IFRS 17
Insurance Contracts

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IFRS 17 Programme

Session 1	Recap: Core model and premium allocation approach (PAA)
Session 2	PAA with comparison to unearned premium
Session 3	Challenges in applying PAA
Session 4	Disclosure and presentation requirement
Session 5	Transition, transition presentations and disclosures
Session 6	Audit reports and compliance with IFRS
Session 7	

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Challenges in application Premium Allocation Approach

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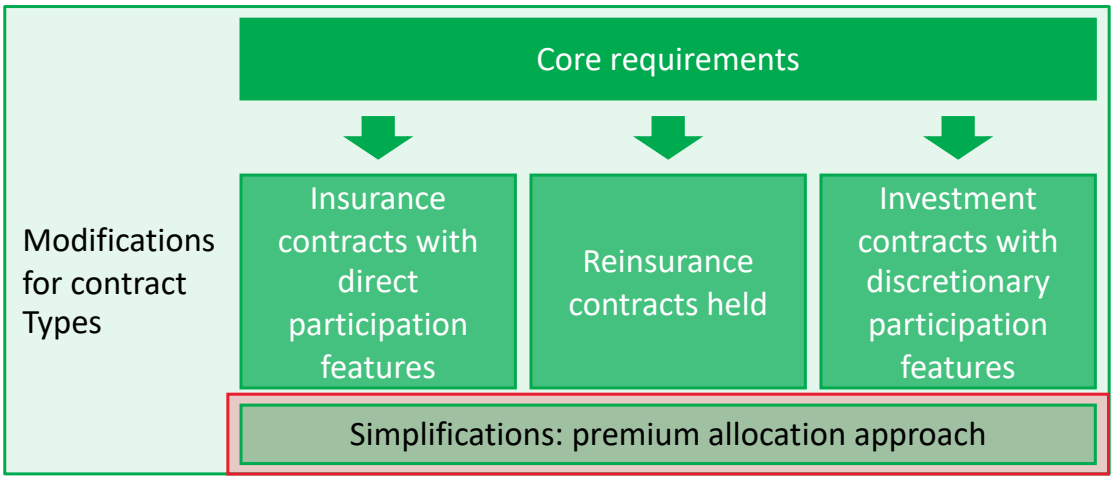
Core Requirements
Snapshot of IFRS 17 Approaches



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When should contracts be separated?

General rule of separation

Not **explicit** in IFRS 17, discussed at **TRG**:

» Lowest unit of account is the contract (includes all components)

» Contract with legal form of single contract generally considered a single contract

» Separation could be appropriate if legal form does not reflect substance of contractual rights and obligations

» Assessment of all facts and circumstances, not policy choice

» Reinsurance contract held: fact that underlying contracts are included in different groups is not sufficient to conclude that accounting as a single contract does not reflect its substance

TRG February 2018, Paper 1

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When do you separate components?

Specific rules of separation

» A contract may contain components that could/should be accounted for under another IFRS. Insurer should separate:
  » embedded derivatives applying IFRS 9 guidance
  » Investment components if the component is distinct
  » Non insurance goods and services if distinct
» After separation as above, insurer must apply IFRS 17 to all remaining components

IFRS 17.11 to 13, 17.B31 to B35

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Examples
Separating elements in contracts

Legal form versus substance. Consider:

Are elements inter-dependent?	• Theft, accident and fire cover of a vehicle are • Pet insurance and vehicle insurance are generally not
Is duration/ Termination linked?	• Does cancellation, termination of one element trigger the same for others? • Are the durations the same?
Are integral terms linked?	• Can additional elements be added (eg by way of riders)? • Do terms change if element added or terminated?

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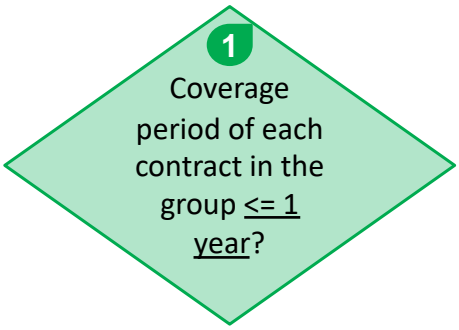
Premium allocation approach
Criteria



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Coverage period

- *The period during which the entity provides coverage for insured events. This period includes the coverage that relate to all premiums within the boundary of the insurance contract.*
  - Begins when coverage for unexpected event starts
  - Ends when the entity has the practical ability to reassess risks and reset premiums
- Note: a claims period may extend beyond the end of the coverage period (for example when policyholder has three months to claim after an event has occurred)

IFRS 17 definitions

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Considerations

» A number of factors need to be considered:

Factor	Considerations
Contract terms	Do the specific contract terms allow the insurer to: • cancel, or • fully reprice the contract
Implied terms	Are there potential implied terms, for example: • Past practice • Legal or prudential requirements • Consumer protections
Intention	• Intention does not matter unless it has created a legitimate and actionable expectation for policyholder to enforce

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Example
Contract Boundary

» Insurer issues four types of car insurance contracts:

	A contract that….	Automatically eligible (Y/N)
1	Can be cancelled by either party with 30 days notice, expected to continue for 2 years	
2	Signed for 1 year, automatic renewal, annual inflation increase, **only** policyholder can cancel	
3	Signed for 1 year, automatic renewal, annual increase decided by Addis, **only** policyholder can cancel	
4	Signed for one year, no automatic renewal	

