MILLIMAN RESEARCH REPORT

Transition to IFRS 17

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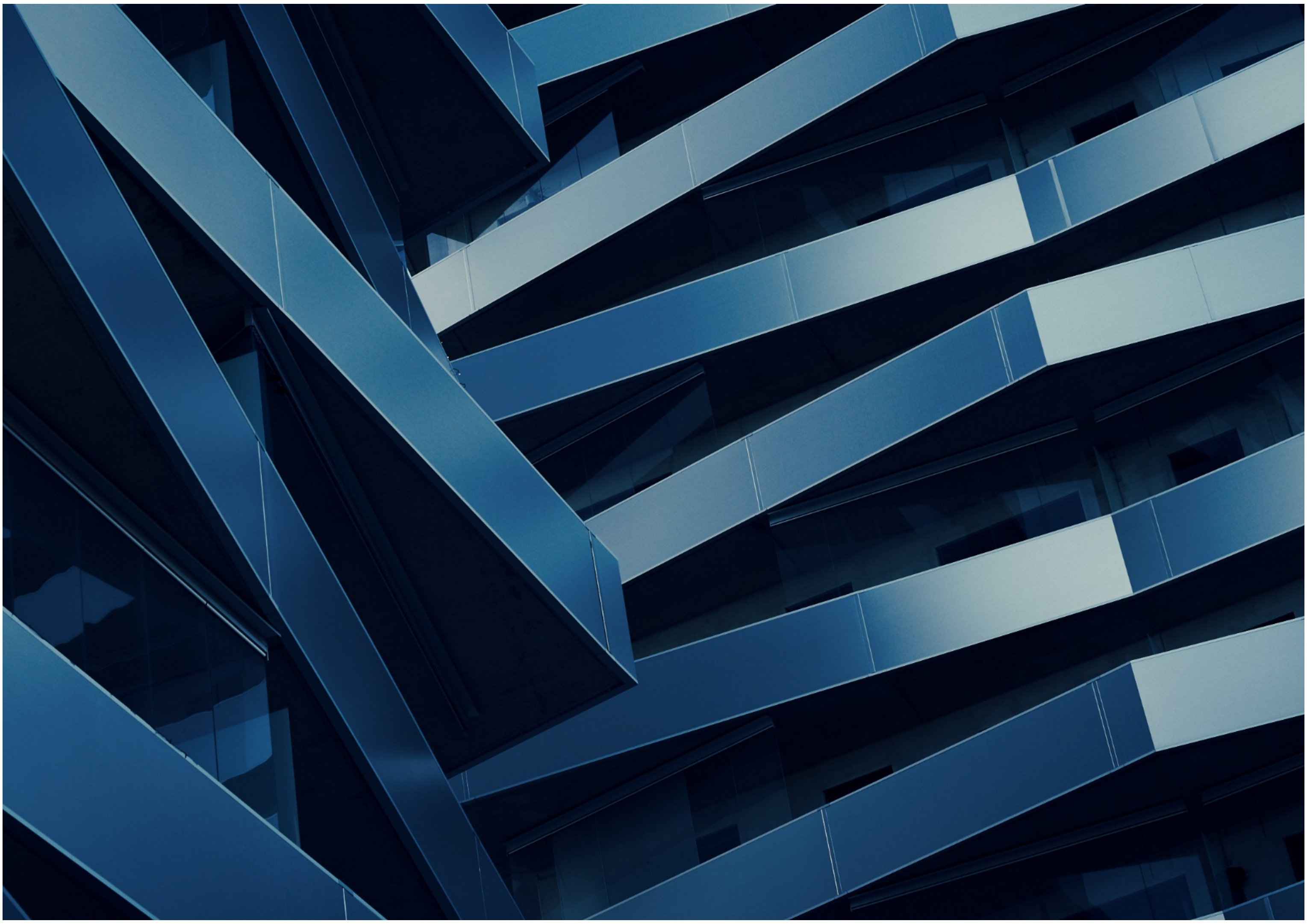

