The twelve lessons learned from the implementation of IFRS 17 in the Spanish and Portuguese markets

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IFRS 17 marks a fundamental change in how insurance companies present and interpret their financial statements. As a principle-based standard, IFRS 17 allows companies the flexibility to choose certain methodological approaches, some of which can greatly influence how results are recognized.

In this document we present an analysis of some methodological aspects that have had a significant impact on the implementation of IFRS 17 in the Spanish and Portuguese markets.

Regulatory obligation

IFRS 17 came into force on January 1, 2023, and is mandatory for all listed and unlisted entities that prepare their consolidated financial statements under the IFRS standards.

In the Spanish market, the Dirección General de Seguros y Fondos de Pensiones (Spanish Insurance Authority) is responsible for regulating and supervising the operations of insurance companies, focusing on solvency, capital adequacy, and other factors related to the insurance sector's activities. However, it has not established the obligation to report local financial statements under international standards. The obligation to adopt IFRS 17 arises from international accounting legislation, adopted by the European Union, which obliges entities to report their consolidated financial statements under the guidelines of the international standard.

In contrast, in the Portuguese market, the Autoridade de Supervisão de Seguros e Fundos de Pensões (Portuguese Insurance Authority) has opted to replace its local accounting standards with the guidelines of the IFRS.

In this document we present the main lessons learned from collaboration with different clients in the Spanish and Portuguese markets.

1. CHOICE OF VALUATION APPROACH IN TRANSITION

IFRS 17 came into force on January 1, 2023, but its publication required comparative financial statements, so companies had to make their first closing under IFRS 17 on December 31, 2021. This is known as the transition date.

The standard allows the application of three different approaches for the valuation of technical provisions at the date of transition: the full retrospective approach (FRA), the modified retrospective approach (MRA), and the fair value approach (FVA).

The choice of valuation approach is not a trivial decision. The selected method could directly influence the level of profitability of a group's contracts at the transition date and, therefore, their accounting classification.

When choosing the valuation approach, it is also important to consider that the higher the contractual service margin (CSM), the greater the company's capacity to absorb the volatility of future claims and the lower the probability of incurring losses in the future.

In some cases, the lack of historical information that prevents the application of the FRA and the MRA leads companies to use the FVA.

It is worth mentioning that, in accordance with IFRS 13, fair value is defined as the price that would be received from selling an asset or the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date.

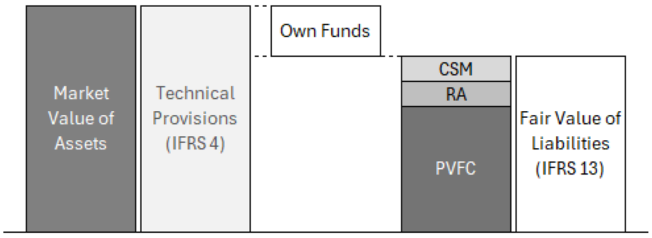
The fair value definition established by IFRS 13 has a direct impact on setting the amount of the CSM, which must be recognized in the transition balance sheet.

In general, for profitable contracts, IFRS13 results in a lower CSM, meaning that future revenues from insurance services and, therefore, the company's future results, will be lower. But, on the other hand, applying the FVA results in higher equity capital in the transitional balance sheet.

However, in other cases, the FVA can turn loss-making contracts into profitable ones. For example, for some contracts with a high guaranteed rate and negative value of in-force business (VIF) at transition, the application of the FVA could create a CSM with, of course, a negative impact on own funds.

This situation is relevant when valuing a group of contracts under the building block approach (BBA). With the MRA, a loss component (LC) would emerge, whereas it would not arise under the FVA. In case of any favorable change in the expected evolution of the portfolio, the FVA would result in an increase in the CSM, which would cause earnings to be deferred over time. In contrast, under the MRA, this change would lead to a direct recovery (loss reversal) reflected in the income statement.