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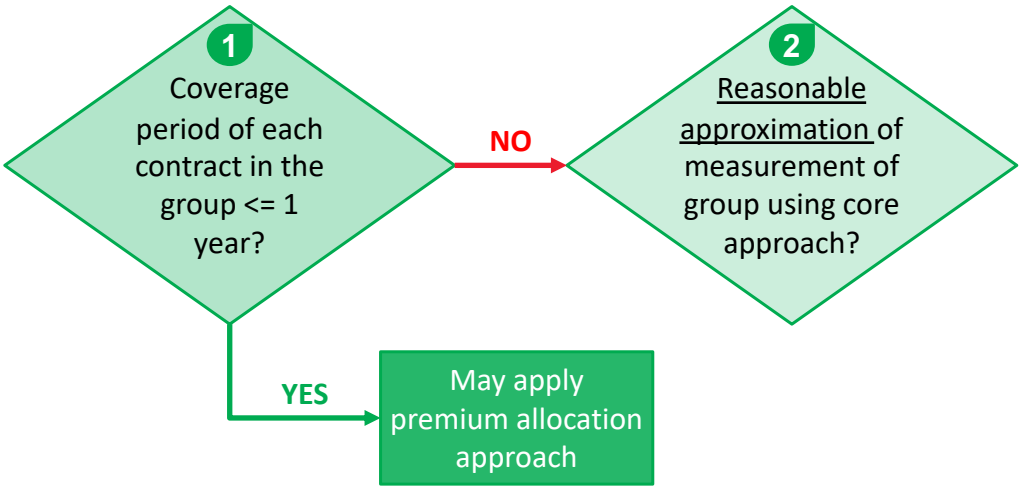
Premium allocation approach
Criteria



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1 Present value of future cash flows
Criteria: reasonable approximation

- Reasonable approximation is **not** met if entity expects significant variability in the fulfilment cash flows before claims are incurred
- Variability in estimates increases for example with:
  - Extent of future cash flows relating to embedded derivatives in the contract
  - Length of coverage period

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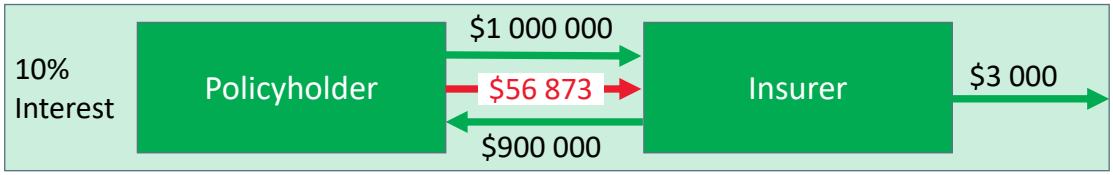
Example
One year vehicle contract

- Insurer writes 100 car contracts and expects that:
  - Interest rate is 10%
  - It pays $3 000 in car inspection costs on 1 January for all contracts
  - Policyholders pay an annual premium of $10 000 each on 2 January
  - Total risk premium is $5 000 per month, $56 873 discounted
  - Insurer expects claims of $75 000 per month ($900 000 in total)



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Example
One year vehicle contract – acquisition cost

	PAA		Core	
Initial payment	**Debit**	**Credit**	**Debit**	**Credit**
Acquisition cost asset	3 000		3 000	
Cash		3 000		3 000
Insurance liability	3 000		3 000	
Acquisition cost asset		3 000		3 000
Insurance liability	3 000		3 000	

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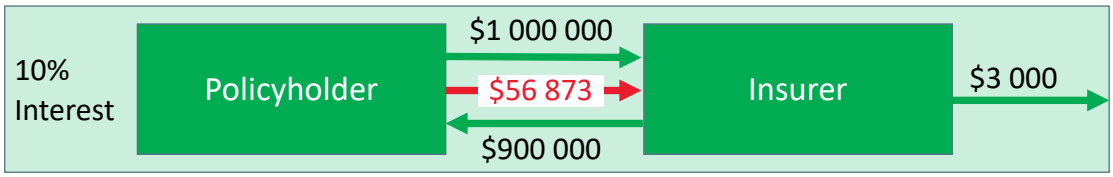
Example
One year vehicle contract – initial recognition



	PAA		Core	
Initial recognition	Debit	Credit	Debit	Credit
Insurance liability (premiums)	-		1 000 000	
Insurance liability (claims)		-		853 088
Insurance liability (risk)		-		56 873
Insurance liability (CSM)		-		90 039
Insurance liability	3 000		3 000	

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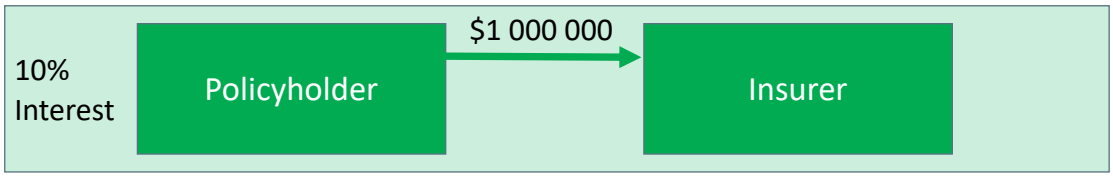
Example
One year vehicle contract – receipt of premium



	PAA		Core	
Premium receipt	Debit	Credit	Debit	Credit
Cash	1 000 000		1 000 000	
Insurance liability (premiums)		1 000 000		1 000 000
Insurance **initial** liability		997 000		997 000

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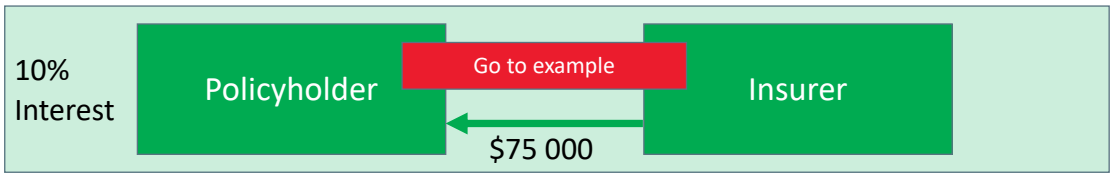
Example
One year vehicle contract – Interest and payment of claim



	PAA		Core	
End month 1	Debit	Credit	Debit	Credit
Interest expense	8 308		8 308	
Insurance liability		8 308		8 308
Claim expense	75 000		75 000	
Cash		75 000		75 000
Insurance liability		930 308		930 308

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Example
One year vehicle contract – Profit recognition journals

