

Implications of the New Global Accounting Standards for Insurance Contracts

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Insurance is a complex business. The intricate relationship between assets, liabilities and earnings is not a straightforward concept in an insurance business where the profits or losses can emerge over many years in an uncertain pattern.

Investors find it uneasy to compare financial statements of insurers in different jurisdictions. To tackle this issue, the International Accounting Standards Board (“IASB”) in May 2017 announced that the new International Financial Reporting Standard (“IFRS”) 17 for Insurance Contracts would replace the interim IFRS 4 effective on 1 January 2021 (#1).

This paper explores the implications of IFRS 17 on insurers’ valuation of insurance contracts, measurement of profit attribution and disclosure of risk governance.

Accounting Model under IFRS 17

IFRS 17 has three central concepts. First, the current value of an insurance contract is measured initially and annually based on the best estimates of all prospective cash flows generated from the contract. Second, insurance premiums revenue is recognized proportional to the insurance coverage, i.e. services being provided, rather than the cash received. Third, insurance liability measurement should include a risk adjustment for uncertainty. These concepts serve to give insurers potential benefits of better insights into business performance and process standardization.

The following are typical steps to be carried out by an insurer under the IFRS 17 accounting model:

Step 1 – Grouping of Contracts: An insurance contract is recognized upon commencement of the insurance coverage period. A portfolio of contracts is split into three groups - (i) onerous contracts (#2), (ii) profitable contracts at the outset and unlikely to become onerous, and (iii) other profitable contracts at the outset and may become onerous. Insurance contracts issued in a single year within each product line are expected to have similar risks as illustrated below.

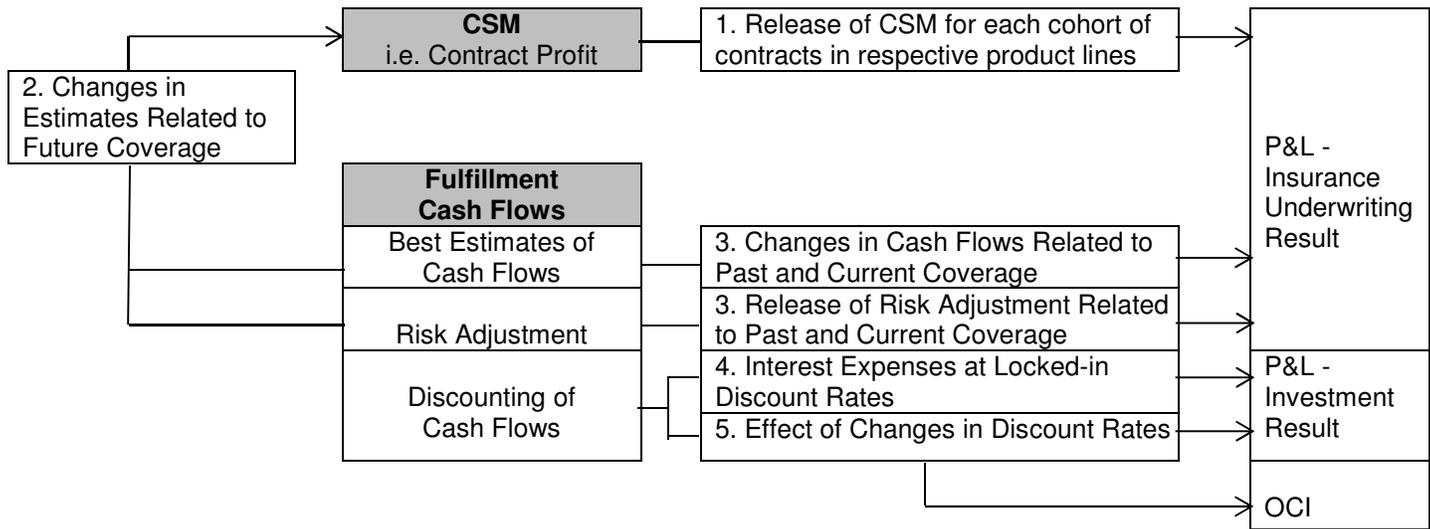
Groups* of Contracts by Product Lines in Consecutive Years	2021 Whole Life	2021 Term Life	2022 Whole Life	2023 Whole Life
(i) Onerous Contracts				
(ii) Profitable Contracts Unlikely to Become Onerous	Contracts issued in the same year, i.e. grouped by cohort		Contracts in the same product line, i.e. grouped by risk exposure	
(iii) Other Profitable Contracts				

* All contracts in a group are issued no more than a year apart.

