# IFRS 17

## *Insurance Contracts*

Darrel Scott

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*National Bank of Ukraine*

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## Disclaimer



Unless specified otherwise, the accounting requirements that are the subject matter of this presentation are the IFRS Standards as issued by the IASB that are applicable on or after 1 January 2023



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# Questions and answers

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## Question 1a

Could you, please, describe the approach how to apply changes in accounting policy retrospectively? What is the impact on financial statements?

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## Example
### *Applying an policy retrospectively*

» Insurer holds investments in associates as part of its investment fund

» Applying IAS 28.18, insurer can equity account or fair value the associates

» Insurer previously chose to equity account the associates

» In the 2023 financial year, insurer elects to change its accounting policy to fair value

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## Example
### *Applying an policy retrospectively*

| Carrying amount | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|
| **Equity accounting** | | | | |
| Cost | 1 000 | | | |
| Equity earnings | | 100 | 135 | 70 |
| Carrying amount | 1 000 | 1 100 | 1 235 | 1 305 |
| **Fair value carrying amount** | 1 000 | 1 250 | 1 350 | 1 320 |
| *Cumulative difference in carrying values* | 0 | 150 | 115 | 15 |

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## Example
### *Applying an policy retrospectively*

| Carrying amount | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|
| **Equity accounting** | 1 000 | 1 100 | 1 235 | 1 305 |
| **Fair value** | 1 000 | 1 250 | 1 350 | 1 320 |
| *Cumulative difference* | 0 | 150 | 115 | 15 |

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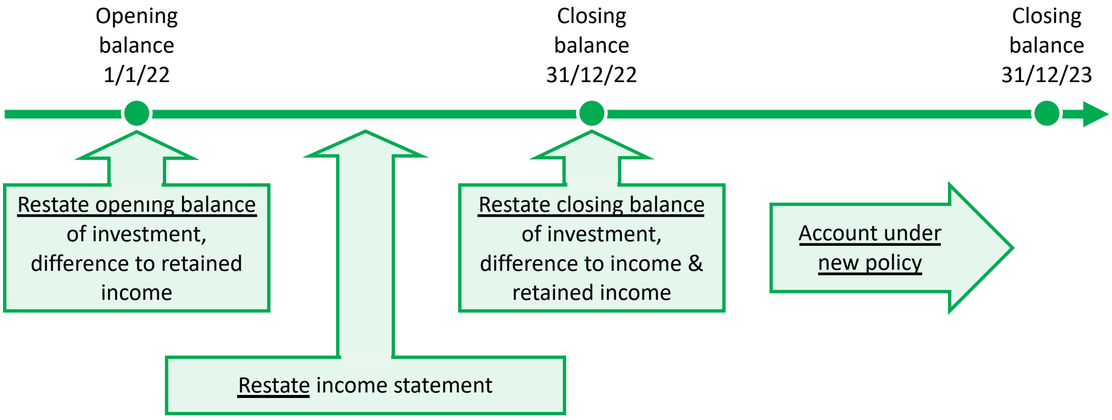
## Example
### *Applying an policy retrospectively*

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## Example
## *Applying an policy retrospectively*

| | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|
| Equity accounting | 1 000 | 1 100 | 1 235 | 1 305 |
| Fair value | 1 000 | 1 250 | 1 350 | 1 320 |
| Cumulative difference | 0 | 150 | 115 | 15 |

Journal required to give effect to change in policy:

| Debit/(credit) | 2019 & 20 | 2021 | 2022 |
|---|---|---|---|
| Dr Investment in associate | | 115 | 15 |
| Cr Retained income | | -115 | -115 |
| Dr Earnings from associates | | | 70 |
| Dr Fair value change | | | 30 |

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## Question 1b

How shall an insurance company present the changes in disclosures to financial statements? If it's possible, please, give us the example of applying such approach by P&C insurance company.