	PAA		Core	
End month 1	Debit	Credit	Debit	Credit
Insurance liability (CSM)	87 652		7 652	
Insurance liability (Risk)			5 000	
Insurance liability (claims)			75 000	
Revenue		87 652		87 652
Insurance liability		842 656		842 656

Applying B126 with B125

Alternatively, applying B126

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Example
One year vehicle contract – amortisation of acquisition cost

	PAA		Core	
End month 1	Debit	Credit	Debit	Credit
Acquisition cost expense	264		264	
Revenue		264		264

Applying B126 with B125

Alternatively, applying B126

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Example
One year vehicle contract – Income statement end month 1

	PAA		Core	
Income statement	Debit	Credit	Debit	Credit
Revenue		87 916		87 916
Claims	75 000		75 000	
Acquisition expense	264		264	
Underwriting margin		12 652		12 652

Breakdown				
CSM				7 652
Risk margin				5 000
Underwriting margin				12 652

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Example
One year vehicle contract – Income statement 1st 6 months

	PAA		Core	
Income statement	Debit	Credit	Debit	Credit
Revenue		527 495		527 495
Claims	450 000		450 000	
Acquisition expense	1 582		1 582	
Underwriting margin		75 913		75 913
Breakdown				
CSM				45 913
Risk margin				30 000
Underwriting margin				75 913

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Reasonable approximation
Drivers of different outcomes

Event	PAA	Core
Change in expected future claims	No effect on PAA if not onerous	Change in liability components, and consequential change in immediate profitability

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Example
One year vehicle contract – end half year

- Insurer changes its expectations at end of half year:
  - Expects:

Month	Original	Revised
Month 7 – 11 (per month)	75 000	75 000
Month 12	75 000	100 000

  - Present value effect of expected increase in claims is $23 786

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Example
One year vehicle contract – change in claims

	PAA		Core	
End month 1	Debit	Credit	Debit	Credit
Opening balance		510 908		510 908
Insurance liability (CSM)	-		23 786	
Insurance liability (Claims)		-		23 786
Insurance liability		510 908		510 908

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Example
One year vehicle contract – Interest and payment of claim

	PAA		Core	
End month 7	Debit	Credit	Debit	Credit
Interest expense	4 258		4 258	
Insurance liability		4 258		4 258
Claim expense	75 000		75 000	
Cash		75 000		75 000
Insurance liability		440 166		440 166

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Example
One year vehicle contract – Profit recognition journals

	PAA		Core	
End month 7	Debit	Credit	Debit	Credit
Insurance liability (CSM)	87 652		3 571	
Insurance liability (Risk)			5 000	
Insurance liability (claims)			75 000	
Revenue		87 652		83 571
Insurance liability		427 514		431 594

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Reasonable approximation
Drivers of different outcomes

Event	PAA	Core
Change in expected future claims	No effect on PAA if not onerous	Change in liability components, and consequential change in immediate profitability
Change in interest rates	No change if not onerous	Change in liability, and consequential change in immediate profitability

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Example
One year vehicle contract – end half year

» Interest rates change at end of half year from 10% to 5%. No change in expected cash flows:

Month	Original	Revised
Month 7 – 12 (per month)	75 000	75 000
Present value of cash outflows	437 161	443 510

» Change in present value due to interest rate is $6 348

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Example
One year vehicle contract – change in interest rate

	PAA		Core	
End month 1	Debit	Credit	Debit	Credit
Opening balance		510 908		510 908
Interest rate change expense	-		6 348	
Insurance liability (Claims)		-		6 348
Insurance liability		510 908		517 257

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Example
One year vehicle contract – Interest and payment of claim

	PAA		Core	
End month 7	Debit	Credit	Debit	Credit
Interest expense	4 258		2 463	
Insurance liability		4 258		2 463
Claim expense	75 000		75 000	
Cash		75 000		75 000
Insurance liability		440 166		444 719

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Example
One year vehicle contract – Profit recognition journals

	PAA		Core	
End month 7	Debit	Credit	Debit	Credit
Insurance liability (CSM)	87 652		7 652	
Insurance liability (Risk)			5 000	
Insurance liability (claims)			75 000	
Revenue		87 652		87 652
Insurance liability		427 514		432 067

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Reasonable approximation
Drivers of different outcomes

Event	PAA	Core
Change in expected future claims	No effect on PAA if not onerous	Change in liability components, and consequential change in immediate profitability
Change in interest rates	No change if not onerous	Change in liability, and consequential change in immediate profitability
Uneven earnings pattern	Less sensitive	More sensitive, especially risk release

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Reasonable approximation
Level of assessment

- Eligibility is assessed at group level (ie offsetting and averaging)
- Judgement will be needed:
  - Determine reasonable expected future scenarios
  - Identify the range of relevant scenarios from the specific features and circumstances of the group
  - Future scenarios should reflect the variability in the FCF the entity expects
- Generally applied using 'shock' scenarios the comparing PAA model to core model

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Reasonable approximation
Susceptibility

- The differentiators are very sensitive to:

Factor	Susceptibility
Duration of coverage period	• Changes in interest rates • Unexpected average claims experience • Changes in assumptions
Complexity	• Unexpected average claims experience • Changes in external factors (eg forex rates) • Changes in assumptions
Variability of risk	• Unexpected average claims experience • Changes in assumptions