FIGURE 1: CSM ESTIMATION UNDER IFRS 13



The first lesson we learned is that, generally for profitable contracts, the application of the FVA can penalize future income statements, and the effort involved in gathering information to apply the MRA can be worthwhile if the objective is to recognize a higher level of income from the insurance service and a higher profit in future years.

2. LOSS COMPONENT TREATMENT UNDER THE VARIABLE FEE APPROACH AT TRANSITION DATE

In general terms, IFRS 17 establishes that, when a loss occurs, it must be recognized immediately in the income statement, generating a LC that can be amortized or reversed in the future.

Nevertheless, the standard also states that, when valuing a group of contracts at the transition date using the variable fee approach (VFA) and applying the MRA, any losses that arise should be recorded in the company's own funds without giving rise to the recognition of a LC.

In this case, since there is no LC, any favorable change in the expectation of the future evolution of the business would give rise to the recognition of a CSM, resulting in a deferral of the profit over time through its release.

However, under the BBA, the existence of a LC at the transition date implies that any recovery will result in direct income to the income statement. Until the LC is fully recovered, no CSM will be recognized.

Therefore, in this second lesson, we see again the importance of the choice of the transition valuation approach for groups of contracts that may be in a loss position at the transition date. The chosen method can determine the profitability of the corresponding group of contracts.

3. AMORTIZATION OF LOSS COMPONENT

The valuation of portfolios with high-interest-rate guarantees may result in the recognition of a significant loss because of the cost of such guarantees. This circumstance would result in the recognition of a LC, which would be provisioned and immediately recognized as a service expense in the income statement.

Based on the standard, the LC amount will be amortized over the life of the portfolio, based on the cash flows of the insurance component and adjusting both the income and the expense of the insurance result as insurance contract coverage is provided, but without having an impact on the result for the year.

Therefore, the amortization pattern will not directly consider the existence of high financial guarantees in the contracts.

This inconsistency can produce a slow and progressive amortization of the LC, which could lead to a significant volume of unamortized losses at the maturity of a group of contracts, reflecting the company's inability to manage and reverse such losses.

The third lesson learned is that the analysis of contracts with high-interest-rate guarantees is especially relevant for managing the existence of a LC and its corresponding amortization. At transition date, this situation can also be managed by avoiding the recognition of the losses by applying the MRA and valuing using the VFA if the portfolio meets the eligibility requirement or by applying the FVA.

4. IMPACT ON FINANCIAL RESULTS: BBA VS. VFA METHOD

Following the standard, the valuation of businesses with financial profit sharing, depending on the features of each group of contracts, can be performed by applying the BBA, which is the general method, or by applying the VFA.

In both BBA and VFA, the valuation of contracts (present value of future cash flows [PVFC] and CSM) is done by projecting risk-adjusted investment returns; that is, without considering the risk premium from the asset portfolio backing the corresponding group of contracts. Therefore, both approaches lead to the same initial amount of CSM.

The CSM, under the BBA, is locked into the initial economic conditions, reflecting the technical and financial margin based on a risk-neutral valuation basis (without risk premium). However, under the VFA, the CSM reflects the market value of the variable fees that the company expects to obtain at any time for the corresponding group of contracts.

Under both methods, the CSM will absorb impacts on the present value of future fulfillment cash flows due to changes in the operating assumptions (future business expectations).

However, under the BBA, any impact on future profits due to changes in the economic environment will be immediately recognized in income statements (or in the own funds in case of applying the other comprehensive income [OCI] accounting option), while under the VFA this would adjust the CSM.

Thus, the impact in the income statement would be smoothed under the VFA, and so it can be said that the valuation method has an impact in terms of management of the income statement.

Under the BBA, the financial margin in the income statement reflects any realized capital gain or loss from the current period as well as the risk premium implicit in the investment return, which is not included in the CSM. In contrast, under the VFA, no financial margin is recognized in the income statement. Instead, the variable fee earned by the company, based on the performance of the underlying assets, is fully recognized through the CSM.