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## Simple Example
### *Applying an IFRS 17 retrospectively*

- Insurer issues one year insurance contracts with a one clear claim period
- UPR same as IFRS 17 for LRC, but different for LIC (UPR **not** discounted)

| Carrying value | UPR | IFRS 17 | Difference |
|---|---|---|---|
| 2021 closing balance | 3 000 | 2 727 | 273 |
| 2022 closing balance | 3 200 | 2 909 | 291 |

| Debit/(credit) | 2021 | 2022 |
|---|---|---|
| Dr Insurance liability | 273 | 291 |
| Cr Retained income | -273 | -273 |
| Dr Interest unwind | | 273 |
| Cr Claims (discounting effect on claim) | | -291 |

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## Example
### *Applying an IFRS 17 retrospectively - presentation*

| Insurance liability | 2022 | 2023 |
|---|---|---|
| Opening balance | 3 000 | 2 909 |
| Adoption of IFRS 17 | -273 | - |
| Revised Opening balance | 2 727 | 2 909 |
| Interest accrued | 273 | 291 |
| Claims paid | -3 000 | -3 000 |
| New claims | 2 909 | 3 091 |
| Closing balance | 2 909 | 3 091 |

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## Example
### *Applying an IFRS 17 retrospectively - presentation*

| Retained income | 2022 | 2023 |
|---|---|---|
| Opening balance | 0 | 1 091 |
| Adoption of IFRS 17 | 273 | - |
| Revised Opening balance | 273 | 1 091 |
| Income for the year (interest expense) | -273 | -291 |
| Income for the year (claims) | -2 909 | -3 091 |
| Income for the year (premiums) | 4 000 | 4 300 |
| Closing balance | 1 091 | 2 009 |

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## Question 1b

Could you, please, present an example of applying IFRS 1 'First time adoption of IFRS' for financial statements of insurance company which has a time break in implementation of IFRS 17?

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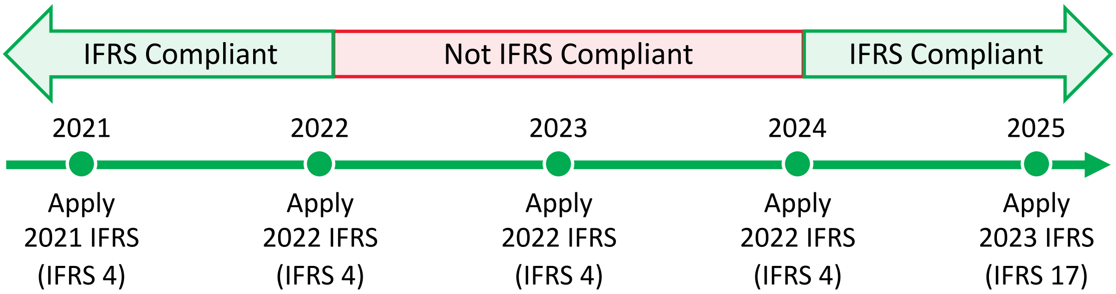
## IFRS 1 for insurance entity
### *Example timeline*

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## First Time adoption after a break

Insurer that did not state unreserved compliance with IFRS in most recent AFS

**Either**

**Apply IFRS 1**

Fully retrospective, except:
- Mandatory exceptions, eg
  - Estimates
  - Derecognition of FIs
  - IFRS 17 transition
- Optional exceptions

**Or**

**Apply IFRSs retrospectively in accordance with IAS 8**

Fully retrospective to effective date of IFRS 17:
- IFRS transition relief ends 1 Jan 2022/23 as though adopted on time
- Plus all IFRS 1 disclosures

*IFRS 1.4A and 4B*

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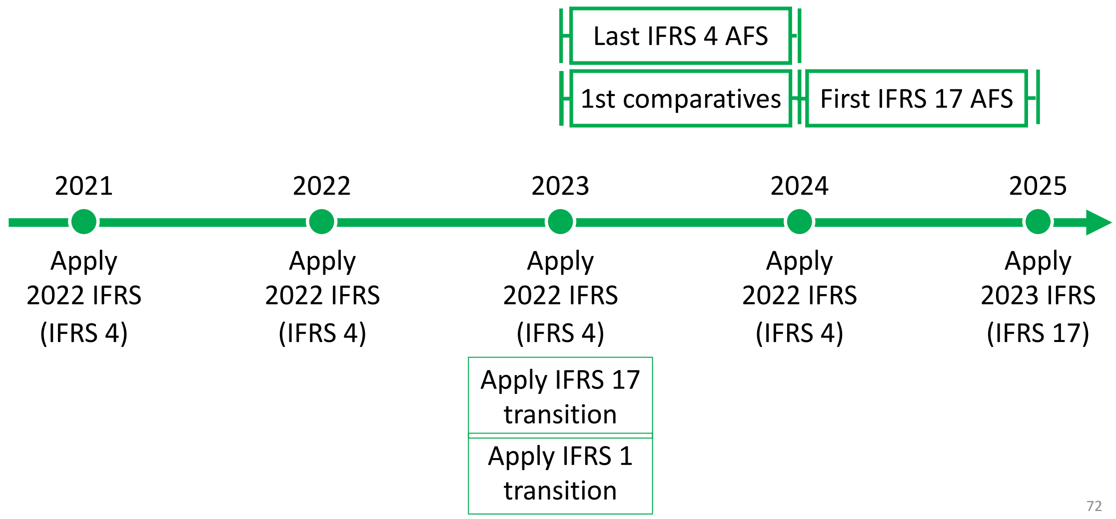
## IFRS 1 for insurance entity
### *IFRS 1 application*

