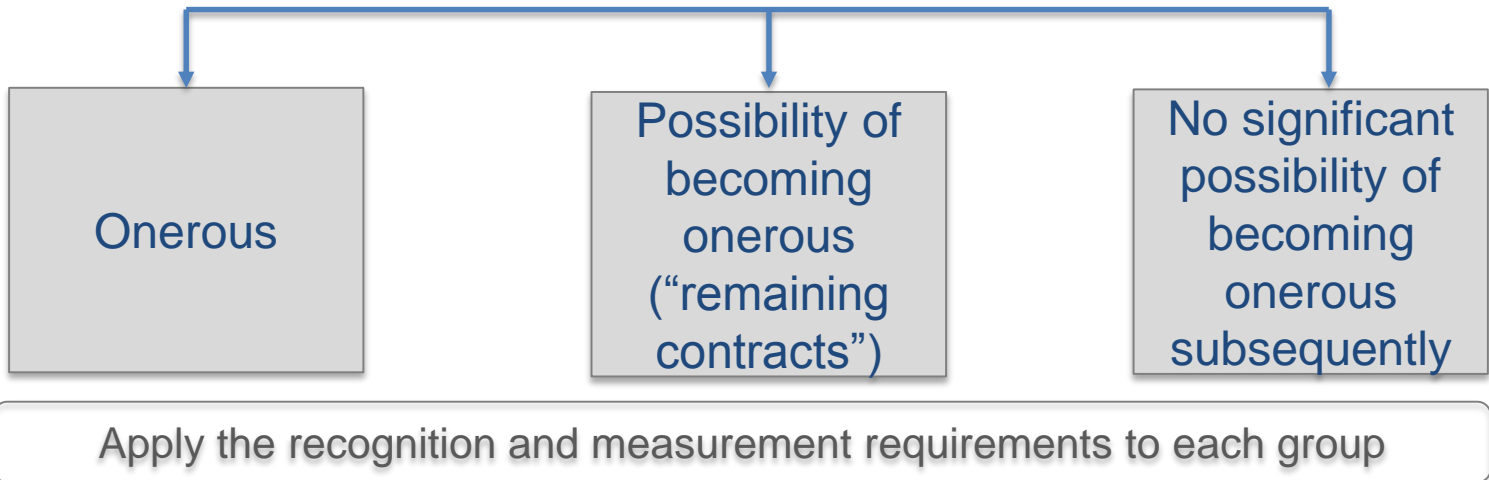
GROUPING

GROUPING*

Step 1
Identification of *portfolios* of insurance contracts issued <u>at inception</u>
(IFRS 17, paragraph 14)

Step 2
Divide portfolios of contracts into annual time buckets (cohorts)
(IFRS 17, paragraph 22)

Step 3
Divide annual cohorts into *groups* of contracts, at inception (if any):
(IFRS 17, paragraph 16)

| Onerous | Possibility of becoming onerous ("remaining contracts") | No significant possibility of becoming onerous subsequently |

Apply the recognition and measurement requirements to each group

* Referred to in IFRS 17 as Level of aggregation

GROUPING

REGULATORY EXEMPTION

Law or regulation may constrain entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, e.g. gender, age, etc.

IFRS 17 permits such contracts to be aggregated into the same group.

GROUPING

LIMITED TO ONE YEAR COHORTS TO ENSURE

- The carrying amount of CSM (contractual service margin = unearned profit) for the group reflects coverage to be provided under contracts within the group (i.e. contracts that have not lapsed or expired)

- The allocation of the CSM to P&L faithfully depicts profitability in contracts over time

- Full run-off of CSM to P&L once coverage period has ended

GROUPING

ONEROUS CONTRACTS

- Identified at initial recognition

- May assess onerousness by measuring a set of contracts rather than individual contracts

- Remains a separate group and loss recognised immediately in profit or loss

GROUPING: EXAMPLE

Example 1: A set of 100 identical contracts are written with a probability that 5 of the policyholders will claim

100 contracts are a group; the company does not treat the 5 contracts as a separate group

Example 2: A company issues 500 contracts; there is information that a set of 200 identical contracts are under-priced, but the company expects that a set of 300 profitable identical contracts will cover losses (or possible losses) on the other set of 200 under-pricedcontracts

Group A – losses on the 200 under-priced contracts are recognised immediately
Group B – profits on 300 contracts recognised over the coverage period

Source: IASB

GROUPING

RELEVANT FOR

Measuring CSM and its allocation in profit or loss
(IFRS 17, paragraph 38)

NOT RELEVANT FOR

Measuring the fulfilment cash flows of a group of contracts
(IFRS 17, paragraph 24)

Measuring and allocating directly attributable expenses
(IFRS 17, paragraphs 24 and BC177)

