IFRS 17 – Life Insurance

Kamlesh Gupta, FIAI

WIRC of ICAI

October 27, 2018

Disclaimer

The views presented in this presentation are personal and not necessarily of my employer or of the Institute of Actuaries of India.

The views reflect a position at this point in time, and may change in the future as the discussion around IFRS 17 develops.

Agenda

- Background
- Scope
- Key concepts
- Measurement approaches
- Simple examples
- Transition
- Impact and conclusions

Background

Why IFRS 17 (a principle-based standard)?

<u>Issues with current insurance accounting</u>

- Difficult to interpret for common investor
  - Sources of profit not clear
  - Current statements do not provide all relevant information
- Different profit recognition patterns
  - At the beginning, distributed throughout or in the end
- Lack of comparability
  - Across industries

Timelines

- Interim standard IFRS 4
- May 18, 2017: IFRS 17 issued (20 years in making)
- April 01, 2020: Effective date for India
- January 01, 2021: Effective date globally

Scope

Scope

The entity shall apply IFRS 17 to:

- Insurance and reinsurance contracts it issues
- Reinsurance contracts it holds
- Investment contracts with discretionary participation features (DPF) it issues, provided the entity also issues insurance contracts

What changes?

What changes?

Almost everything!

Insurance Contract

"A contract under which one party (the issuer) accepts <u>significant</u> insurance risk from <u>another party</u> (the policyholder) by agreeing to compensate the policyholder if a <u>specified</u> <u>uncertain</u> future event (the insured event) <u>adversely affects</u> the policyholder."

Insurance contracts or not

- Term products
- Life-contingent annuities
- Endowment product
- Whole-life product
- Self-insurance
- ULIP pension product without significant cover

Key concepts

Key concepts

- Aggregation
- Coverage boundary
- Unbundling
  - Investment Component
  - Embedded Derivative

Aggregation

- Portfolio of contract which are ‘similar risks’ and ‘managed together’
- Each portfolio is divided into minimum three groups:
  - A group of contracts that are onerous on initial recognition
  - A group of contracts that, on initial recognition, have no significant possibility of becoming onerous subsequently
  - A group of any remaining contracts in the portfolio

Contract boundary

- The entity has the ‘practical ability’ to reassess the risk of the portfolio of insurance contracts that contains the contract and can set a price or level of benefits that fully reflects the risk of that portfolio.
- The contract boundary is reassessed at each reporting date and, therefore, may change over time.

Unbundling or Separation
Investment component

<u>Investment component</u>

An ‘investment component’ represents the amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.

Investment component

An investment component is distinct if:

- It and the insurance component are not ‘highly inter-related’; and
- A contract with equivalent terms is sold or could be sold separately in the same market or jurisdiction.

Embedded Derivatives

An embedded derivative is separated from the host insurance contract under IFRS 9 when

- The economic characteristics and risks of the embedded derivative are not closely related to those of the host contract
- The embedded derivative would not be an insurance contract as a stand-alone instrument