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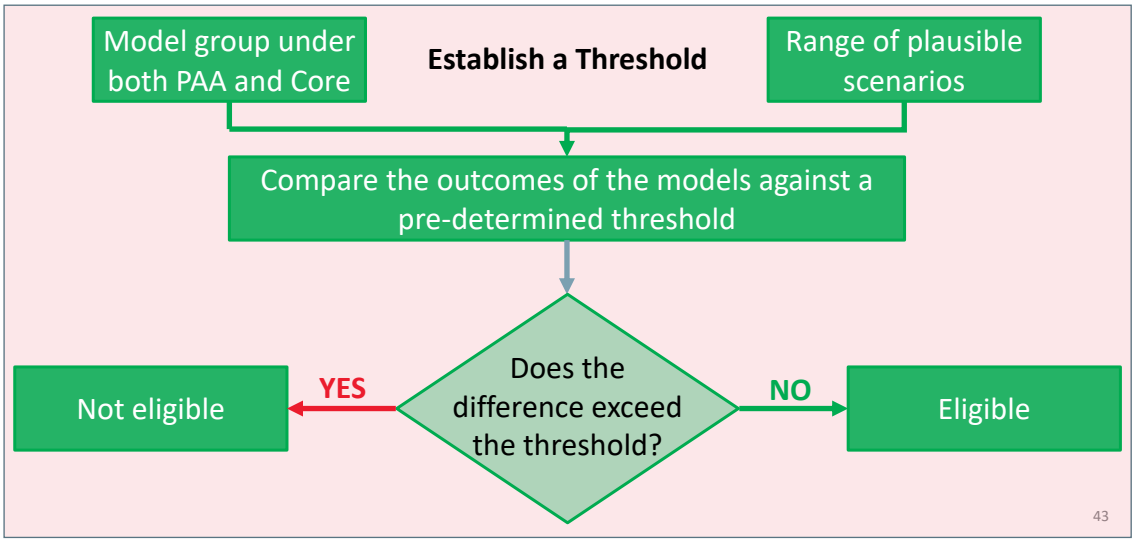
Reasonable approximation
Testing



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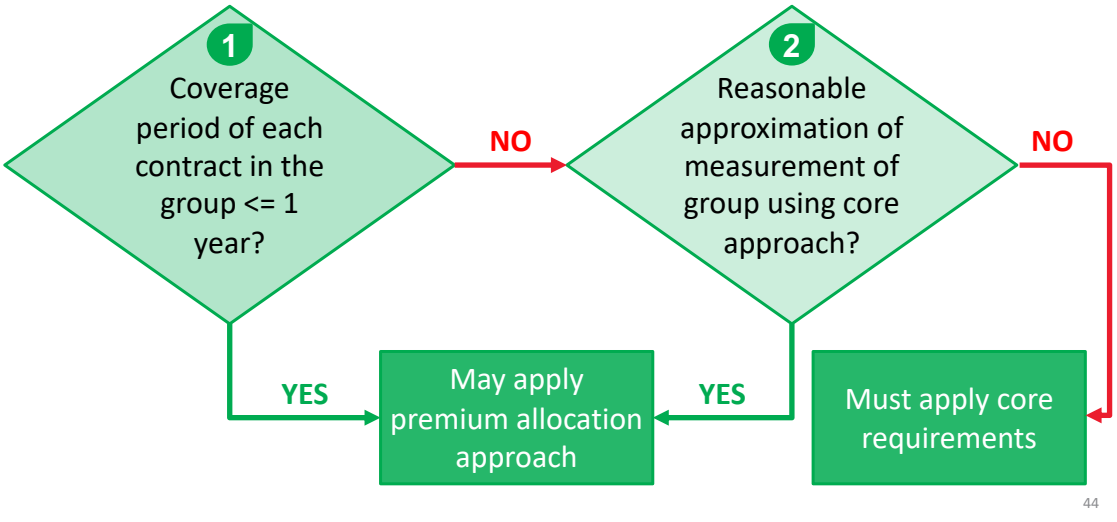
Premium allocation approach
Criteria



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Recognition

- Insurance contracts are recognised from the earliest of:
  - beginning of coverage period of first contract in group
  - date when first payment from a policyholder becomes due, or
  - for onerous contracts, when the group becomes onerous (facts and circumstances)
- If no contractual due date, then date received
- Acquisition cash flow asset or liability is recognised when incurred, and derecognised when the group of insurance contracts to which the cash flows are allocated is recognised

IFRS 17.25 to 28

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Identifying onerous contracts
At initial recognition

Identify portfolios of contracts	• Based on internal management information, and • Type of risk

Determine whether subsets are onerous	• **Facts and circumstances test**
	• Pricing data:
	  • Formalised process of documenting pricing methodology
	  • Cataloguing and building audit trail, or
	• Reserving data
	  • Full reserving calculation
	• Other (strategy, marketing etc)

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Identifying onerous contracts
Subsequent

Determine whether groups are onerous

- **Facts and circumstances test**
- Other information (eg identification of pricing error, losses on completed contracts)
- Pricing data
  - Changes in more recent pricing
- Reserving data
  - Full reserving calculation

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Premium allocation approach
Simplifications - initial measurement

Premiums (if any) received at initial recognition

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Cash premium received at initial recognition creates/increases liability

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Initial recognition
Delayed premium

- In some jurisdictions:
  - First payment of premium can be delayed beyond commencement of coverage period
  - If contract not onerous, recognition happens on commencement of coverage
  - However, there are no cash flows
  - Therefore contract (group) recognised at zero unless triggered by
    - Acquisition costs
    - Some other cost

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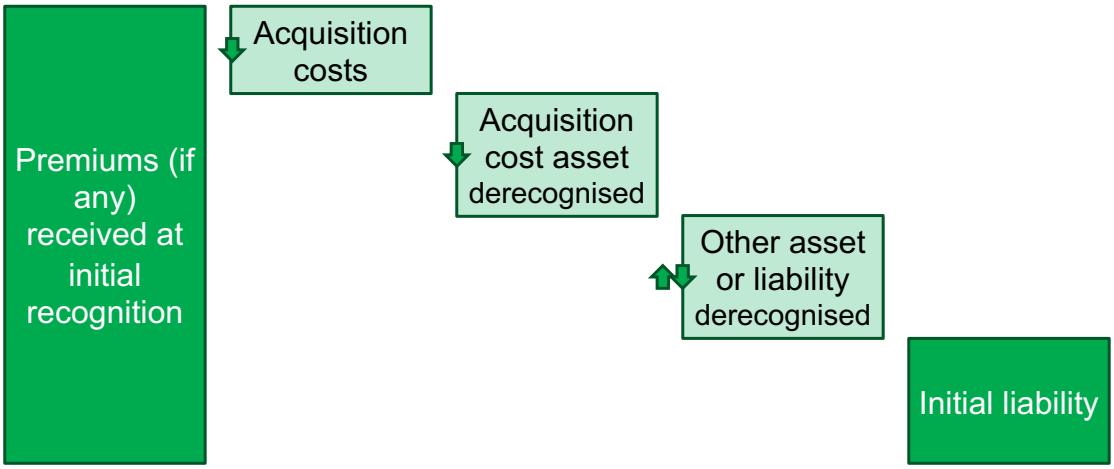
Premium allocation approach
Simplifications - initial measurement