Measuring and allocating the risk adjustment
(IFRS 17, paragraph BC213 (b) and BC214)

Can be measured at a higher level

INDUSTRY CONCERNS - GROUPING

Identifying onerous contracts	IFRS 17, paragraphs 16 and 17: The level at which onerous contracts at inception should be identified is unclear

Arguments in favour of IFRS 17

- Helps to avoid understatement of liabilities at a more granular level than today

- Recognition of losses at inception contributes to prudence

Arguments against IFRS 17

- Profitability is assessed on a portfolio basis

- It is feared that pricing is to be done on a single parameter basis (instead of a multiple parameter basis today), leading to an increase in standard deviation of the price, hence an increased number of onerous contracts

INDUSTRY CONCERNS - GROUPING

Grouping - mutualisation	IFRS 17, paragraphs 16 and 22: The aggregation requirements will lead to a significant number of groups and it is unclear how it applies to mutualisation. It will increase implementation and operational costs.

Arguments in favour of IFRS 17

- Grouping is used to build a meaningful CSM, limiting cross-subsidisation, reducing averaging

- Mutualisation can be considered when determining groups

- Helps to avoid understatement of liabilities in a more granular level than today

Arguments against IFRS 17

- Significant cost and systems implications

- Allocation of 'mutualised amounts' to groups of contracts is seen as artificial and not used in business

- A significant change to current practice

The term mutualisation is not used in IFRS 17. Instead IFRS 17 refers to sharing of risks, i.e. when insurance contracts in one group affect the cash flows to policyholders in a different group.
In practice, the term covers a variety of effects such as individual contract requirements, risk-diversification or cross-subsidisation

INDUSTRY CONCERNS - COHORTS

Annual cohorts requirement	IFRS 17, paragraph 22: This does not reflect the nature of insurance business and is costly.

Arguments in favour of IFRS 17

Arguments against IFRS 17

All contracts

- Appropriate amount of CSM in P&L and CSM amortised to zero at maturity

- Application results in useful trend information regarding the CSM over time

- Cross-generation risk-sharingmutualisation can be considered

- Will require significant changes to systems and increase costs

- Average results reflect how the pricing is set a portfolio level

- There is no need for using annual cohorts, the use of coverage units is sufficient

Direct participation contracts

- Using annual cohorts avoids showing averaged profits over time thereby blurring the trend information

- Change current practice based upon open portfolios where profit increases over time as underlying items increase due to changes in fair value as well as new policies written

INDUSTRY PROPOSALS – GROUPING (1/2)

- Ask the TRG to provide an interpretation that reduces the issues raised with level of aggregation as required by IFRS 17

- Disregard the annual cohort requirement if the principle of paragraph BC138 as per IFRS 17 is satisfied (i.e. the groups together provide the same result as a single combined risk-sharing portfolio)

- From mutuals' side:
  - a) Be able to defer the acquisition costs
  - b) Be able to use mutualisation to decrease the loss before calculating a new CSM amortisation

INDUSTRY PROPOSALS – GROUPING (2/2)

- Delete the annual cohort requirement
- Rely on the roll-forward of the CSM to disclose the profitability of the new annual business based on MCEV-practices (MCEV = market consistent embedded value)
- Use coverage units instead of the annual cohorts to reflect trend information

- Group contracts based on maturity date instead of upon inception date

GENERAL MODEL

GENERAL MODEL – INSURANCE LIABILITY

INITIAL MEASUREMENT

Fulfilment cash flows	Probability weighted expected cash flows
	Discounted
	Risk adjustment
Contractual service margin	

Includes consideration of a full range of possible outcomes and all cash flows within the contract boundary

Consistent with current market and reflects characteristics of insurance liability

Compensation required for bearing uncertainty around timing and amount of claims

Represents unearned profit in the contract that will be recognised over time based on coverage units

Measurement of an insurance contract incorporates all available information in a way consistent with observable market data.

GENERAL MODEL – INSURANCE LIABILITY

RISK ADJUSTMENT

Definition: The compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts (IFRS 17, Appendix A)

IFRS 17 does not prescribe how the risk adjustment is to be calculated

The risk adjustment also reflects:
- The degree of **diversification benefit** an entity considers
- Favourable and unfavourable outcomes, reflecting an entity's degree of risk aversion

GENERAL MODEL – INSURANCE LIABILITY

SUBSEQUENT MEASUREMENT

Liability for remaining coverage

Fulfilment cash flows	Probability weighted expected cash flows
	Discounted
	Risk adjustment
Contractual service margin	

+

Liability for incurred claims[1]

Fulfilment cash flows	Probability weighted expected cash flows
	Discounted
	Risk adjustment

[1]Zero at inception

Measurement of an insurance contract incorporates all available information in a way consistent with observable market data.