Measurement approaches

Measurement approach

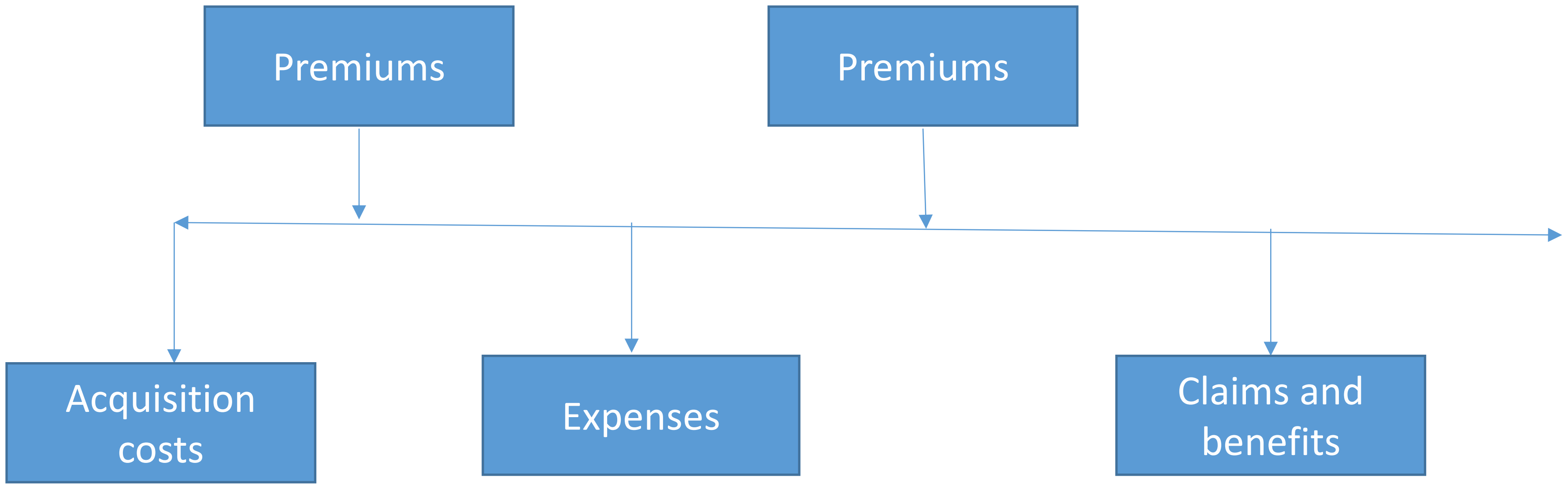
	General model	Premium allocation approach	Variable fee approach
Why is it needed?	Default model for all insurance contracts	Simplified model for short-term contracts	Model for direct participating business
Mandatory / Optional	Mandatory	Optional	Mandatory
Products	Long-duration term products	Group one year renewable term	Unit Linked products

Initial Measurement – General Measurement Model

Source: KPMG

Future cash flows

- Current estimates of future cash flows
- Probability weighted and unbiased
- Stochastic modeling where necessary for financial options and guarantees



Discounting

- CSM discounting at locked-in rate
- Cash flows discounting rate can change
- To reflect characteristics of the liabilities
- Two methods
  - Top down
  - Bottom up