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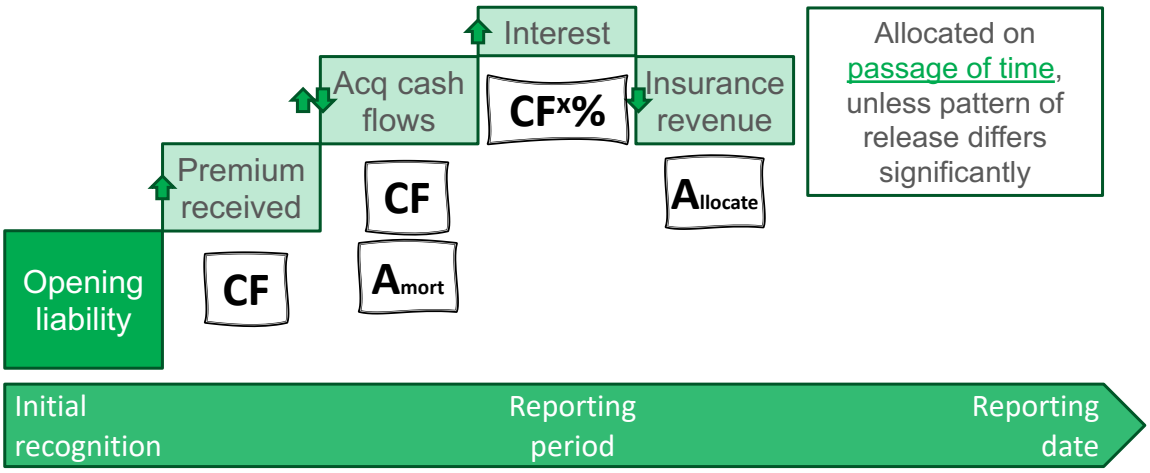
Premium allocation approach
Simplifications - subsequent measurement



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Allocation of insurance revenue

'If expected pattern of release of risk differs significantly from passage of time, then recognise revenue on the basis of the expected timing of incurred insurance service expenses'

- Thus:
  - Pattern of release from risk is uneven, then
    - Look at the expected expenses (biggest of which is likely to be claims)
    - If pattern is uneven, then use that pattern

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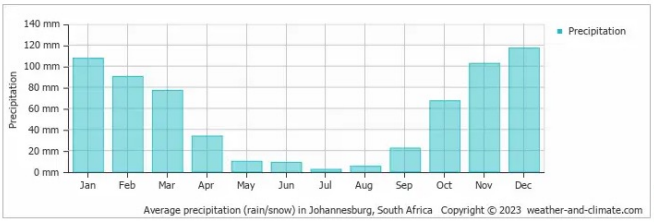
Example
Pattern of release

» Insurer provides insurance for damage related to flooding

» In a particular jurisdiction:

» Rainy season commences September, peaks December, ends April



» Insurer has previously studied their claims data and noted that it tracks rainfall

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Example
Pattern of release

» Premium of $100 000 received monthly commencing in January

	Jan	Feb	Mar	Apr	May	Jun
Premium received ($'000)	100.0	100.0	100.0	100.0	100.0	100.0
Average rainfall (mm)	108	90	78	36	10	8
Allocated revenue ($'000)	200.3	166.9	144.7	66.7	18.6	14.8

	Jul	Aug	Sep	Oct	Nov	Dec
Premium received ($'000)	100.0	100.0	100.0	100.0	100.0	100.0
Average rainfall (mm)	2	4	22	68	102	119
Allocated revenue ($'000)	3.7	7.4	40.8	126.1	189.2	220.7

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Example
Of different patterns of release

Types of contracts	Example
Vehicle contracts	If conditions causing accidents are seasonal: • Snow, hail, rain • More and less frequent use of vehicles
Personal accident	If personal accidents are driving by events: • Sports injuries (such as skiing or water sports)
Fire insurance	If fires are seasonal: • Wild fires in dry season, or • Fires caused by electricity overload in winter
Travel insurance	• If typically linked to popular holiday times

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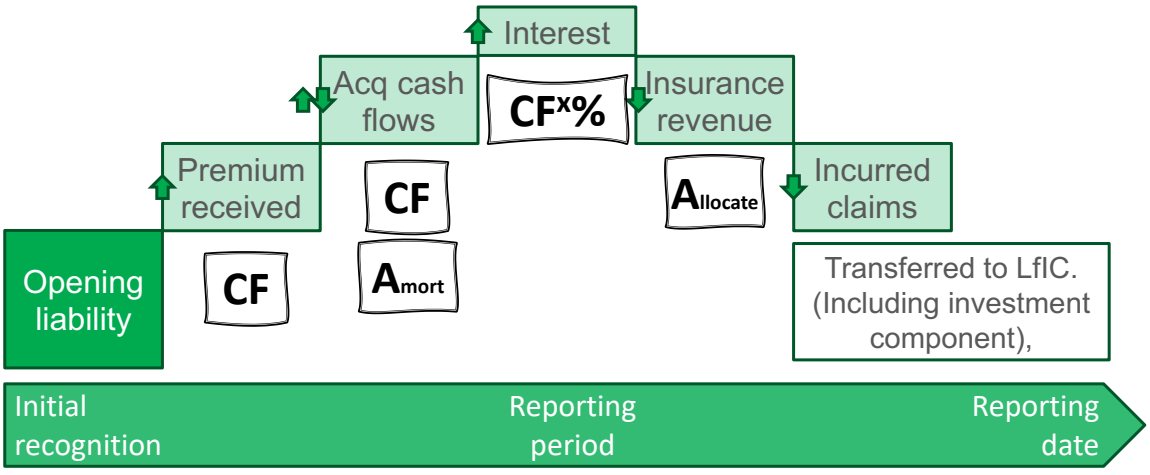
Premium allocation approach
Simplifications - subsequent measurement