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## IFRS 1 Transition

- » IFRS 1 requires fully retrospective except for:
  - » Mandatory exemptions (including IFRS 17 transition requirements)
  - » Optional exemptions
- » Assuming:
  - » Insurers with a break continue to apply all other IFRSs
  - » Do not avail of the optional exemptions
- » Then
  - » Application of IFRS 17 transition as normal
  - » IFRS 1 disclosures including reasons for break

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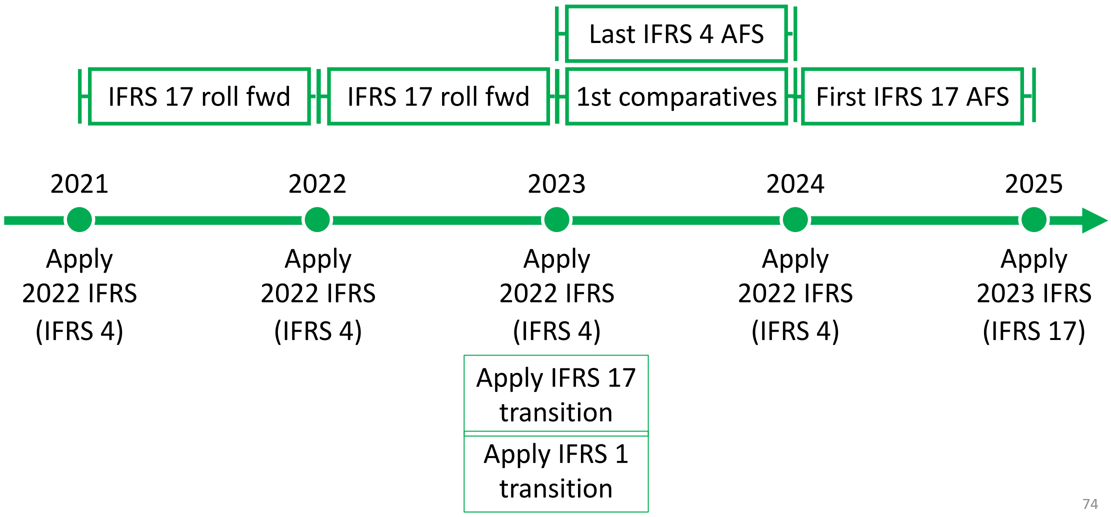
## IFRS 1 for insurance entity
### *IAS 8 application*

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## Question 3

Where do we <u>present risk of non-performance for reinsurance contracts</u> held? In PV of future cash flows or risk adjustment?

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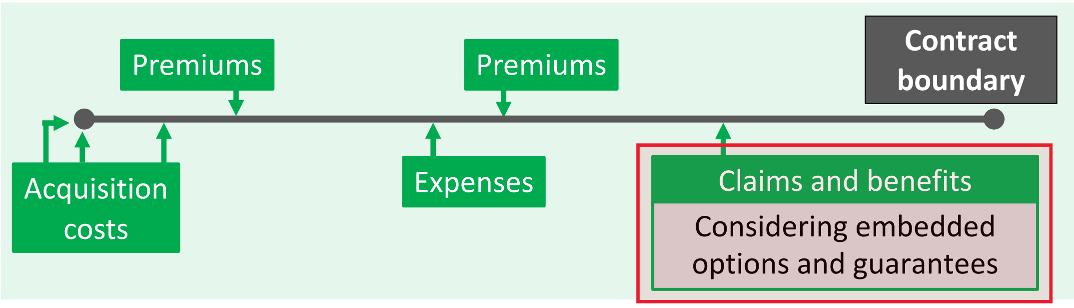
## Present value of future cash flows
### *Cash flows*

