**IFRS 17 and its possible implications, Imrich Lozsi,**

*Introduction*

By issuing the long-awaited IFRS 17, the final accounting standard for insurance contracts in May 2017, the work on insurance accounting project has come to an end. Insurers affected by its requirements are starting their preparations as the remaining time until 1 January 2021, which is the date when IFRS 17 comes into effect, is short. At present, we have approximately three years for the implementation which, given the complexity of the requirements, causes headache for many insurers. Apart from technical challenges, they are also considering the impacts of IFRS 17 on their results and perhaps more importantly also on the way, how an insurance company will be managed under the new regime. As the content and format of the reported results will be materially different from those seen currently, there are valid concerns that this may cause some uncertainty and even confusion if the new numbers are not well understood. This article summarizes some of the key changes introduced by IFRS 17 and discusses the possible implications associated with them.

*Scoping requirements*

In contrast with Solvency II, which applies to legal entities, IFRS 17 is valid for contracts, which contain significant insurance risk. The legal form of the entity issuing these contracts does not matter. IFRS 17 may equally be relevant for insurance companies, pension funds or other entities, if these issue contracts containing significant insurance risk. The requirements of IFRS 17 also apply to reinsurance contracts held. This means that IFRS 17 introduces a common measurement model for insurance contracts and related reinsurance assets.

*Separation of contract components*

Some non-insurance components of an insurance contract must be separated from the host insurance contract and should be accounted for separately. This holds for certain embedded derivatives and distinct investment and service components which are not highly inter-related with the insurance component. This is in contrast with the current accounting, under which a single client contract is not broken down to its components but all its cash flows are valued together. Under IFRS 17, the contract cash flows must be separated to those related to the insurance, embedded derivative, distinct investment and distinct service components. These separated cash flows must be valued separately, by using different IFRS standards (IFRS 9 or IFRS 15).

To comply with the separation requirements a single contract must possibly be accounted for by using three different accounting models IFRS 17, IFRS 9 and IFRS 15. This means that the expected cash flows from such contract must be separable in primary systems, actuarial and accounting systems. Separation of some cash flows, however, may require development of complex allocation procedures. For instance, determination of the proportion of the expenses attributable to the investment and insurance part of the same contract might be a challenge.

*Level of aggregation*

Perhaps the biggest challenge of IFRS 17 relates to the desired level of aggregation when calculating insurance contract liabilities. Liabilities should be calculated at the level of groups, which reflects the way how the entity is managing its business. Apart from this, groups should contain contracts with
similar risks, similar initial profitability and contracts which were issued within a given time period, lasting maximum one year. Separate groups should be formed from contracts which are expected to be loss making at their issue. This requirement limits the possibility of offsetting expected losses from onerous contracts with expected profits from profitable ones.

By applying the aggregation requirements of IFRS 17 an entity will disclose financial information, which allows monitoring the evolution of the profitability of different rating books, i.e. groups of similar contracts issued in a given year, over the whole lifetime of the given group. This provides useful information for management of this rating book. From the financial information disclosed under IFRS 17 it is possible to derive, at any time, the profits which were already recognized and those which are expected to be recognized in future.

Regardless of the fact how challenging these aggregation criteria for entities are, the grouping requirements under IFRS 17 represent a relief in comparison with what an accounting standard would normally require. Generally, accounting standards set out requirements for individual contracts and they require accounting on a contract-by-contract basis. The permitted grouping under IFRS 17 is only a relaxation on the basis that similar grouping possibility also exist under some other IFRS standards.

**Liability valuation using the general model**

The core parts of IFRS 17 deal with the approach to liability valuation and profit recognition, which are changed in comparison with the current regime. Within the general model, also referred to as the Building Block Approach („BBA“), the liability is presented as the sum of three components, namely:

- Cash Flows („CF“);
- Risk Adjustment („RA“); and
- Contractual Service Margin („CSM“).

The fourth building block refers to the effect of time value of money („TVM“), what means that the IFRS 17 liability should be generally evaluated on a discounted basis.

The Cash Flow and Risk Adjustment components are present values and are calculated using current assumptions. The Contractual Service Margin is a retrospective element, expressing the remaining profits from the group of insurance contracts. At initial recognition, the Contractual Service Margin is set at the level which eliminates profits from the group of insurance contracts. These initial profits will be recognized in future, in line with the way how the insurer provides insurance coverage and other services to policyholders. CSM is increased by interest valid at issue of the contracts, therefore it necessary to keep these historical interest rates until the run off of these contracts.

**Profit recognition**

To complete the profit and loss account („PnL“) or other comprehensive income („OCI“) under IFRS 17 it is necessary to monitor the above liability components separately over the whole duration of the group of insurance contracts. Profit and loss arise in line with the originally projected changes in CF, RA and CSM components of the liability over time (i.e. along the pattern implied by initial recognition) and in line with emergence of actual cash flows. Changes in estimates of future CFs and RA arising from non-market assumptions, made during periods after initial recognition, are accounted for against the CSM, unless such change would result in negative CSM. This loss must be recognized in PnL immediately.
Changes in future CFs, RA arising from discount rates and other market assumptions are accounted for via PnL or OCI. This is an accounting policy choice. Thanks for division to market and non-market assumptions, insurers’ profit and loss accounts will contain separate lines for expressing the insurance technical and investment results.