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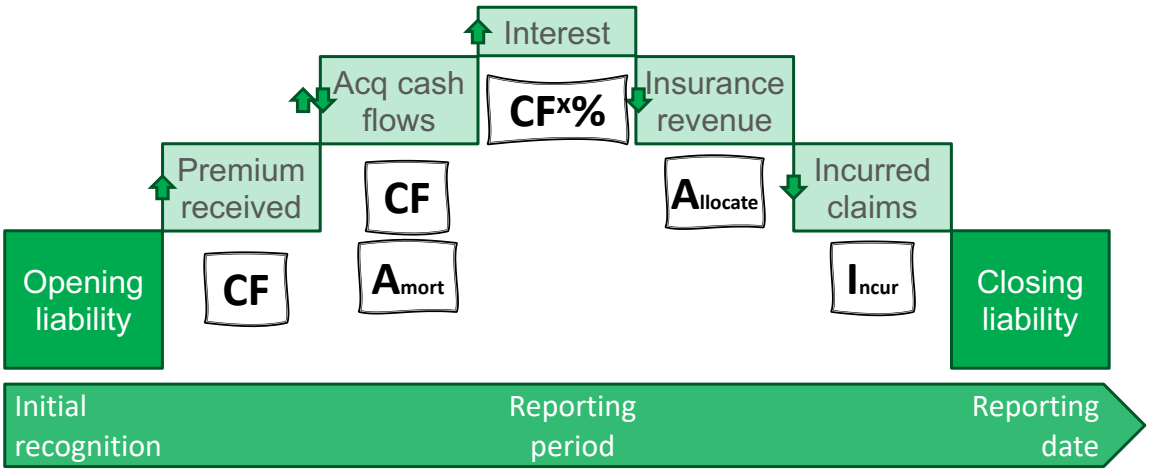
Premium allocation approach

Simplifications - subsequent measurement



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Liability for incurred claims

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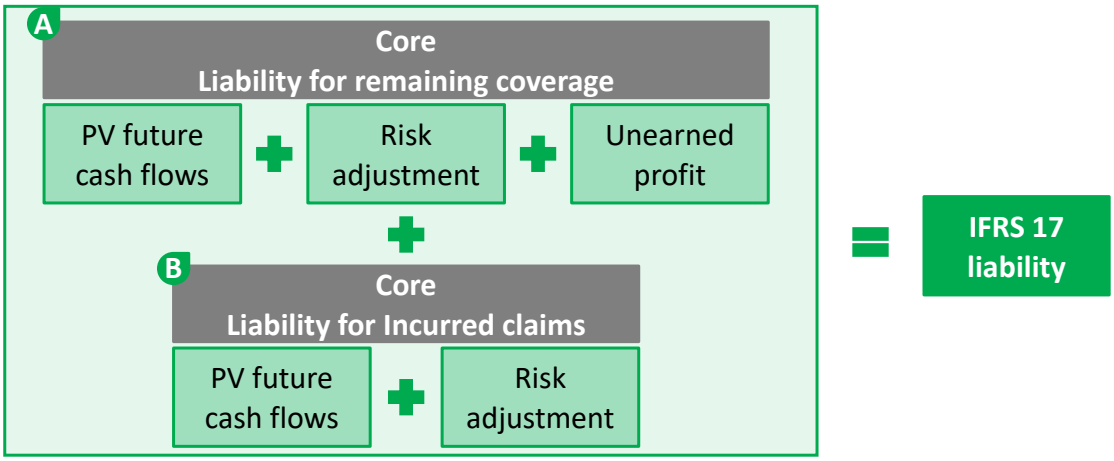
Core requirements



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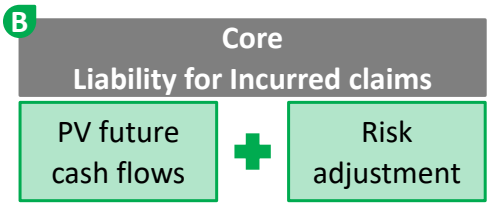
Premium Allocation Approach
Simplifications



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Fulfilment cash flows
Liability for incurred claims[1]

- *LfIC*: An entity's obligation to investigate and pay for:
  - valid claims for insured events that **have already occurred**,
  - Valid claims for insured events that have occurred but for which claims have not been reported,
  - other incurred insurance expenses, and
  - amounts related to services that have already been provided

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Incurred by not reported

Mechanistic	• Based on historic average time between occurrence of event and reporting • Multiplied by average daily claims • Will differ between products (eg health care and car accident) and severity (big accidents and small accidents)
Judgemental	• Based on events (for example floods) • Based on weighted analysis of recent history • Based on market information (for example inflation)
Mixture	• Combination of above factors

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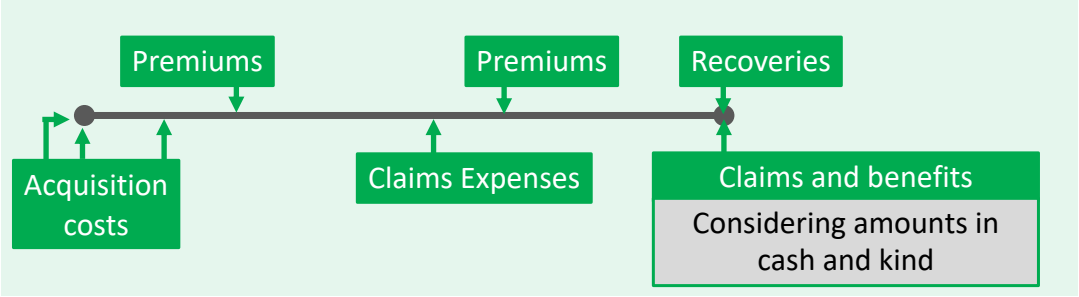
1 Present value of future cash flows
Cash flows