The fourth lesson learned is that applying one method or the other, beyond compliance with the eligibility requirement applicable to the VFA, has implications from the standpoint of management of the income statement.

5. PROFIT SHARING TREATMENT UNDER THE BBA

The valuation of profit-sharing contracts under the BBA makes the reporting process more complicated due to the impact that any changes in the economic environment may have on the contractual obligations.

Companies must design analysis-of-change processes that correctly isolate the effects of change in the economic environment on the fulfillment cash flows, because those effects are considered financial risks and do not adjust the CSM but are part of the insurance finance expenses.

Furthermore, for groups of contracts in which the OCI option applies, the company must be also able to separate from such financial risks the amount that will be taken to the income statement as insurance finance expense and the amount that will be taken to the own funds as OCI. For this purpose, in both Spain and Portugal, companies generally calculate an effective interest rate to quantify the impact to be taken against OCI and the one flowing to the income statement. The calculation of this effective rate can be complex, especially if stochastic valuation techniques are used for the fulfillment cash flows.

The fifth lesson is that the valuation of groups of profit-sharing contracts according to the BBA introduces a certain complexity both in terms of adjusting the CSM and in terms of correctly separating the insurance finance expense between the income statement and the OCI.

6. GENERAL CONSIDERATIONS ABOUT OTHER COMPREHENSIVE INCOME

The use of the OCI accounting option for the valuation of insurance liabilities (IFRS 17) helps to minimize the volatility that the valuation of financial instruments (IFRS 9) could generate in the financial statements. However, this benefit only happens when assets are valued under fair value with changes in OCI (FV OCI).

FIGURE 2: OPTIONS FOR A CONSISTENT VALUATION OF ASSETS AND LIABILITIES

Assets (IFRS 9)	Liabilities (IFRS 17)	P&L	Balance
Amortize Cost	OCI	Stable	Volatile
FV P&L	OCI	Volatile	Stable
FV OCI	OCI	Stable	Stable
Amortize Cost	P&L	Volatile	Volatile
FV P&L	P&L	Stable	Stable
FV OCI	P&L	Volatile	Stable

By applying the OCI accounting option, the effects that fluctuations in the economic environment may have on the valuation of assets and liabilities are offset, limiting their impact on the company's income statement and balance sheet.

It should be noted that, in the Spanish and Portuguese markets, most insurance companies, whose business has a significant financial component, have chosen to apply the OCI option as an element to mitigate volatility in the income statement and balance sheet.

The sixth lesson learned is the importance of the OCI accounting option for controlling the volatility of the result and the need for a joint analysis of the accounting treatment of financial instruments and insurance contracts.

7. RELEASE OF THE CSM UNDER THE VFA: THE "BOW WAVE EFFECT"

Coverage units are used to align the recognition of income (and expenses) with the insurance service provided over time.

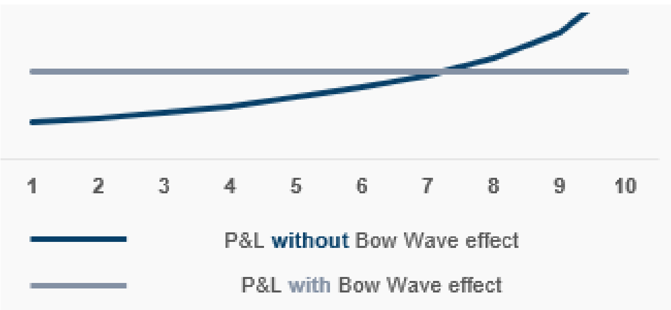
In both Spain and Portugal, and especially for saving business, companies mainly use discounted coverage units, which allows them not to overestimate the insurance service at the end of the portfolio's life and, therefore, to avoid artificially delaying the recognition of income from insurance services.