Step 2 – Initial Valuation of Contracts: Once recognized, insurance contracts will be measured by the building block approach (#3), which incorporates all available information in a way consistent with observable market data and divides the carrying amounts of insurance contract assets and liabilities into the following four blocks.

Objectives	Building Blocks	Building Block Features
Provision for unrealized future profits	Contract Service Margin (“CSM”)	Unrealized future profits are recognized as the CSM which is measured as the positive difference between the risk-adjusted present value of expected cash inflows and outflows at inception of the contracts.
Present value of future cash flows that will arise from fulfillment of the contract (“Fulfillment Cash Flows”)	Best Estimates of Cash Flows	Probability weighted inflows (e.g. premiums) and outflows (e.g. claims, operational costs and taxes) within the contract boundaries which are based on whether and at what prices the contracts are renewable.
	Risk Adjustment	Capital required as compensation for the non-financial risk of bearing uncertainty about the amount and timing of future cash flows from the contracts.
	Discounting of Cash Flows	The applied discount rates should be consistent with observable market prices of financial instruments comparable with the contract liability cash flows.

Step 3 – Subsequent Valuation of Contracts: After initial recognition, changes in estimates of the present value of expected cash flows may arise from the effect of changes in the discount rates or from changes in (i) the expected timing of payments, or (ii) the expected amounts to be paid. Such changes are recognized as Profit or Loss (“P&L”) or Other Comprehensive Income (“OCI”) as shown in the below figure with explanatory points.



1. The CSM amortization pattern is based on the passage of time and release of the CSM will be recognized in the P&L as underwriting result. Release of the CSM reflects the expected duration and size of the contracts remaining in and newly added to the same group at the end of the financial reporting period.
2. Changes in estimates of future cash flows and risk adjustment (other than the discount rates) related to future coverage (e.g. changed assumptions) are absorbed in the CSM.
3. Changes in estimates of cash flows and risk adjustment related to the past and current coverage (i.e. experience variances) are represented in P&L as underwriting result.
4. Interest expense on contract liabilities is determined using locked-in discount rates at contract inception and recognized in the P&L as investment results. The yield curve derived from the bond market at contract inception is used for all financial reporting dates to calculate interest expense on liabilities for incurred claims.
5. Changes in the discount rates compared with the locked-in discount rates at contract inception are (i) recognized in P&L as investment results or (ii) presented separately as OCI. The use of locked-in discount rates is to avoid accounting mismatches that would otherwise arise due to the effect of changes in the return on the assets held by the insurer, and to avoid recognizing investment gains or losses as part of the underwriting activity.

Step 4 – Presentation of Financial Results: The Statement of Comprehensive Income reports insurance underwriting outcome separated from investment performance. Besides, IFRS 17 brings important changes to the presentation of business results in the Balance Sheet as regards insurance contract liabilities and retained earnings.

Statement of Comprehensive Income		Key Components
Insurance Contract Revenue (#4)	x	Release of the CSM, Change in Risk Adjustment, Expected Claims and Expenses in Fulfillment Cash Flows, Allocated Insurance Premium Related to the Recovery of Directly Attributable Contract Acquisition Costs.
Claims and Expenses	(x)	Actual Claims and Expenses Incurred, Allocated Insurance Premium Related to the Recovery of Directly Attributable Acquisition Costs, Onerous Contracts.
Insurance Underwriting Results	X	
Investment Income ^	x	Investment Income Recognized, Measured and Presented in Accordance with IFRS 9 Financial Instruments.
Interest Expenses on Contract Liabilities	(x)	Interest Expenses Calculated Using Locked-in Discount Rates.
Investment Results	X	
Other Profit and Loss	X	
Corporate Tax	(x)	
Profit After Tax	X	
Gain / Loss on Financial Assets Measured at Fair Value through OCI ^	x / (x)	Financial Assets Recognized, Measured and Presented in Accordance with IFRS 9 Financial Instruments.
Effect of Discount Rate Changes	(x)	Effect of Changes on Fulfillment Cash Flows (if the OCI Option is Selected).
Total Comprehensive Income	X	

^ Along with IFRS 17, insurers are required to adopt IFRS 9 for Financial Instruments no later than 1 January 2021 to recognize and measure financial assets and liabilities as highlighted in the summary table.