The profit and loss account under IFRS 17 does not contain premiums. This is because premiums are not considered to be a fair representation of the way how insurers provide insurance coverage and other services to policyholders. Instead of premiums, the top line of the profit and loss account will contain Insurance Contract Revenue, which for a given accounting period, represents the change in the liability due to services provided during this period. Insurance Contract Revenue contains the allocation of the initial CSM and RA to the given period as well as the release of the liability for covering expected cash flows during the same period. On a present value basis, Insurance Contract Revenue equals premiums (see Chart 1 below).

**Chart 1: IFRS 17 liability at initial recognition and future profits**

\[
\text{Initial Liability} = PV(\text{Claims & Expenses}) + PV(\text{RA}) + CSM - PV(\text{Premium}) = 0
\]

\[
\text{Insurance Revenue} = \text{Release CSM (PnL)} + \text{Release RA (PnL)} + \text{Release to cover claims and expenses (PnL)} \rightarrow \text{future profits}
\]

\[
\text{PV (Insurance Revenue)} = \text{PV (Premium)}
\]

**Liability valuation for short duration contracts**

Under some conditions, IFRS 17 permits to use for calculation of the liabilities for future claims a simplified valuation model, the so-called Premium Allocation Approach (“PAA”). This model does not require separate calculation of the CF, RA and CSM components but expresses the initial liability as difference between received premiums and acquisition costs. This means that under the PAA, both the liability and the Insurance Contract Revenue (equals release of the liability to cover claims and expenses) are proportional to (historical) premiums. The PAA liability is therefore not a current estimate and must be tested for adequacy in light of current assumptions.

The eligibility conditions for usage of the simplified PAA model include low variability of the cash flows and the following ones:
If it can be reasonably expected that the PAA simplification would produce a measurement of the liability that would not differ materially from the measurement using the BBA; or
- If the coverage period of each contract in a group is one year or less.

If the above conditions are met, the reporting entity may choose whether to use the PAA model or not.

**Variable fee approach (“VFA”)**

The variable fee approach is a modification of the general model for contracts which contain direct participation feature. In contract with the PAA model, which is optional, the VFA model is compulsory if the conditions of the direct participation are met, for instance for unit-linked business. The main difference between the VFA and BBA models is that under the VFA model, changes in discount rates and other market assumptions are accounted for against CSM.

**Implications for insurers**

The new accounting standard will definitely bring a greater transparency to the disclosed financial statements of insurers. They will need to disclose a lot of commercially sensitive information, which will also enable better comparison with their peers. The cost of preparation of such disclosures and maintaining the regular reporting process within the currently applied timeframes, might be however huge. In order spend these costs effectively, the preparations for IFRS 17 should be started very soon, if not already late. The effort with implementation will be comparable with those related to Solvency II. Nevertheless, IFRS 17 will be even more challenging as the pressure of making the figures right will be perhaps even higher than under Solvency II. The latter is about the balance sheet whereas IFRS 17 is about profits.

A successful implementation project will need to involve various stakeholders and will require good project management. Everything in the companies will be affected. If we start with the products, we assess that the pricing of the product should not be affected if the current pricing already works with up to date and market consistent assumptions. On the other hand, some entities may willing to change their product design in order to avoid the burden associated with the separation and grouping requirements. The new accounting requirements may therefore change the current product landscape.

On the preparation of the calculations a lot of work should be done in identification of the data requirements, ranging from primary systems, data warehouses, accounting and actuarial systems. This we see as the key success factor for the implementation: definition of the proper data and making the necessary changes in system in order to be able to calculate the IFRS 17 figures on time.

There is a big discussion how the new standard will change insurers’ KPIs. Perhaps the most debated figure is the premiums, which sometimes seem to disappear from the earth after introduction of IFRS 17. Yes, premiums will not part of the profit and loss account but policyholders will continue to pay premiums which we will still need to process and store. They will appear, for instance, in the liability movements presented in disclosures. They may be also part of specific parts of the disclosures, it is up to decision of the insurer.

KPIs should not dramatically change for non-life insurers applying the PAA. The combined ratio will remain similar to those before introduction of IFRS 17. Difference will be only in level of reserves and in
discounting as the current KPI usually does not contain discounting effect whereas the IFRS 17 based figure will.

Life insurers will probably be willing to report, instead of the Value of New Business, the new CSM acquired via the current year sales. This may become a new metrics for valuation of the new business.

Nevertheless, the true implications will be better visible when insurers start to disclose their financial statements prepared under IFRS 17. We need to wait and work on our own implementations until then.