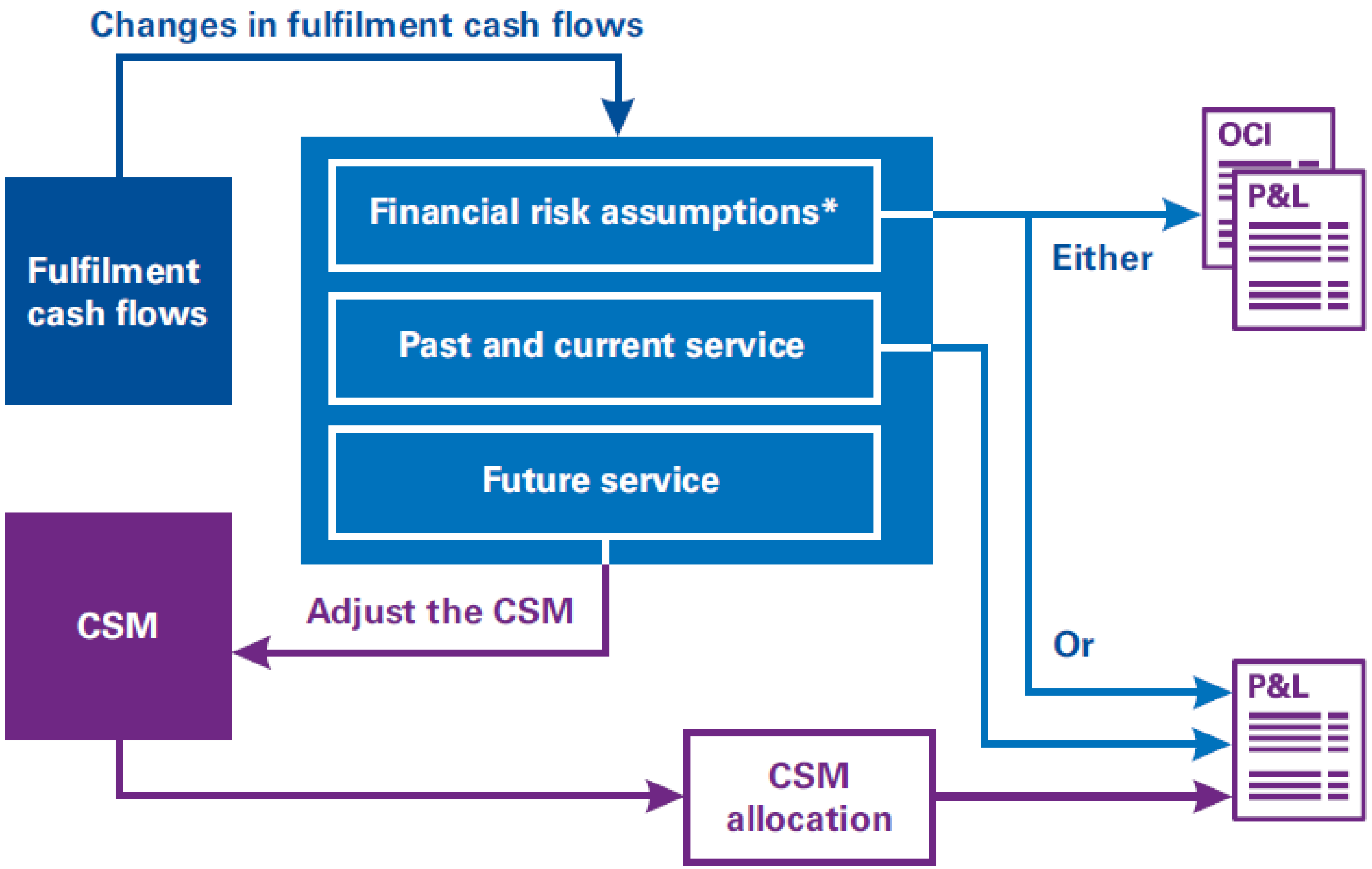
Risk Adjustment

- Explicit adjustment for the compensation a company requires for bearing insurance risk
  - No more implicit risk adjustment to expected cash flows and lack of transparency regarding ‘reserve releases’
- Part of total unearned profit
- Recognized in P&L as the company is released from the risk
- Various possible methods of calculation
  - Need to provide confidence level

Contractual service margin

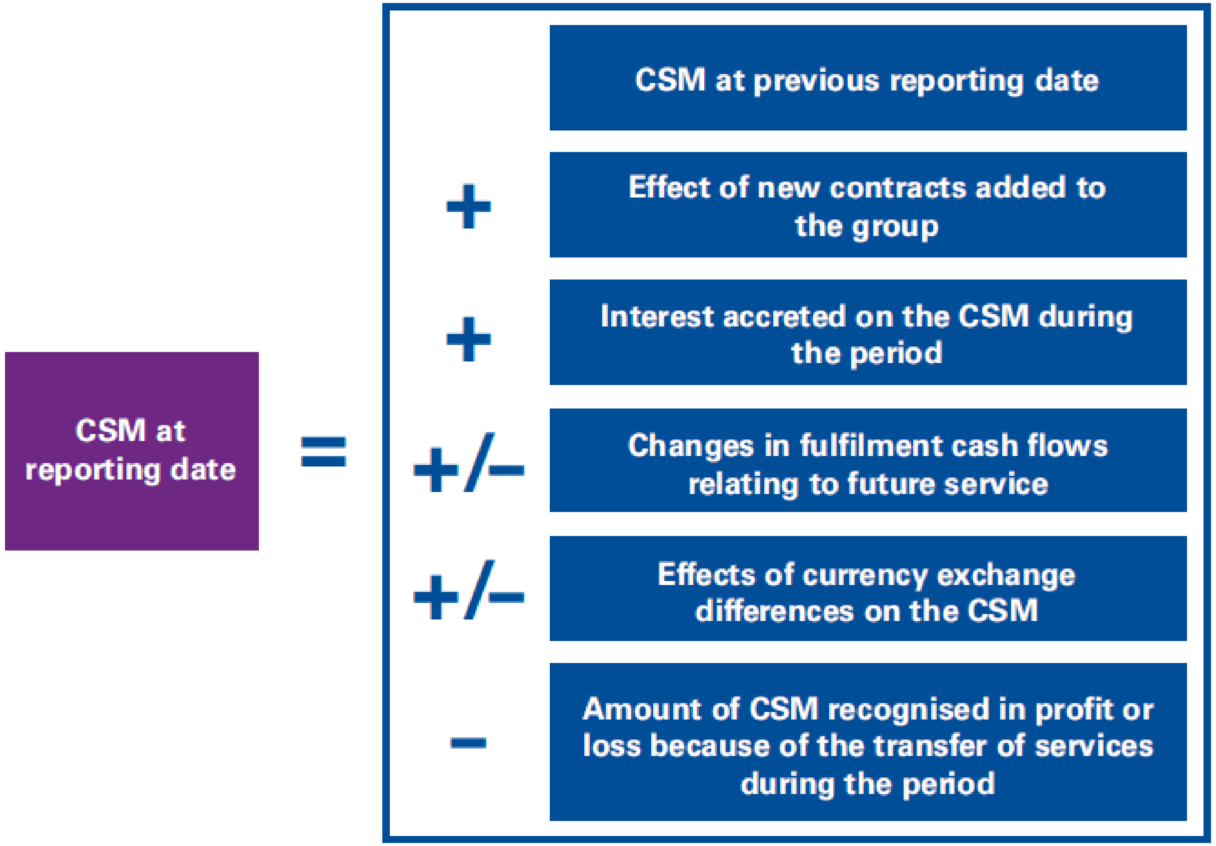
- Represents the unearned profit
- Measured at initial recognition
- Negative CSM not allowed (except for reinsurance contracts held)
  - Onerous contracts
  - Loss component
- Unwinding at locked-in rate
- Amortization over coverage duration
  - No unique method