» **Current estimate** of all future cash flows in contract boundary




» Probability weighted and unbiased

» Stochastic modelling for financial options and guarantees, where relevant





## Simple example
### *Expected credit loss – present value of future cash flows*

» Insurer expects to claim $1 100 from reinsurer in 1 years time

» Interest rate is 10%

» Reinsurer credit rating implies 2% chance of default with LGD of 100%

| | PV | Probability | Weighted value |
|---|---|---|---|
| 1. Cash flow occurs as expected | 1 000 | 98% | 980 |
| 2. Default | 1 000 | 2% | 0 |
| Unbiased FCF value | | | 980 |

» Unbiased effect of the probability of default is included in measurement

## 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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## Simple example
### *Expected credit loss – present value of future uncertain cash flows*

» The unbiased present value of future cash flows is $980

» Insurer acquiring 1 000 of such cash flows would expect:

| | Cost | Cash received | Profit/(loss) |
|---|---|---|---|
| 1. Defaulting cash flows (20) | 19 600 | 0 | -19 600 |
| 2. Non–defaulting (980) | 960 400 | 980 000 | 19 600 |

» But there is inherent uncertainty in this, if actual defaults are 5%:

| | Cost | Cash received | Profit/(loss) |
|---|---|---|---|
| 1. Defaulting cash flows (50) | 49 000 | 0 | -49 000 |
| 2. Non–defaulting (950) | 931 000 | 950 000 | 19 000 |

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## Simple example
### *Expected credit loss – present value of future uncertain cash flows*

» Note this is worse if the insurer is completely exposed to one reinsurer:

| | Cost | Cash received | Profit/(loss) |
|---|---|---|---|
| 1. No default | 980 000 | 1 000 000 | 20 000 |
| 2. Default | 980 000 | - | -980 000 |

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## Reinsurer risks

| Risk | Description | Accounting |
|---|---|---|
| Insurance risk transferred | Mirrors risk of the underlying to the extent transferred | Measured consistent with underlying |
| Non-performance risk | Captures all non performance risk | |
| - Credit risk (financial risk) | Risk that reinsurer defaults on its obligations | Measured as credit margin in cash flow value |
| - Other (**either** financial or non-financial risk) | Risk that reinsurer avoids expected payment for reasons other then credit | Measured as **either** credit margin or insurance risk (policy choice) |

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## Question 2

I understand that VFA model is out of scope of our Zoom-meetings – you told us about that. Even though so I would like to ask you one general question about applying of VFA model in life insurance. Therefore, could you please describe in general an approach of applying VFA model in life insurance? When is VFA model used to apply in life insurance practice?

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## Core Requirements

***Snapshot of IFRS 17 Approaches***

Core requirements

Modifications for contract Types

- Insurance contracts with direct participation features
- Reinsurance contracts held
- Investment contracts with discretionary participation features

Simplifications: premium allocation approach

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# Contracts with participation features

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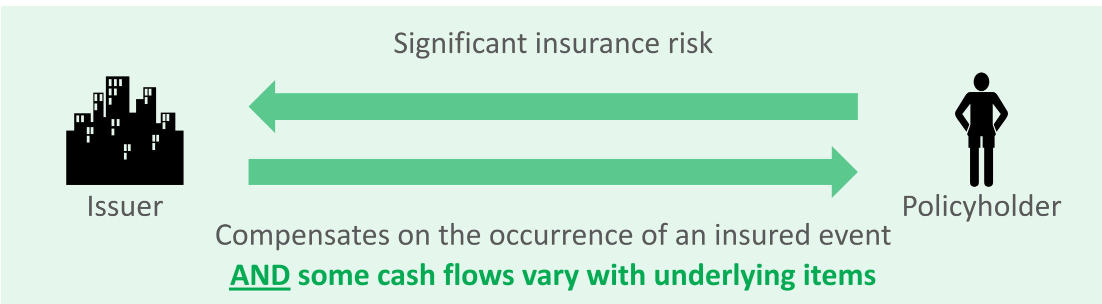
## What is a participating insurance contract?