INDUSTRY CONCERNS – GENERAL MODEL

Investment component	IFRS 17, paragraph B96 (c): The requirement to update CSM with differences between the expected and actual investment component is operationally complex.

Arguments in favour of IFRS 17

- Avoids situations where delay or acceleration in repayment of an investment component does not allow offsetting a gain or loss (of the experience adjustment) in the current period with a loss or gain (of the changes in estimates of the present value of future cash flows) in future periods

Arguments against IFRS 17

- Operationally complex and costly

INDUSTRY CONCERNS – GENERAL MODEL

CSM at locked-in rate	IFRS 17, paragraphs 44(b) and B72 (b): Under the general model, CSM is accreted using the discount rate at inception

Arguments in favour of IFRS 17

- CSM is the unearned profit. The treatment is consistent with that required for other unearned profits

- Allocation of a CSM that is accreted at a locked-in rate results in useful pricing trend information

Arguments against IFRS 17

- Applying different discount rates to different parts of the insurance liability is difficult to explain to users

- Use of a locked-in discount rate requires tracking the original discount rate over time

INDUSTRY CONCERNS – GENERAL MODEL

CSM and coverage units	IFRS 17, paragraph B119: CSM allocation is mechanical.

Arguments in favour of IFRS 17 | **Arguments against IFRS 17**

All contracts

- As not all contracts in a group have an identical duration, a systematic allocation of CSM avoids showing an earnings pattern that is higher at the end of the duration of the group (with fewer contracts still in-force) than during the overall life of the group (with more contracts in-force) which could lead to building of hidden reserves

- A linear allocation pattern of the CSM does not reflect how the business earns profit on its contracts

Direct participation contracts

- Showing a CSM allocation pattern over the duration of a group of contracts reflects application of the long-term business model

- The revenue would not reflect the economics of asset management services included within the contracts, as these normally increase with the volume of the assets over the life of the contracts

COHORTS VS NO COHORTS

COHORTS VS NO COHORTS

COVERAGE UNITS ASSIGNED TO CSM

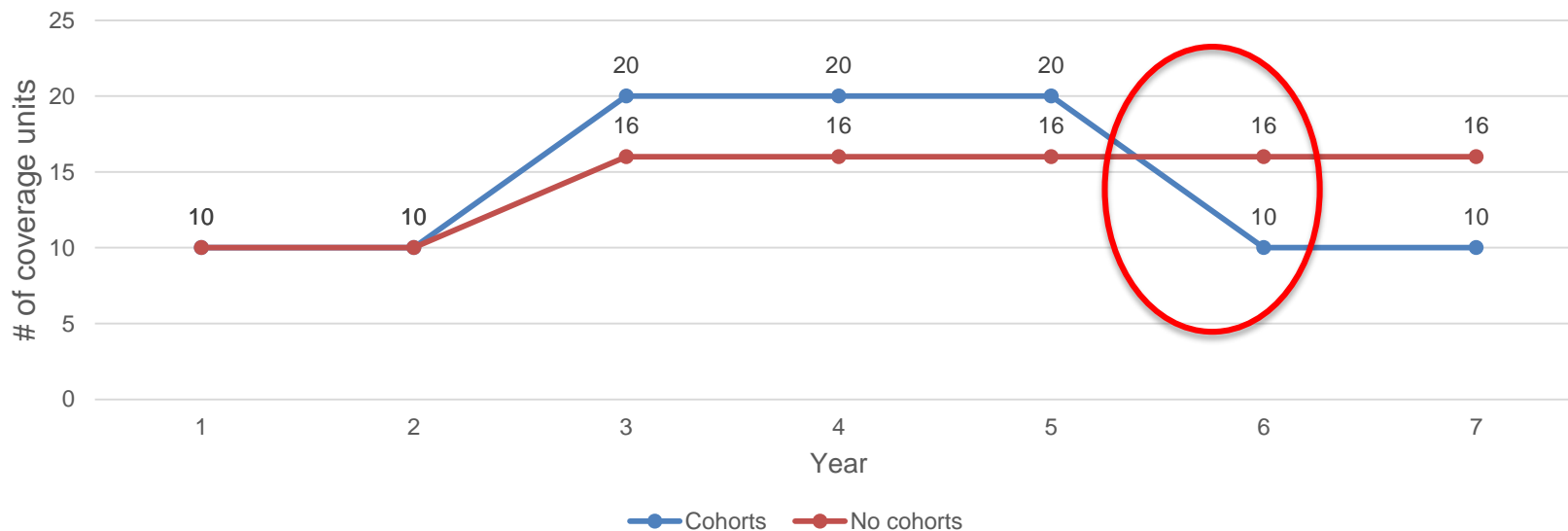No. of contracts in-force at end of each year
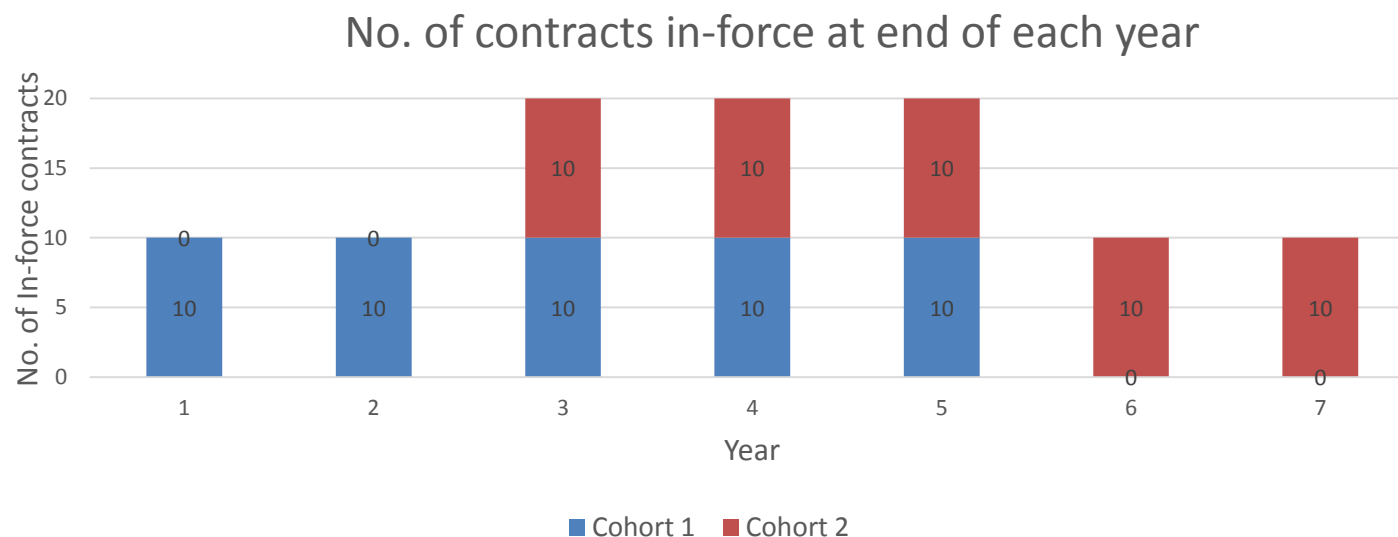
Cohort 1: 10 contracts which start in Y0 and end in Y5