Objectives of IFRS 9	Simplify the classification framework for financial assets and liabilities	Improve the transparency and timeliness of credit loss provisions	Align general hedge accounting with risk management activities
New Features of IFRS 9	<ul style="list-style-type: none"> • Classification subject to the business model and nature of contractual cash flows. • Consistent with IFRS 17 in relation to asset-liability management and accounting mismatches. • Financial assets are measured by fair value through P&L, fair value through OCI or amortized cost. 	<ul style="list-style-type: none"> • Provide definitions of “significant increase in credit risk” and “default”. • Shift from “incurred loss” to “expected credit loss” based on forward looking information. • Impairment is measured as either 12-month expected credit loss or life-time expected loss in 3 stages. 	<ul style="list-style-type: none"> • Split into micro and macro hedge accounting. • Move from a highly quantitative approach to a more qualitative methodology for hedge effectiveness testing.

Step 5 – Disclosure and Disaggregation: The financial statements disclose qualitative and quantitative information that enables independent interpretation of the nature, amount, timing and uncertainty of cash flows from the issued insurance contracts. Such information includes how much risk the insurer has taken on, what drives the insurer’s performance and the value of embedded options and guarantees in the insurance contracts. The insurer therefore should identify the appropriate disaggregation level of its disclosure in terms of product lines, geographical areas and reportable segments to present the following new items required under IFRS 17.

1. Reconciliation of booked insurance premiums to insurance contract revenues.
2. Yield curve used for discounting of cash flows.
3. Valuation methods, key inputs and the range plus weighted average of the key inputs applied to each product line.
4. Type and extent of risks assumed by the insurer, i.e. appetite and management for insurance risk and other risks in terms of exposure, concentration and sensitivity.

Implications of IFRS 17

The arrival of IFRS 17 shortly after Solvency II implementation (#5) will lead insurers that have established the three pillar approach under Solvency II to draw on the experience and apply a similar approach to comply with IFRS 17. For insurers operating business in jurisdictions that have not adopted Solvency II, the three pillar approach still provides insight to the IFRS 17 implementation process outlined in the comparison table.

IFRS 17	Solvency II	Remarks
• Valuation Presented in the Balance Sheet	• Pillar 1 – Capital Requirements	Substantial overlaps in the measurement and disclosure of these items
• P&L Attribution in the Income Statement	• Pillar 2 – Risk Governance and Controls	
• Risk Disclosure in the Financial Statements	• Pillar 3 – Risk Model Disclosure	
• CSM, Short-Duration Insurance Contracts and Unbundling Requirements		No similar requirements under Solvency II

The concept and measurement of the CSM are unique to IFRS 17. The CSM serves to defer and amortize profit at inception over the coverage period of an insurance contract. The level of CSM is directly impacted by the cash flows calculated because it is measured on amortized cost basis and allocated to the underlying cohorts of contracts.

Insurance contracts with negative CSM at inception cannot be offset by other contracts with positive CSM and must be reported in P&L as onerous contracts. The CSM will absorb the effect of changes in expected future profitability during the life time of a profitable contract and can be offset only within each profitable contract group. As the release of CSM must be linear over the expected coverage period, contracts in the same group should have similar expected durations for aggregation and stochastic projections.

The carrying amounts of insurance contracts in a liability position and in an asset position are affected by the cash flows as well as the income and expenses recognized in P&L and OCI. Whether an insurance contract portfolio is in a net asset or net liability position largely depends on the timing of the expected cash flows.

Accurate estimates are critical. If assumptions with regard to future coverage change, the CSM can be unlocked to allow for the impact of such changes to spread over the remaining duration of the contracts, as long as the revised CSM is not negative. When the CSM is depleted, extra losses due to changes in the assumptions are recognized immediately whereas profits from such changes should first be used to offset previous losses before building up a positive CSM. The accuracy of an insurer's estimates will become a very meaningful source of information about the insurer's management ability, system capacity, and business resilience.

IFRS 17 is to a large extent principle-based and requires expert analysis on how to apply the standard in the specific context of each insurer, which will need to make a number of strategic choices and determine how its valuation and revenue are presented to its stakeholders. Such strategic choices cover discount rates, product design, risk adjustment and disclosure as explained in the ensuing paragraphs.