» **Current estimate** of future expected claims cash flows



» Probability weighted and unbiased

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1 Present value of future cash flows
Discount rates

Reflect time value of money and financial risks

» Characteristics of the cash flows

» Liquidity of the insurance contracts

» To extent that financial risks are included in the cash flows

Consistent with observable market prices (if any)

Timing | Currency | Liquidity

Exclude the effect of factors in the observable market prices not relevant to insurance contracts eg credit risk

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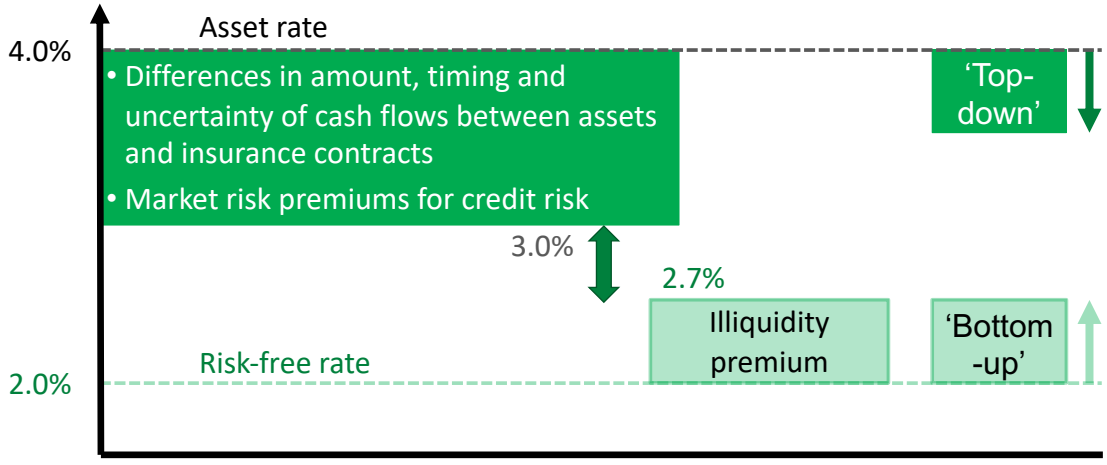
1 Present value of future cash flows
Determining the discount rates



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Present value of future cash flows

» The principle is relatively simple. For a contract with the following possible outcomes (10% discount rate):

	Scenario	Prob	Present value	PV x probability
1.	Pay claim of 5 000 in 6 months	5%	4 761	238
2.	Pay claim of 5 000 in 12 months	5%	4 545	227
3.	Pay no claim, pay rebate of 1 000	80%	909	727
4.	Pay no claim, pay no rebate	10%	0	0
Probability weighted cash outflow				1 193

» The challenge is the data and the number of scenarios
  » Eg assumptions of different sizes of claims, or lapse rates

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2 Risk adjustment

- Explicit, current adjustment for compensation insurer requires for bearing non-financial risk (eg insurance risk)
- Compensation that makes a company indifferent between:
  - fulfilling a liability that has a range of possible outcomes; and
  - fulfilling a liability that will generate fixed cash flows

	Group A		Group B	
	Probability	Pay-off	Probability	Pay-off
	50%	1 000 000	100%	500 000
	50%	0		
Probability weighted average	(0.5 x 1m)+(0.5 x 0) = CU0.5m		1 x 0.5m = CU0.5m	

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Risk adjustment

May be linked to:

- Internal pricing determination
- Internal reserving requirements
- External requirements such as prudential calculation

May be expressed as:

- A percentage of premium
- An absolute amount

May or may not be discounted

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Premium Allocation Approach
Simplifications

B

Core
Liability for Incurred claims

PV future cash flows + Risk adjustment

Simplifications	Optional practical expedient
» Consistent with core model, but » Optional practical expedient	» Discount claims at current rate unless settlement expected in no more then 1 year

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Premium Allocation Approach
Simplifications

Core Liability for remaining coverage			+	Core Liability for Incurred claims		=	IFRS 17 liability
PV future cash flows	Risk adjustment	Unearned profit		PV future cash flows	Risk adjustment		

Premium allocation Liability for remaining coverage	+	Premium allocation Liability for incurred claims	=	IFRS 17 liability
» No split required » Cash flows based, limited forecasting » Other practical expedients		» Consistent with core » Practical expedient for discount rate		

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Onerous Contracts

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Onerous contracts
Recognition

- *If at any time during the coverage period, facts and circumstances indicate that a group of insurance contracts is onerous, an entity shall calculate the difference between:*
  - The carrying amount determined above and
  - The fulfilment cash flows calculated applying the core model (ignoring discounting if that is what the entity has elected)
- Determined:
  - **Only if** facts and circumstances indicate (don't have to test otherwise)
  - At a group level
  - At initial inception or subsequently

IFRS17.57

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Onerous contracts
Loss component

- If a PAA contract is initially or subsequently onerous, entity recognises the expected loss in profit or loss immediately (*loss component*)
- General requirements of IFRS 17 require establishing, tracking and running-off of a 'loss component'
  - Loss component is 'amortised' over the life of the contract until it is zero (it must be zero at the end of the contract)
  - The standard does not specify the pattern for the pattern of recognition.

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Onerous contract example
Example

- Addis issues a 2 year vehicle insurance contract:
  - Premium in advance of $24 000,
  - Expected claims year 1 & year 2 $12 500,
  - For simplicity
    - Interest is zero,
    - risk margin is zero,

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Onerous contract example
Example

» 2 year contract, premium $24 000, expected claims yr 1 & 2 $12 500, interest is zero, risk margin is zero, what is the expected loss?