However, for contracts valued under the VFA, the discounted coverage units are not fully avoiding the deferral of the recognition of the insurance service income.

The term "bow wave effect" is used to describe the behavior of the CSM under the VFA. Specifically, this term refers to how the CSM is accrued and how the profit or gain is released in the income statement.

- It should be noted that the contract's valuation is done by projecting risk-adjusted investment returns; that is, without considering the risk premium from the asset portfolio backing the corresponding group of contracts. However, the accrual of the CSM at each reporting date reflects the total return of the underlying items over a period (including risk premiums earned on assets) and the non-realization of the time value of financial options and guarantees (TVFOG).
- The release of the CSM in the income statement occurs gradually based on the evolution of the coverage units. That is to say, the recognition will depend on the amount and distribution over time of the cash flows linked to the service provided.

FIGURE 3: BOW WAVE EFFECT



Therefore, the CSM, at each closing date, grows at a higher interest rate than initially estimated, as well as with the release of the TVFOG, resulting in a cumulative increase in the expected future profits to be earned on the contracts, which distorts the initial profit pattern.

The allocation of the risk premium and the part of the TVFOG released to the results is slowed down due to its allocation through the CSM.

The seventh lesson we wish to highlight is that, in portfolios where the VFA is applied, it is necessary to make an adjustment that neutralizes the bow wave effect and allows the release of the CSM according to the reality of the services provided.

8. BREAKDOWN BETWEEN INSURANCE COMPONENTS AND INVESTMENT COMPONENTS

If for any reason a company is unable to separate the components of its insurance contracts (insurance component, investment component, service component, or others), both the company's income statement and balance sheet could face greater volatility.

Under this situation, a higher (or lower) than expected volume of investment-related benefits paid, such as surrenders or maturities, would lead to a loss (or gain) in the income statement, as well as a lower (or higher) PVFC, resulting in an increase (or reduction) in the CSM.

This can create higher levels of volatility in both the income statement and the balance sheet. This higher volatility would be neutralized if these investment-related benefit cash flows were treated as an investment component.

Therefore, the eighth key lesson is the importance of making the effort to separate the components of an insurance contract to avoid volatility and accurately reflect insurance service income and expenses in the financial statements.

9. RISK ADJUSTMENT

IFRS 17 does not prescribe a specific method for calculating the risk adjustment (RA), but it requires companies to disclose the methodology used and the chosen confidence level.

The RA is set aside to address the uncertainty related to the fulfillment of actuarial or business assumptions.

In profitable portfolios, the RA can be seen as a portion of the expected future profit that is not recognized in the CSM.

However, unlike the CSM, the RA does not absorb losses that may arise from changes in future services. Thus, the higher the RA, the lower the CSM, reducing the ability of the company to absorb negative changes in the PVFC.

The RA is gradually reduced over time to reflect the diminishing uncertainty as time passes.

When defining the confidence level of the RA, it is crucial to understand its implications on both the CSM and the future earnings of the business. This consideration is particularly important in portfolios with limited profit margin, where a small CSM may not have sufficient capacity to absorb an adverse change in the portfolio's future performance.

Additionally, it is crucial to properly calibrate the parameters used in the RA calculation method in order to maintain consistency from year to year.

The ninth lesson learned is that companies must analyze the desired level of confidence not only in terms of the uncertainty associated with each business, but also taking into consideration the implications from a balance sheet and income statement point of view. Additionally, a balance between complexity and reasonableness of the RA should be found.

10. ACQUISITION EXPENSES: BUILDING BLOCK APPROACH VS. PREMIUM ALLOCATION APPROACH

Under the general model (BBA), acquisition expenses are not explicitly reserved in the traditional sense of creating an accounting provision on the balance sheet. Instead, they are incorporated in the calculation of the CSM at the time of the issuance of the group of contracts.