Changes in Fulfilment cash flows



Source: IFRS 17 – First Impressions - KPMG

Changes in CSM



Source: IFRS 17 – First Impressions - KPMG

Reinsurance

- Aggregated in portfolio
  - “similar risk” and “managed together”
- Assumptions used consistent with those for underlying contracts
- CSM at initial recognition
  - Negative value possible
- Effect of non-performance of the reinsurers will be included in the estimates of the reinsurance cash flows
- Change in estimates of the expected credit loss
  - Not to CSM but in the P&L

Example 1

Contract details

Example of the contract with following parameters:

- Single Premium = INR 900
- Coverage period = 3 years
- Annual cash outflow = INR 200
- Risk adjustment = INR 120
- Discount rate = 5% p.a.

Initial Recognition and year-end projections

	Initial Recognition
Estimates of the PV of future in flows	(900)
Estimates of the PV of future out flows	545
Estimates of the PV of future cash flows	(355)
Risk adj for non-fin risks (e.g. mortality)	120
Fulfillment cash flows	(235)
CSM	235
(Asset) liability on initial recognition	0

Initial Recognition and year-end projections

	Initial Recognition	End of Year 1	End of Year 2	End of Year 3
PV of future in flows	(900)	0	0	0
PV of future out flows	545	372	191	0
PV of future cash flows	(355)	372	191	0
Risk adj for non-fin risks	120	80	40	0
Fulfillment cash flows	(235)	452	231	0
CSM	235			
(Asset) liability on initial recognition	0			

Movement for first year

	Estimates of the PV of future cash flows	Risk-adj for non-financial risk	CSM	Insurance contract liability
Opening balance	0	0	0	0
Changes related to future service: new contracts	(355)	120	235	0
Cash inflows	900	0	0	900
Insurance finance expenses	27	0	12	39
Changes related to current service	0	(40)	(82)	(122)
Cash outflows	(200)	0	0	(200)
Closing balance	372	80	165	617

Experience in second year

- Claim amount is INR 150 instead of INR 200
- Assumption Review for 3rd policy year:
  - Cash outflow: INR 200 -> INR 140
  - Risk adjustment: INR 40 -> INR 30

Change in assumptions for year 3

	Initial Recognition	End of Year 1	End of Year 2	End of Year 3
Estimates of the PV of future in flows	(900)	0	0	0
Estimates of the PV of future out flows	545	372	~~191~~ 133	0
Estimates of the PV of future cash flows	(355)	372	~~191~~ 133	0
Risk adj for non-fin risks	120	80	~~40~~ 30	0
Fulfillment cash flows	(235)	452	~~231~~ 163	0
CSM	235			
(Asset) liability on initial recognition	0			