» Payments to policyholders vary with returns on underlying items through participation features

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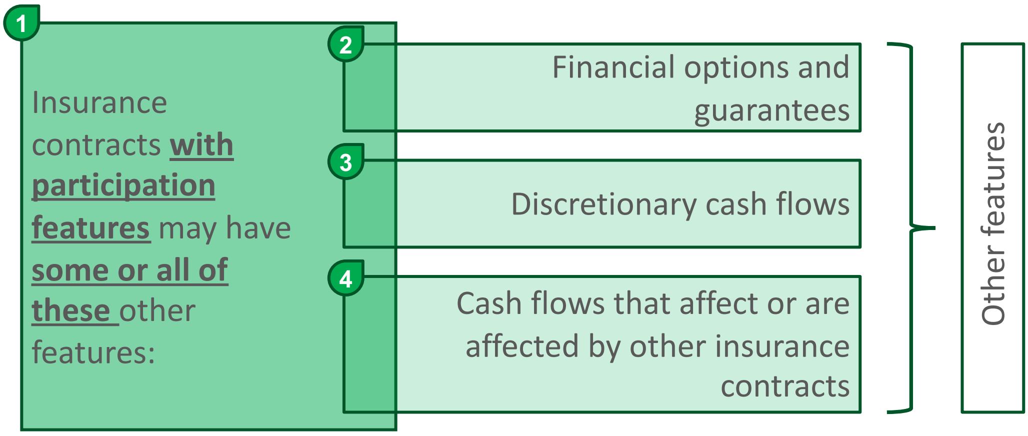
## Participation contracts
*Contracts with participation and other features*

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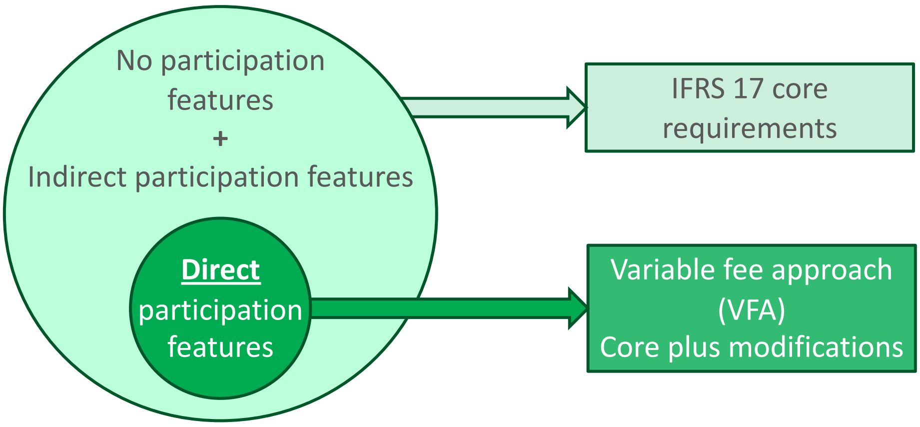
## Participation contracts
*Extent of participation*

» Insurance contracts:

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# Variable fee approach

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## Variable fee approach
### *When is the criteria applied?*

Inception → Subsequently

Assess against VFA criteria*

Do not reassess after inception *unless* there is a specified modification

* considering all features of the contract eg whether the contract's cash flows affect or are affected by cash flows to other policyholders

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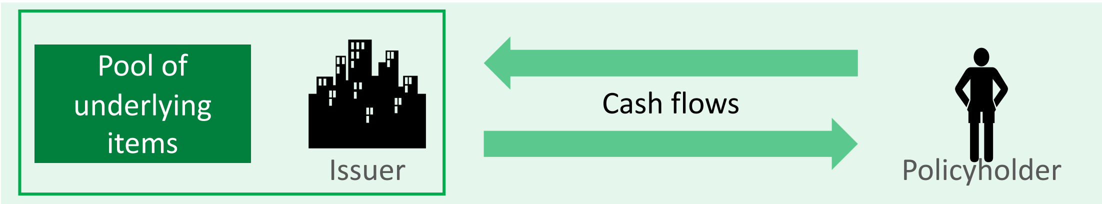
## Variable fee
### *Criteria (a)*

Contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items

» Discretionary cash flows do not preclude such a share

» Enforceable link to underlying items

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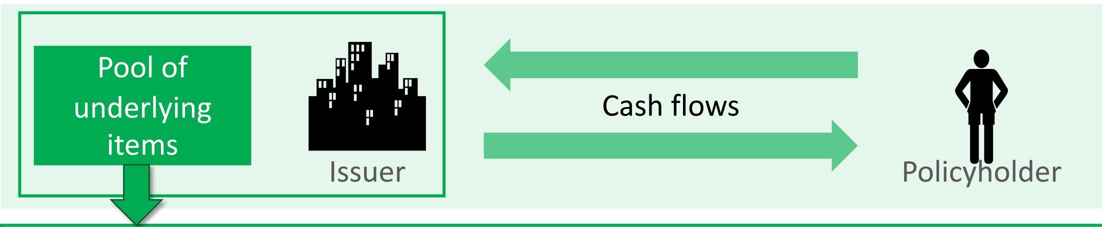
## Variable fee
### *Criteria (a)*




» Can comprise any items but must be identified in contract

» eg net assets of the entity or a subset

» Need not be held - can be a reference portfolio of assets

» eg index

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## Variable fee approach
### *Criterion (a)*

Criterion a) **not** met if any of the following are applicable:

» The underlying items determining the amount of entity's obligation can be changed with retrospective effect

» No pool of underlying items is identified in the contract

  » eg past practice that policyholders receive a return that reflected the entity's (or a subset of assets) performance is not evidence by itself that there are underlying items identified in contract

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## Variable fee approach
### *Criterion (b) and (c)*

The entity:

b) expects to pay an amount equal to a substantial share of the fair value returns on underlying items and

c) expects a substantial proportion of any change in the amounts to be paid to vary with the change in fair value of underlying items

Contracts with the following features are not precluded from meeting these criteria:

» a minimum guarantee return

» a return that is based on amortised cost of underlying items*

** Discussed at February 2018 IFRS 17 TRG meeting*

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## Variable fee approach
### *Criterion (b) and (c)*

For criteria b) and c):

» Interpret 'substantial' in the context of the objective:
  » provision of investment-related services and
  » a fee to compensate for that service determined by reference to underlying items

» Assess variability in amounts:
  » over the duration of insurance contracts
  » on a present value probability weighted average basis

If theoretically linked but no probability of exceeding guarantee then fails

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## Variable fee approach (VFA)
### *Relative to GMM*

» Only difference is in subsequent measurement of CSM:

| | Fulfilment cash flows | | |
|---|---|---|---|
| | PV of future cash flows | Issue year Risk adjustment | CSM |
| Initial recognition | Same requirements | Same requirements | Same requirements |
| Subsequently | Same requirements | Same requirements | Different requirements |

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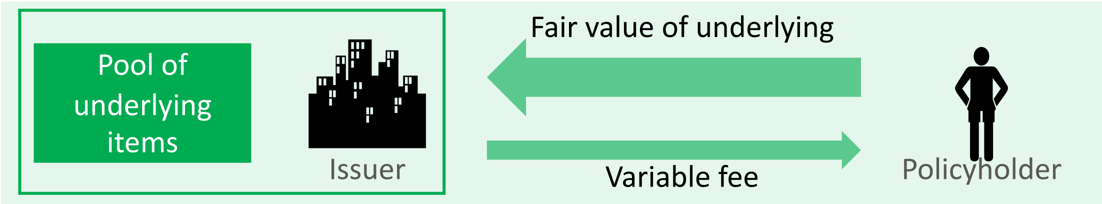
## Variable fee
### *Day 1 obligations*




On Day 1, entity's obligation to policyholder (fulfilment cash flows) is equal to fair value of underlying items less a variable fee

The variable fee is deducted in exchange for future services to be provided and comprises:
- entity share of fair value of underlying items less
- changes in fulfilment cash flows not based on the returns on underlying items

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## Variable fee approach
### *Subsequent measurement of CSM*

- Subsequently, the CSM is adjusted for changes in the variable fee:

Core: Changes in fulfilment cash flows related to future service applying core requirements

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VFA Adjustments*: Changes in effect of time value of money and financial risk not relating to underlying items + Changes in entity's share of the fair value of underlying items

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Changes in variable fee

Adjust the CSM to the extent that it does not fall below zero

Related to future service for contracts with direct participation features

* An entity could choose to recognise some or all of changes in effect of financial risk in profit or loss if specified risk mitigation conditions are met