Cohort 2: 10 contracts which start in Y3 and end in Y7

COHORTS VS NO COHORTS
EXAMPLE 1: NOT TRACKING MATURITY AND PROFITABILITY

COVERAGE UNITS ASIGNED TO CSM PER YEAR

Cohorts:

Reflect trend in CSM per year
- From Y2 to Y3, CSM allocation increases due to CSM allocation of new business in Y3
- From Y5 to Y6, CSM allocation decreases as cohort 1 ends (i.e. reflection that contracts in cohort have ended)
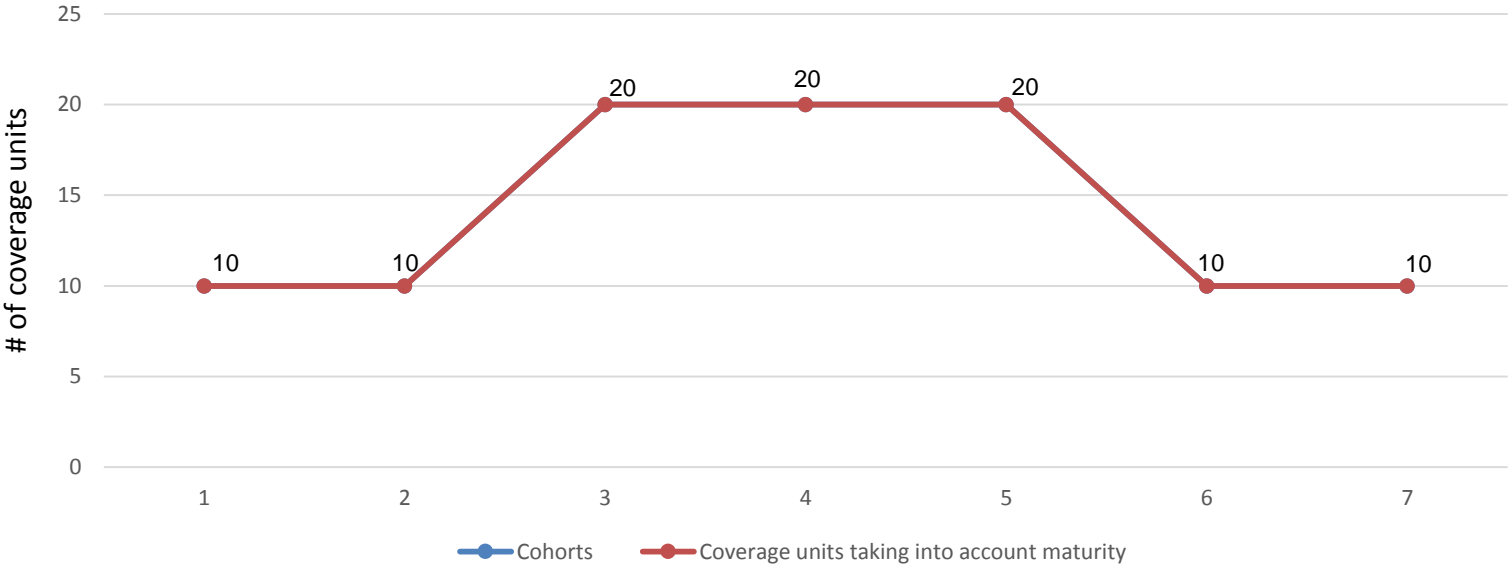
No cohorts:

From Y3 to Y7 reflects an average allocation of CSM to profit or loss

COHORTS VS NO COHORTS
EXAMPLE 1: NOT TRACKING MATURITY AND PROFITABILITY

ALLOCATION OF CSM TO PROFIT OR LOSS
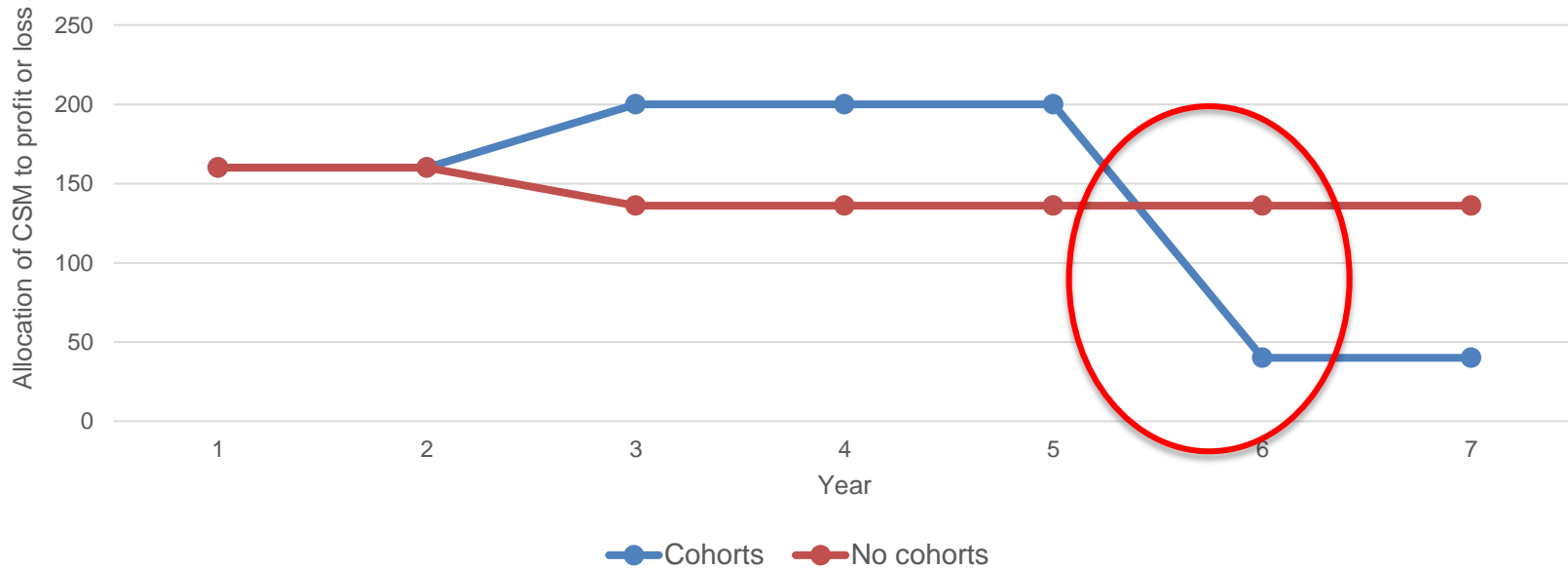
Cohorts:

Reflect trend in CSM per year

- From Y2 to Y3, CSM allocation increases due to CSM allocation of new business in Y3
- From Y5 to Y6, CSM allocation decreases as cohort 1 ends (i.e. reflection that contracts in cohort have ended)

No cohorts:

From Y3 to Y7 reflects an average allocation of CSM to profit or loss

From Y2 to Y3 decrease in CSM allocation due to averaging

COHORTS VS NO COHORTS
EXAMPLE 2: TRACKING MATURITY BUT NOT PROFITABILITY

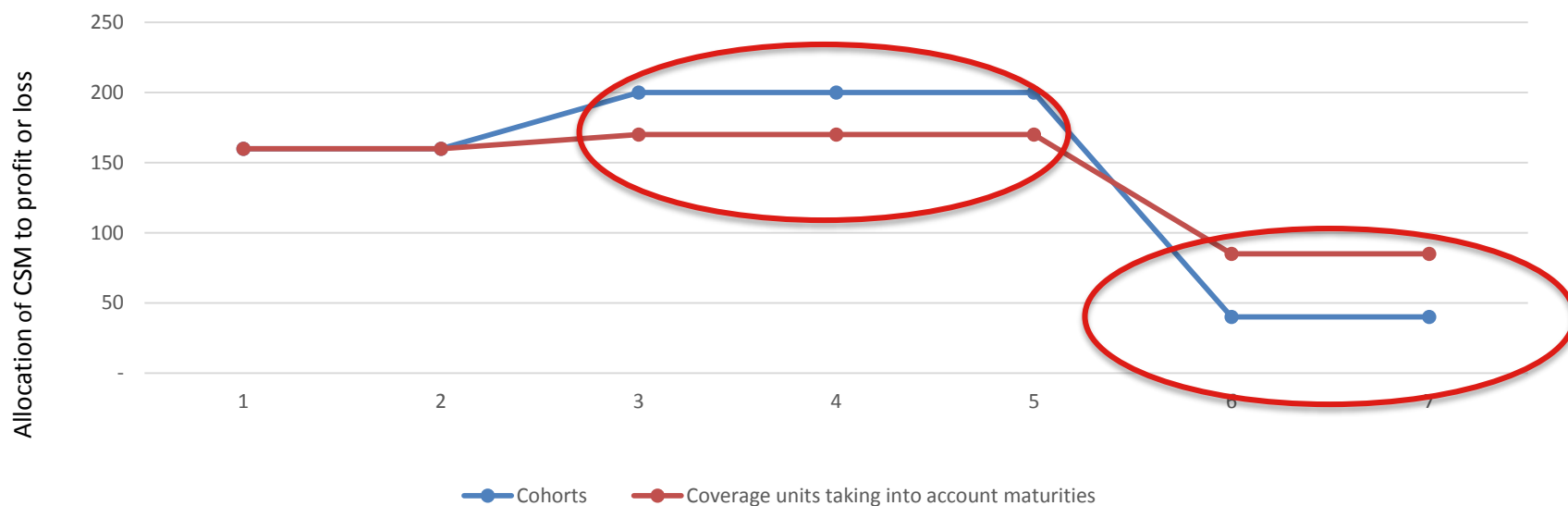## COVERAGE UNITS ASIGNED TO CSM PER YEAR

Legend: Cohorts — Coverage units taking into account maturity

Under both methods, the same number of coverage units is assigned every year

COHORTS VS NO COHORTS
EXAMPLE 2: TRACKING MATURITY BUT NOT PROFITABILITY

ALLOCATION OF CSM TO PROFIT OR LOSS

Cohorts —— Coverage units taking into account maturities ——

Cohorts:

Reflect trend in CSM per year
- From Y2 to Y3, CSM allocation increases due to CSM allocation of new business in Y3
- From Y5 to Y6, CSM allocation decreases as cohort 1 ends (i.e. reflection that contracts in cohort have ended)

No cohorts:

From Y2 to Y3 CSM allocation increases but less than using cohorts
From Y6 to Y7 CSM allocation decreases but shock is partly absorbed by profits set aside during Y3-Y5