Movement for 2nd year

	Estimates of the PV of future cash flows	Risk-adj for non-financial risk	CSM	Insurance contract liability
Opening balance	372	80	165	617
Changes related to future service	(58)	(10)	68	0
Cash inflows	0	0	0	0
Insurance finance expenses	19	0	8	27
Changes related to current service	(50)	(40)	(121)	(211)
Cash outflows	(150)	0	0	(150)
Closing balance	133	30	120	283

Movement for 3rd policy year

	Estimates of the PV of future cash flows	Risk-adj for non-financial risk	CSM	Insurance contract liability
Opening balance	133	30	120	283
Changes related to future service	0	0	0	0
Cash inflows	0	0	0	0
Insurance finance expenses	7	0	6	13
Changes related to current service	0	(30)	(126)	(156)
Cash outflows	(140)	0	0	(140)
Closing balance	0	0	0	0

P&L

	Year 1	Year 2	Year 3	Total
Changes related to current service	122	211	156	489
Insurance service expense	0	0	0	0
Insurance service result (A)	122	211	156	489
Investment Income	0	0	0	0
Insurance finance expenses	(39)	(27)	(13)	(79)
Finance result (B)	(39)	(27)	(13)	(79)
Profit (A+B)	83	184	143	410

Experience in second year

- Claim amount is INR 400 instead of INR 200
- Assumption Review for 3rd policy year:
  - Cash outflow: INR 200 -> INR 450
  - Risk adjustment: INR 40 -> INR 88

Change in assumptions for year 3

	Initial Recognition	End of Year 1	End of Year 2	End of Year 3
Estimates of the PV of future in flows	(900)	0	0	0
Estimates of the PV of future out flows	545	372	~~191~~ 429	0
Estimates of the PV of future cash flows	(355)	372	~~191~~ 429	0
Risk adj for non-fin risks	120	80	~~40~~ 88	0
Fulfillment cash flows	(235)	452	~~231~~ 517	0
CSM	235			
(Asset) liability on initial recognition	0			

Movement for 2^{nd} policy year

	Estimates of the PV of future cash flows	Risk-adj for non-financial risk	CSM	Insurance contract liability
Opening balance	372	80	165	617
Insurance finance expenses	19	0	8	27
Changes related to future service	238	48	(173)	113
Cash inflows	0	0	0	0
Changes related to current service	200	(40)	0	160
Cash outflows	(400)	0	0	(400)
Closing balance	429	88	0	517

Movement for 3rd policy year

	Estimates of the PV of future cash flows	Risk-adj for non-financial risk	CSM	Insurance contract liability
Opening balance	429	88	0	517
Changes related to future service	0	0	0	0
Cash inflows	0	0	0	0
Insurance finance expenses	21	0	0	21
Changes related to current service	0	(88)	0	(88)
Cash outflows	(450)	0	0	(450)
Closing balance	(450)	0	0	0

P&L

Statement of profit or loss	Year 1	Year 2	Year 3	Total
Changes related to current service	122	(160)	88	50
Changes related to future service	0	(113)	0	(113)
Insurance service expense	0	0	0	0
Insurance service result (A)	122	(273)	88	(63)
Investment Income	0	0	0	0
Insurance finance expenses	(39)	(27)	(21)	(87)
Finance result (B)	(39)	(27)	(21)	(87)
Profit (A+B)	**83**	**(300)**	**67**	**(150)**

Example 2

Insurance contract liability roll forward

	Estimates of the present value of future cashflows	Risk adjustment	Contractual service margin	Liability
BEGINNING OF PERIOD	163,962	5,998	8,858	178,818
Changes related to:				
- Future service yet to be provided	(784)	1,117	(116)	217
- Current service provided in the period	35	(604)	(923)	(1,492)
- Past service adjustment to past claims	47	(7)	-	40
Insurance service result	(702)	506	(1,039)	(1,235)
Insurance finance expenses	9,087	-	221	9,308
TOTAL CHANGES IN P&L	8,385	506	(818)	8,073
CASHFLOWS	18,833	-	-	18,833
END OF PERIOD	191,180	6,504	8,040	205,724

- Results excluding the effects of reinsurance
- Some insurance finance expenses may be presented in Other Comprehensive Income (OCI)