Discount Rates

Fulfillment cash flows are measured using the current discount rates at each reporting period end. The discount rates to be used should be consistent with observable market rates of financial instruments that reflect the characteristics (e.g. timing, currency, liquidity) of the cash flows. An insurer has the discretion to select discount rates by top-down approach or bottom-up approach. Top-down approach means the insurer can start from an actual or a reference portfolio of assets and remove the characteristics, e.g. credit risk premium, not inherent to the insurance liabilities. Bottom-up approach involves a risk free rate as the starting point to which relevant characteristics, e.g. illiquidity premium, of the insurance liabilities are added.

The top-down approach is linked with asset liability management, which enables the insurer to base the discount rate on a reference portfolio that can be purchased to back the insurance liabilities concerned and to evaluate the actual economic mismatch in asset and liability management. Nevertheless, an insurer may choose the bottom-up approach that is similar to its existing valuation frameworks, e.g. Solvency II, GAAP. The insurer's management board should consciously weigh the pros and cons before deciding which approach to use for its selection of discount rates.

Product Features

Insurance products with participation features contain contract terms specifying that the policyholder participates in a share of a clearly identified pool of underlying items, e.g. asset value, investment return. For insurance contracts with participating features, an insurer will recognize the CSM in P&L on the basis of the passage of time and may unlock the discount rates at contract inception to reflect higher future participation payments related to a higher expected investment return and vice versa. Worth noting is that the discount rate unlocking depends mainly on the product nature with participation features and the IFRS measurement of the corresponding asset portfolio.

For a non-participating contract which does not entitle its policyholders to share the insurer's profits, a locked-in discount rate is applied to determine the CSM at inception and thereafter the amortized interest cost calculated using this same rate is reported in P&L. Insurance product features can vary considerably and the risks covered by insurance contracts largely define their classification.

IFRS 17 places an increased focus on risk and it is possible that insurers may review their demand for reinsurance products as part of their overall risk management strategy. This can result in decisions to manage product and business risks in a different way. Insurers will continue to look for ways to mitigate their risks and reduce financial reporting volatility. Their demand for reinsurance products may remarkably increase subsequent to the implementation of IFRS 17.

Risk Adjustment

The purpose of the risk adjustment is to measure the effect of uncertainty in the cash flows of insurance contracts that arise from non-financial risks. It may reflect risks originated from the rights and obligations created by insurance contracts, e.g. operational risks. The risk adjustment is an entity-specific measure of uncertainty and is separated from the estimates of cash flows or the discount rates to avoid double counting. A higher risk adjustment is imposed on insurance contracts with (i) lower frequency and greater severity of claims, (ii) longer duration for similar risks, (iii) wider probability distribution and, (iv) emerging experience that increases the uncertainty on non-financial risks.

An insurer is required to disclose the technique used in its estimation of the risk adjustment and the confidence level corresponding to the result of that technique. Although every insurer can determine the risk adjustment from its own perspective, a uniform confidence level equivalent can be additionally reported to make comparison among different insurers possible.

Risk and Financial Models

The financial results coming out of the IFRS 17 process will have a predominant impact on the balance sheets and income statements of insurers. It is important for insurers to have quality controls around the numbers calculated by their systems. If an insurer has an existing cash flow model for management or regulatory reporting and would like to adapt such a model for IFRS 17 purpose, the impact of model errors can have potentially significant consequences and the insurer should ensure the presence of robust risk governance. Even if a model has been validated as fit for use in solvency reporting, the insurer still needs to conduct a separate validation of the model for adoption under IFRS.

IFRS 17 will put high demands on publicly listed insurers' efficiency and effectiveness because these insurers are obliged to inform their stakeholders of their financial results within six to ten weeks after each reporting period. Both external and internal stakeholders will require the management to provide a view on the expected results for the next reporting period. Some insurers may need to forecast their financial statements for the sake of making day-to-day strategic and business decisions. These forecast processes will likely rely on the aggregated financial and risk models that need to be developed and improved from the current actuarial models. The IFRS 17 related calculations and forecasts have to be completed fast since the disclosure under this new standard includes the consolidation and analysis of the results and risks.