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## Variable fee approach
*Example*

- Fact pattern – a group of insurance contracts with direct participation features
- Between initial recognition and the end of period 1:
  - The fair value of the underlying items increases from CU1,000 to CU1,135. Change of CU135
  - The fulfilment cash flows—liability for remaining coverage* are remeasured from CU795 to CU900. Change of CU105

** All fulfilment cash flows (both those that vary based on returns on underlying items and those that do not)*

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## Variable fee approach
*Simplified example*

CU135
**Changes in fair value of underlying items**

Note, this captures extent that return will be shared with P/h

CU105
**Changes in FCF** - liability for remaining coverage (including time value of money & financial risks)

CU30
Changes reflect variable nature of fee

(net of A and B)

Captures how much remains for the benefit of the company

| | | |
|---|---|---|
| Dr Fair value assets<br>Cr Profit or loss | Dr Profit or loss<br>Cr FCF | Dr Profit or loss<br>Cr CSM |

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## Variable fee approach
***Simplified example***

| Journals | Debit | Credit |
|---|---|---|
| Asset return | 135 | |
| Fair value income | | 135 |
| Return on assets actually held (which are also the underlying items) | | |
| Fair value expense (underlying) | 135 | |
| Fulfilment cash flows | | 105 |
| Contractual service margin | | 30 |
| Allocation of fair value on underlying item to insurance liability | | |

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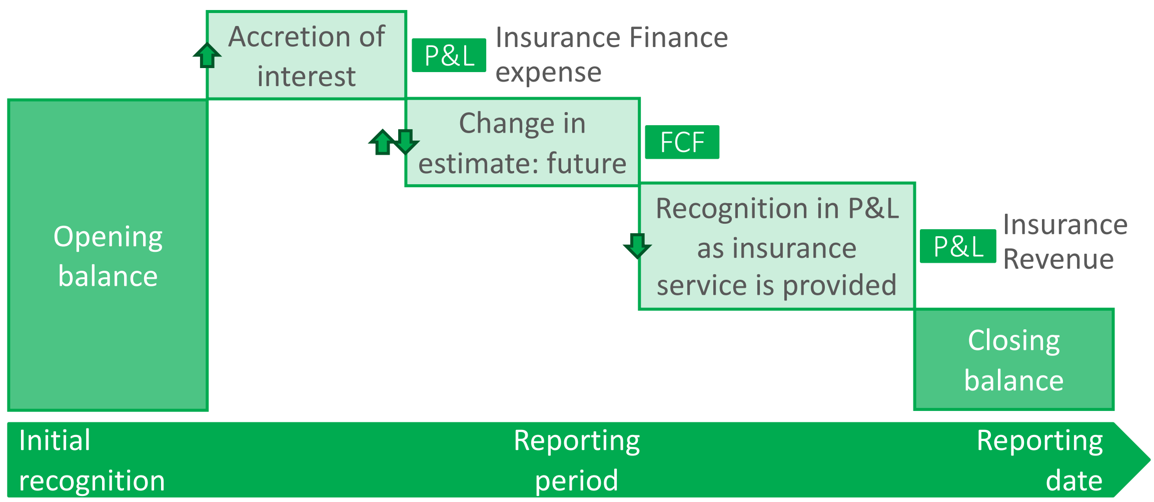
## 3 Contractual Service Margin (CSM)
***Subsequent measurement – core model***