RECOGNITION OF CSM IN P&L

RECOGNITION OF CSM IN P&L

EXAMPLE 1 – HURRICANE INSURANCE

Assumptions

Annual hurricane insurance* where claims estimated to occur during Q3

CSM at inception = EUR10,000 for 100 contracts

Duration of the contracts = 1 year
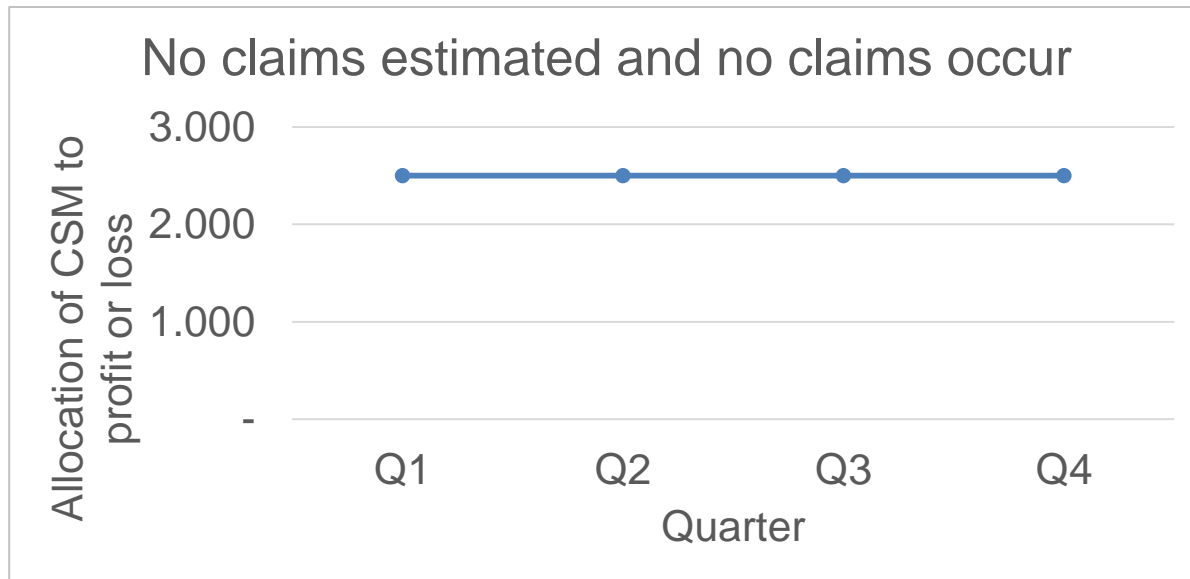The entity reports quarterly

At inception, assume there are 100 coverage units per quarter

* Whilst hurricane insurance would often be one of the risks covered by property insurance, for purposes of the example we focus only on this risk.
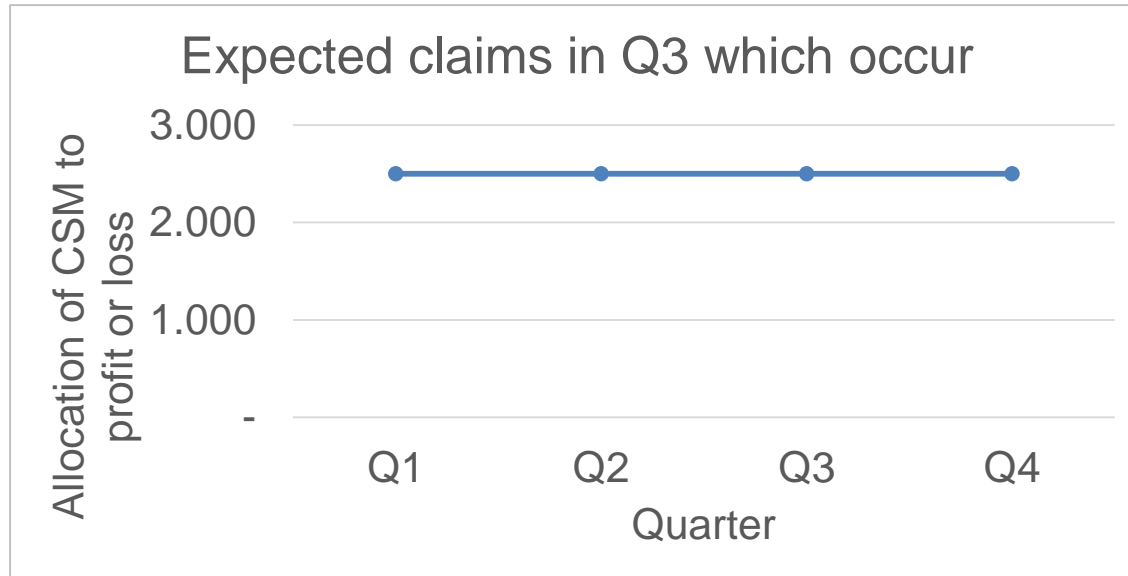
RECOGNITION OF CSM IN P&L

EXAMPLE 1 – HURRICANE INSURANCE

No claims estimated and no claims occur

Linear recognition of CSM to profit or loss

RECOGNITION OF CSM IN P&L

EXAMPLE 1 – HURRICANE INSURANCE

Even though there are claims in Q3, all contracts remain in-force till end of Q4. Therefore, linear recognition of CSM in profit or loss.