Risk Governance Disclosure

Insurers generally find it necessary to assure confidence of their shareholders and market analysts by maintaining stability and predictability of their performance results. Material unexpected financial results can lead to negative impact on their share prices. To comply with IFRS 17, accounts in an insurer's general ledger have to be changed substantially. The reconciliation between the traditional structure of financial statements and the new presentation format is challenging. For insurers following Solvency II, insurance liabilities are valued as part of their balance sheets and reconciliation with IFRS 17 must be documented with sufficient explanation of the disparities in the methodologies and parameters employed.

Once an insurer starts financial reporting under IFRS 17 and IFRS 9, it should align the classification of assets at fair value through P&L and/or OCI with the classification of insurance liabilities so as to minimize accounting mismatch caused by interest rate fluctuations. The alignment will be assessed on a block-by-block basis and disclosed in terms of how the underlying assets are managed. Where risk models for the protection of available capital and solvency ratio are also used for IFRS reporting, the insurer needs to put extra focus on stabilizing its income because the materiality thresholds and accepted volatility of income under IFRS are expected to be lower than the current risk appetite for capital management.

In addition, only three approaches are allowed to derive the IFRS 17 opening balance sheet. If a full retrospective application is impracticable, there is only a choice between a simplified retrospective approach and the fair value approach. The latter two approaches can result in a notable difference in the CSM and management must clearly explain to stakeholders the initial impact on the opening retained earnings as at the transition date. When moving towards greater transparency, insurers had better take an integrated approach that shifts their risk governance from satisfactory to effective and sustainable.

Conclusion

The insurance industry is heading in the right direction, despite the numerous challenges arising from the new global accounting standards. Senior management of insurers should appreciate that greater transparency is demanded by stakeholders and greater accountability is required for their risk management practices. Since the value of insurance liabilities will be more transparent, stronger insurers are in a better position to close merger or acquisition deals at opportunistic prices. IFRS 17 offers an opportunity of valuable differentiation for those insurers which proactively consider how their business strategies will be influenced and wisely anticipate how the insurance marketplace will change. Forward-thinking insurers may take the chance to transform their finance functions and reshape their operational models because even minimum compliance with the new standard will require considerable investment in systems and processes.

Notes:

- (#1) According to the IFRS 17 Effect Analysis published by the IASB in May 2017, unlisted insurers vary by jurisdiction in using different generally accepted accounting principles ("GAAP"), whereas among publicly listed insurers, about 72% of them use IFRS, 20% adopt U.S. GAAP, 2% follow Japanese GAAP, and the remainders adhere to their national requirements. The U.S. accounting standards board, FASB, has been working on a project to simplify and enhance the financial reporting requirements for long-term insurance contracts. Some of the FASB proposed changes, if confirmed, are expected to reduce the differences between IFRS 17 and existing U.S. GAAP.

- (#2) An onerous contract is a contract in which the aggregate cost required to fulfill the contract is higher than the economic benefit to be obtained from it. Such a contract can represent a major financial burden for an insurer. When an onerous contract is identified, an insurer will recognize the net obligation associated with the contract as an accrued liability.
- (#3) Long-term life contracts have to be measured under the building block approach which is the default model for all insurance contracts. IFRS 17 allows two variations of the default model: (i) variable fee approach for participating contracts which cash flows depend on a clearly identifiable set of underlying assets and where participation does not necessarily involve profit sharing with policyholders, e.g. investment-linked insurance; and (ii) premium allocation approach for contracts of shorter duration or of longer term if certain criteria are met, e.g. general insurance, property and casualty insurance.
- (#4) Insurance contract revenue represents the difference between the opening and closing carrying amounts of insurance liabilities for the remaining coverage, excluding amounts immediately recognized in P&L (i.e. applicable to expected losses from onerous contracts which expected cash outflows exceed the expected premium inflows) and changes unrelated to insurance coverage or other services for which the insurer expects to receive consideration.
- (#5) Solvency II is the insurance supervision regime introduced to the member states of European Economic Area effective 1 January 2014. Switzerland, Bermuda and the U.S. are deemed to have fully or partially equivalent rules. Under Solvency II, insurers will need enough capital to have 99.5 % confidence that they could cope with the worst expected losses over a year. The rules have 3 pillars – (i) risk-based capital requirements (ii) enterprise risk management and (iii) public disclosure and transparency. The riskier an insurer's business, the more precautions it is required to take.

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