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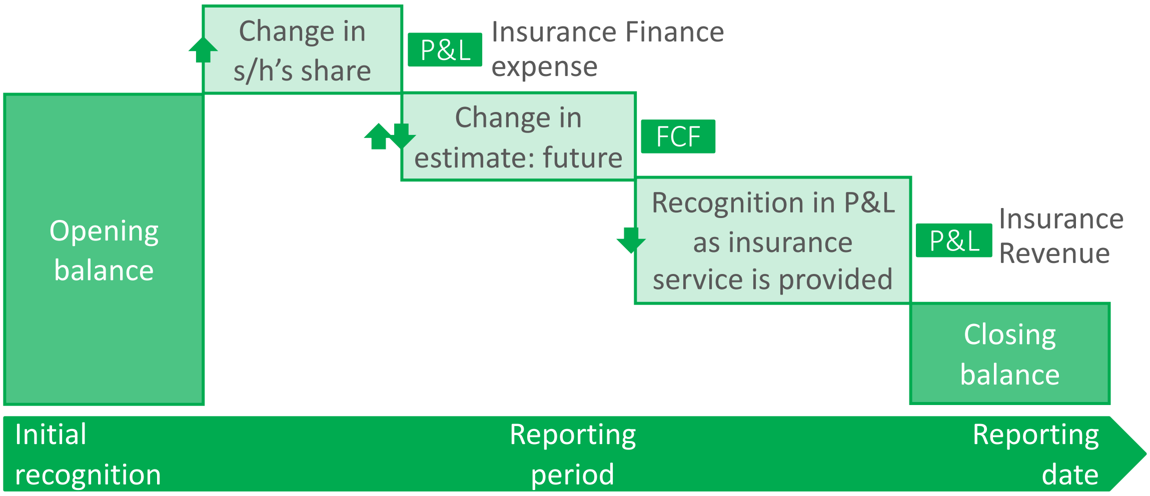
## 3 Contractual Service Margin (CSM)

### *Subsequent measurement - VFA*

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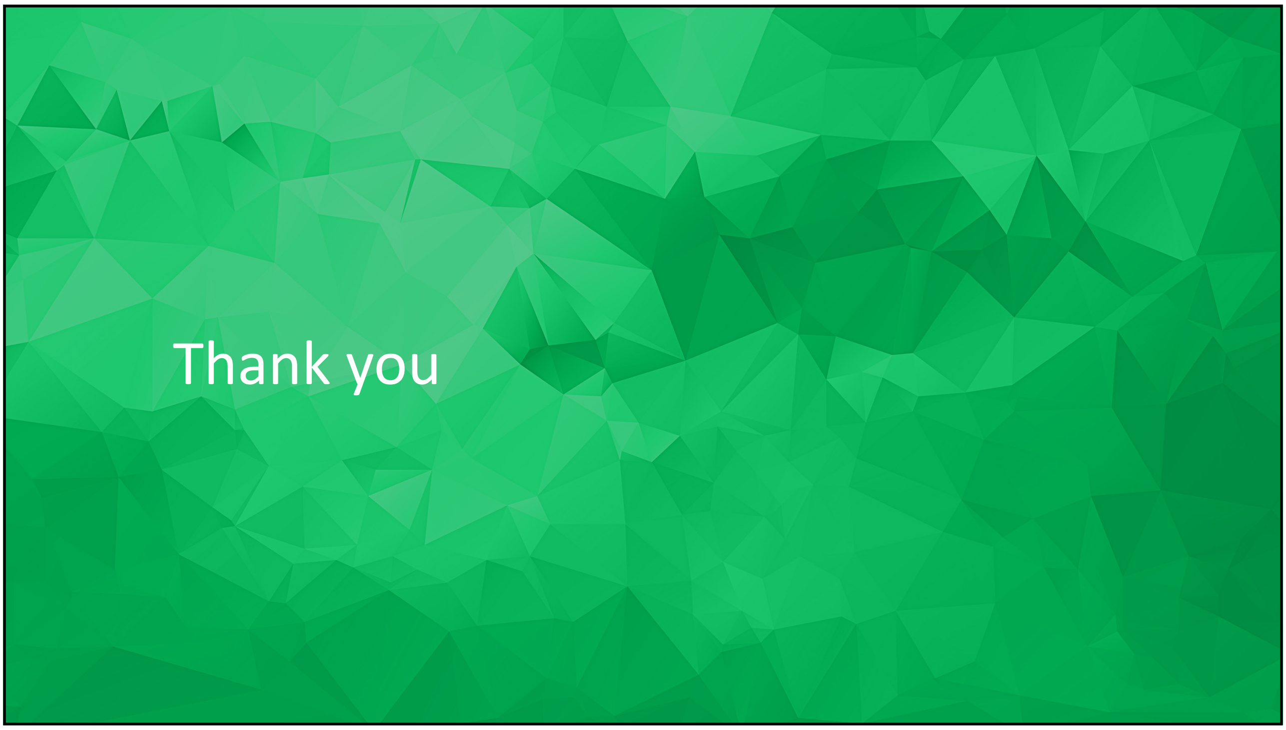


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