RECOGNITION OF CSM IN P&L

EXAMPLE 2 – MORTGAGE INSURANCE

Assumptions

No claims estimated and no claims occur
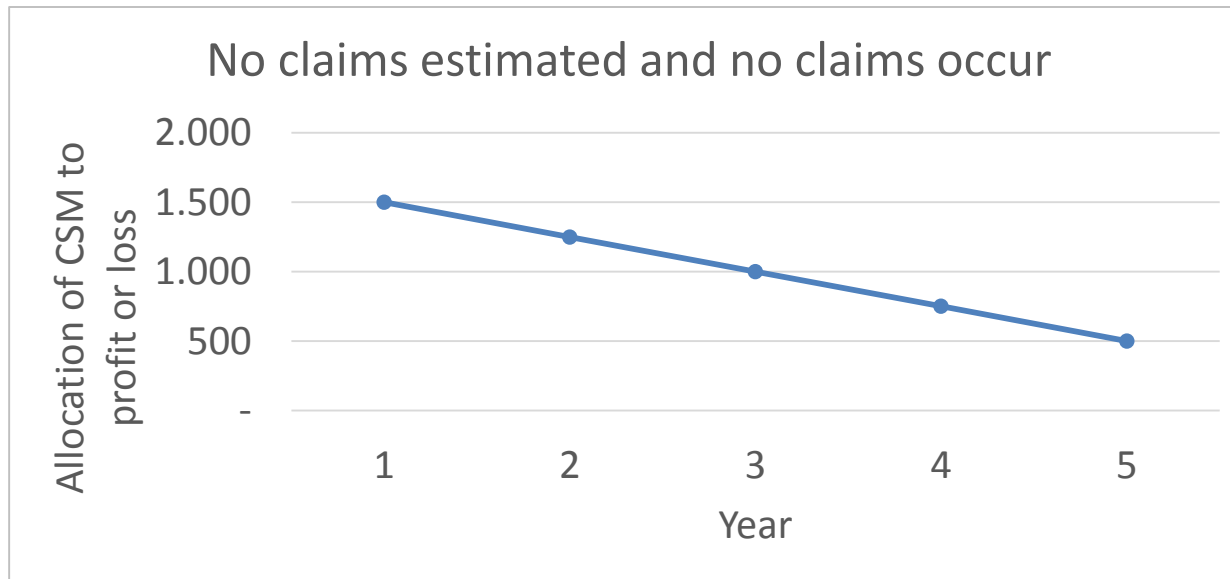
CSM at inception = €5,000 for 10 contracts

Duration = 5 years and quantity of benefits at inception = €400,000

Quantity of benefits decreases by €8,000 each year

Assume, at inception, there are 200 coverage units for whole coverage period

RECOGNITION OF CSM IN P&L

EXAMPLE 2 – MORTGAGE INSURANCE

No claims estimated and no claims occur

(Chart: Allocation of CSM to profit or loss vs Year; line decreasing from ~1.500 at Year 1 to ~500 at Year 5, with points at approximately 1.500, 1.250, 1.000, 750, 500)

Over time, amount to be paid by insurer decreases.
CSM allocation to profit or loss decreases to reflect this.

JARGON USED

JARGON USED

Contract boundary: This concept is used to determine which cash flows are included in the measurement of an insurance contract. Cash flows from future insurance contracts are not in the boundary of an insurance contract.

Coverage period: The period for which the entity provides cover for the insured event – includes all premiums within the contract boundary.

Coverage unit in a group: Coverage provided by the contracts in the group, determined by considering for each contract the quantity of benefits provided under a contract and its expected coverage duration. [Method used to allocate CSM to proft or loss]

CSM (Contractual service margin): The unearned profit the entity will recognise as it provides services in the future.

THANK YOU
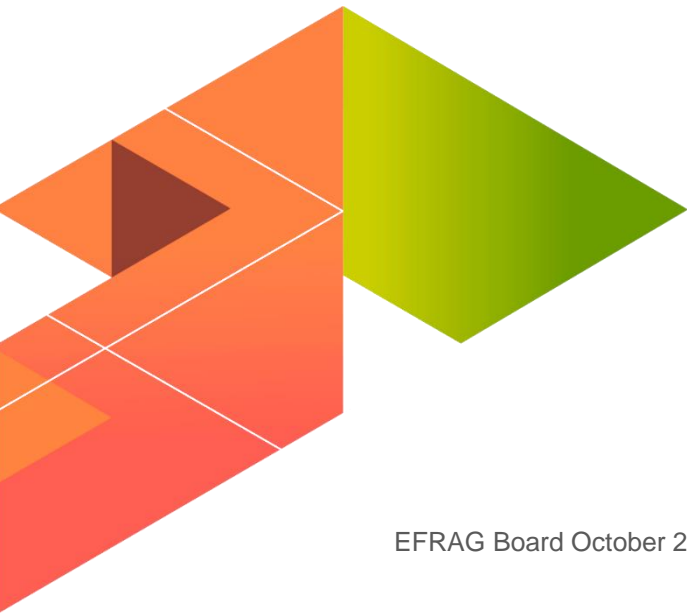
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