	Cash flow	Present value
Cash inflow (premium)	24 000	
Immediate		24 000
Cash out flow (claims)	-25 000	
Interest rate is zero		-25 000
Risk margin (zero)		0
Expect loss		-1 000

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Onerous contracts
Example

» 2 year contract,

» Immediate premium of $1 000,

» Expected claims of $550 in year 1 and $550 year 2

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Onerous contracts
Example

2 yr contract, premium $1 000, expected claims yr 1 $550 and yr 2 $550

Balance sheet	Inception	Year 0	Year 1	Year 2	Ref
Insurance liability OB	-				
Premium received	-				
Revenue recognised	-				
Loss component	-100				17.58
Closing balance	-100				

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Onerous contracts
Example

2 yr contract, premium $1 000, expected claims yr 1 $550 and yr 2 $550

Balance sheet	Inception	Year 0	Year 1	Year 2	Ref
Insurance liability OB	-	-100			
Premium received	-	-1 000			17.55(a)
Revenue recognised	-	-			
Loss component	-100	-			17.58
Closing balance	-100	-1 100			
Revenue	-				
Claims	-				
Loss component	100				
Underwriting loss	100				

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Onerous contracts
Example

2 yr contract, premium $1 000, expected claims yr 1 $550 and yr 2 $550

Balance sheet	Inception	Year 0	Year 1	Year 2	Ref
Insurance liability OB	-	-100	-1 100		
Premium received	-	-1 000	-		17.55(a)
Revenue recognised	-	-	500		17.55(b)
Loss component	-100	-	50		17.58
Closing balance	-100	-1 100	-550		
Revenue	-				
Claims	-				
Loss component	100				
Underwriting loss	100				

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Onerous contracts
Example

2 yr contract, premium $1 000, expected claims yr 1 $550 and yr 2 $550

Balance sheet	Inception	Year 0	Year 1	Year 2	Ref
Insurance liability OB	-	-100	-1 100		
Premium received	-	-1 000	-		17.55(a)
Revenue recognised	-	-	500		17.55(b)
Loss component	-100	-	50		17.58
Closing balance	-100	-1 100	-550		
Revenue	-		-500		
Claims	-		550		
Loss component	100		-50		
Underwriting loss	100		-		

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Onerous contracts
Example

2 yr contract, premium $1 000, expected claims yr 1 $550 and yr 2 $550

Balance sheet	Inception	Year 0	Year 1	Year 2	Ref
Insurance liability OB	-	-100	-1 100	-600	
Premium received	-	-1 000	-	-	17.55(a)
Revenue recognised	-	-	500	500	17.55(b)
Loss component	-100	-	50	50	17.58
Closing balance	-100	-1 100	-550	-	
Revenue	-		-500		
Claims	-		550		
Loss component	100		-50		
Underwriting loss	100		-		

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Onerous contracts
Example

2 yr contract, premium $1 000, expected claims yr 1 $550 and yr 2 $550

Balance sheet	Inception	Year 0	Year 1	Year 2	Ref
Insurance liability OB	-	-100	-1 100	-600	
Premium received	-	-1 000	-	-	17.55(a)
Revenue recognised	-	-	500	500	17.55(b)
Loss component	-100	-	50	50	17.58
Closing balance	-100	-1 100	-550	-	
Revenue	-		-500	-500	
Claims	-		550	550	
Loss component	100		-50	-50	
Underwriting loss	100		-	-	

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Thank you

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Example
One year vehicle contract – Profit recognition journals

End month 1	Core	
	Debit	Credit
Insurance liability (CSM)	7 652	
Insurance liability (Risk)	5 000	
Insurance liability (claims)	75 000	
Revenue		87 652
Insurance liability		842 656

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Example
Paragraph B126 method

Calculate revenue directly:

	1 Jan
Opening balance	1 000 000
Interest	-
Revenue recognised	-

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Example
Paragraph B126 method

Calculate revenue directly:

	1 Jan	31 Jan
Opening balance	1 000 000	1 000 000
Interest	-	8 333
Revenue recognised	-	-87 916

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Example
Paragraph B126 method

Calculate revenue directly:

	1 Jan	31 Jan	28 Feb
Opening balance	1 000 000	1 000 000	920 417
Interest	-	8 333	7 670
Revenue recognised	-	-87 916	-87 916

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Example
Paragraph B126 method

Calculate revenue directly:

	1 Jan	31 Jan	28 Feb	31 Mar
Opening balance	1 000 000	1 000 000	920 417	840 172
Interest	-	8 333	7 670	7 001
Revenue recognised	-	-87 916	-87 916	-87 916

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Example
Paragraph B126 method

Calculate revenue directly:

	1 Jan	31 Jan	28 Feb	31 Mar	30 Apr
Opening balance	1 000 000	1 000 000	920 417	840 172	759 257
Interest	-	8 333	7 670	7 001	6 327
Revenue recognised	-	-87 916	-87 916	-87 916	-87 916

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Example
Paragraph B126 method

Calculate revenue directly:

	1 Jan	31 Jan	28 Feb	31 Mar	30 Apr
Opening balance	1 000 000	1 000 000	920 417	840 172	759 257
Interest	-	8 333	7 670	7 001	6 327
Revenue recognised	-	-87 916	-87 916	-87 916	-87 916
	31 Aug	**30 Sep**	**31 Oct**	**30 Nov**	**31 Dec**
Opening balance	428 800	344 458	259 412	173 658	87 189
Interest	3 573	2 870	2 162	1 447	727
Revenue recognised	-87 916	-87 916	-87 916	-87 916	-87 916

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Example
Alternatively method of calculating

- B126 method:
  - Pmt=(rate,nper,pv)
  - Pmt=(10%/12,12,1000000)
  - =87 916
  - Method assumes that acquisition costs are allocated evenely

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Example
Alternatively method of calculating

- B126 method:
  - Pmt=(rate,nper,pv)
  - Pmt=(10%/12,12,1000000)
  - =87 916
  - Method assumes that acquisition costs are allocated evenely
- B125 and B126 together method
  - Pmt=(10%/12,12,997000)
  - Method allows acquisition costs to be allocated on a different pattern

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Example
Alternatively method of calculating

- B126 method:
  - Pmt=(rate,nper,pv)
  - Pmt=(10%/12,12,1000000)=87 916
  - Method assumes that acquisition costs are allocated evenely
- B125 and B126 together method
  - Pmt=(10%/12,12,997000)=87 652
  - Method allows acquisition costs to be allocated on a different pattern

Both methods are correct

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