Future service – incl. new business

	Estimates of the present value of future cashflows	Risk adjustment	Contractual service margin	Liability
BEGINNING OF PERIOD	163,962	5,998	8,858	178,818
Changes related to:				
- Future service yet to be provided	(784)	1,117	(116)	217
New profitable contracts recognised	(2,344)	969	1,375	-
Estimate changes - profitable contracts	1,452	39	(1,491)	-
New onerous contracts recognised	15	108	-	123
Estimate changes - onerous contracts	93	1	-	94
- Current service provided in the period	35	(604)	(923)	(1,492)
- Past service adjustment to past claims	47	(7)	-	40
Insurance service result	(702)	506	(1,039)	(1,235)
Insurance finance expenses	9,087	-	221	9,308
TOTAL CHANGES IN P&L	8,385	506	(818)	8,073
CASHFLOWS	18,833	-	-	18,833
END OF PERIOD	191,180	6,504	8,040	205,724

- Results excluding the effects of reinsurance
- Positive number in total column = increase in liability = loss in P&L

Current service – profit recognized

	Estimates of the present value of future cashflows	Risk adjustment	Contractual service margin	Liability
BEGINNING OF PERIOD	**163,962**	**5,998**	**8,858**	**178,818**
Changes related to:				
- Future service yet to be provided	(784)	1,117	(116)	217
- Current service provided in the period	35	(604)	(923)	(1,492)
Contractual service margin earned			(923)	(923)
Release from risk		(604)		(604)
Experience loss	35			35
- Past service adjustment to past claims	47	(7)	-	40
Insurance service result	(702)	506	(1,039)	(1,235)
Insurance finance expenses	9,087	-	221	9,308
TOTAL CHANGES IN P&L	8,385	506	(818)	8,073
CASHFLOWS	18,833	-	-	18,833
END OF PERIOD	**191,180**	**6,504**	**8,040**	**205,724**

- Results excluding the effects of reinsurance

Past service – adjusting past claims

	Estimates of the present value of future cashflows	Risk adjustment	Contractual service margin	Liability
BEGINNING OF PERIOD	**163,962**	**5,998**	**8,858**	**178,818**
Changes related to:				
- Future service yet to be provided	(784)	1,117	(116)	217
- Current service provided in the period	35	(604)	(923)	(1,492)
- Past service adjustment to past claims	47	(7)	-	40
Insurance service result	(702)	506	(1,039)	(1,235)

- Results excluding the effects of reinsurance

Insurance finance expenses

	Estimates of the present value of future cashflows	Risk adjustment	Contractual service margin	Liability
Insurance finance expenses	9,087	-	221	9,308
Accretion at historical rate* - P&L	7,170	-	221	7,391
Assumption changes (P&L or OCI)	1,917	-	-	1,917

Cash flows

	Estimates of the present value of future cashflows	Risk adjustment	Contractual service margin	Liability
CASHFLOWS	18,833	-	-	18,833
Premiums received	33,570			33,570
Claims, benefits and other expenses paid	(14,336)			(14,336)
Insurance acqusition cash flows	(401)			(401)
END OF PERIOD	**191,180**	**6,504**	**8,040**	**205,724**

Variable Fee Approach (VFA)

- Applicable for insurance contracts with direct participation features:
  - the contractual terms specify that the policyholder participates in clearly identified pool of underlying items;
  - the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on 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
- No adjustment of CSM for accretion of interest

Premium allocation approach

- An optional simplification if
  - Coverage period one year or less or
  - Measurement not materially different from GMM or VFA
- Initial measurement equals premium received less acquisition costs

Transition

Transition approaches

- Fully retrospective
  - Default approach
- Modified retrospective
- Fair Value

Impact and conclusions

Impact and conclusions

- Transparency
  - Sources of profit – more clarity
- Revenue definition
  - Top-line focus goes
  - Performance metrics will change
- Immediate recognition of losses
  - Relook at product portfolio and pricing
- Large scale process and system upgrades
  - Time and cost
- Consistency
  - With other industries and geographies

Impact and conclusions

- A big accounting change for insurance companies
- Actuarial workings to undergo huge changes
- IT systems need to be advanced to support the change

Accountants, Actuaries and IT professionals need to work together more closely


Questions

Thank you