This means that they are not immediately recognized as an expense in the income statement but are deferred and amortized over the life of the contract.

Therefore, their amortization is through the release of the CSM, which allows the acquisition costs to be recognized in the income statement in line with the recognition of contract revenues.

Under the premium allocation approach (PAA), the standard allows acquisition costs to either be recognized immediately in the income statement in the period they are incurred or to be deferred and recognized over the life of the related group of contracts.

It should be recalled that the PAA is a simplified method applicable only to contracts with a duration of one year or less. However, for portfolios with annual or multiple renewals, the standard also permits the accrual of acquisition costs based on expected future renewals for the relevant group of contracts.

To apply this accrual on a multiyear basis, the company must verify that certain criteria, such as the following, are met:

- Nature of the contract: The insurer must consider that the contract has not been terminated at the end of each period and that the client has a high probability of renewal.
- Estimated renewals: Acquisition expenses should be allocated across expected renewals or the policy coverage period, based on estimates of the renewal rate.

The tenth lesson learned is that, for renewable businesses valued under the PAA, companies can soften the impact of acquisition costs on the income statement by applying multiyear accruals.

11. MUTUALIZATION IN THE VARIABLE FEE APPROACH

The term “mutualization of insurance contracts” refers to the practice of sharing risks and benefits among different contracts within the same group.

IFRS 17 allows the exclusion of annual cohorts for groups of contracts where risks are mutualized and jointly managed. In other words, for these groups, new business is reported alongside the existing portfolio.

This is the case for contracts reported under the VFA, where policyholders share a common portfolio of assets, risks are managed together, and the income generated by this portfolio is distributed among both the policyholders and the insurer.

Thus, the eleventh lesson learned from the practical implementation of IFRS 17 is that the application of the VFA allows for the avoidance of annual cohorts, which simplifies the monitoring of results and the tracking of business evolution. However, mutualization presents the challenge of being able to report the value of new business contribution within the financial statements.

12. REVIEW OF THE ASSUMPTIONS DERIVATION PROCESS

The process of deriving assumptions under IFRS 17 is crucial insofar as assumptions are the key element in the valuation of insurance contracts and the recognition of income and expenses in the income statement.

Under IFRS 17 it is especially important to minimize the deviation between actual and expected cash flows and thereby minimize the volatility this could generate in the company’s income statement and balance sheet.

The twelfth key lesson learned from our involvement in several projects in the Spanish and Portuguese markets is that the current derivation methodologies are not always well suited for accounting reporting under IFRS 17.

Some of the elements that we consider important in relation to this lesson are:

- Ensure consistency between the assumption’s derivation methodology and the projection methodology used in the model.
- Implement backtesting procedures to help with the setup of the assumptions and gain a better understanding of the portfolio’s behavior; these can also incorporate expert judgement.
- Establish controls that provide robustness and justify the selected assumptions.
- In some businesses, projected results could be improved by separating short-term and long-term portfolio behavior (short-term versus long-term assumptions).

In addition, improving the assumptions derivation process will benefit the Solvency II position, being more accurate and reducing any potential volatility in the solvency ratio or solvency capital requirement (SCR).

Conclusion

A detailed analysis of the implications of IFRS 17 is crucial for the management of future earnings and the CSM on the balance sheet. Throughout this article, we have shared some of the lessons learned from our participation in the implementation of IFRS 17 in both Spain and Portugal.

Thanks to this experience, we can affirm that the implementation of IFRS 17 represents a paradigm shift in the way profit and loss are recognized and financial information is presented in insurance companies. Moreover, we have found that it takes a while to learn the standard, as it requires time to assimilate both the methodological part and the interpretation of the results.

This time it takes to learn the standard varies according to the previous experience in actuarial reporting of each company.

At Milliman, we have a team that specializes in the IFRS 17 standard and is able to offer the necessary support, not only in the implementation and methodological development required by the standard, but also in understanding and analyzing the results.

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