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Introduction

The long-awaited standard on insurance contracts, IFRS 17, was published on May 18, and the countdown is now on for companies to be ready for implementation. Companies shall apply IFRS 17 for annual reporting periods beginning on or after 1 January 2021, although early application is permitted for entities that apply IFRS 9 and IFRS 15 on or before the date of initial application of IFRS 17. This might still seem like a long time away, but companies should not underestimate the effort involved and are recommended to start their preparations now. Whilst IFRS 17 is an accounting standard, implementation will require significant actuarial involvement due to the complex nature of the liability calculations as well as the reporting, systems and data requirements.

In this paper we discuss the possible approaches to transition and the main challenges that (re)insurers will face during the transition to IFRS 17. Careful steps are needed to be well prepared for this important accounting policy change; otherwise, (re)insurers may need to perform error corrections and restatements after initial implementation.

Overview

The transition to IFRS 17 involves significant changes in the measurement and presentation of insurance contract liabilities. The standard requires that one of the following approaches should be used to value (re)insurance contact liabilities:

- General model (**GM**): The default approach, previously known as the Building Block Approach
- Premium allocation approach (**PAA**): A simplified approach for short-term contracts
- Variable fee approach (**VFA**): A modified approach for direct participating contracts

As the PAA applies to the pre-claims liability for short-term contracts, the transition is not expected to be a significant issue for these types of contracts and is not discussed further in this paper.

The GM involves a change in measurement of the value of insurance portfolios by defining this as the sum of:

- The present value of fulfilment cash flows, representing the expected cash-flow pattern directly related to the insurance contract discounted by relevant discount rates, taking into account the amount, timing and uncertainty of all cash flows.
- A risk adjustment (**RA**) that represents the required compensation for the uncertainty around the insurance contract cash flows from non-financial risk in comparison with fixed cash flows with the same expected present value.
- A contractual service margin (**CSM**), representing the profit of the insurance portfolio that is expected to be realised as the (re)insurer provides service and is recognised over the term of the portfolio. The contractual service margin serves as a buffer for changes in future services over time. The contractual service margin cannot be negative – any adverse developments that exceed the contractual service margin determined for a group of policies will be recognised in the profit and loss statement immediately. Such developments will be reflected in the determination of the fulfilment cash flows for remaining coverage and, unless the CSM recovers a positive value, the impact of changes in future cash flows of the group will be reflected directly in the profit and loss account as it arises.

Entities are allowed to measure the effect on the fulfilment cash flows of the change in discount curve between the moment of initial recognition of the insurance portfolio and the current period in other comprehensive income (**OCI**), which is part of the balance sheet. As an alternative, the change in discount curve can be accounted for completely in the statement of profit and loss.

The VFA applies to direct participating contracts, which includes unit-linked contracts providing risk benefits. It allows for matching in profit and loss the expense of the participation feature with the income on the underlying items[1] and absorption of the change in future variable fees by the CSM. The effects of non-financial changes unrelated to the underlying items are recognised in the CSM, which is in line with the treatment of the effect of such changes under the GM.

[1] Holders of direct participating contracts share in the returns earned on the underlying items, which are typically a pool of assets.

Full retrospective approach

In line with the requirements for changes in accounting policies as set out in IAS 8, *Accounting Policies, Changes in Accounting Estimates and Changes in Accounting Policies*, a full retrospective approach is in principle required to determine the correct financial position for the earliest prior period presented in the (re)insurer's accounts:

> *Retrospective application means adjusting the opening balance of each affected component of equity […] as if the new accounting policy had always been applied. [IAS 8.22]*

IFRS 17 defines the following dates in the context of the transition:

- Date of **initial application**: Beginning of the reporting period in which the entity applies IFRS 17 for the first time (1 January 2021 for those using calendar year reporting periods who are not early adopters).
- **Transition date**: Beginning of the annual reporting period immediately preceding the date of initial application (1 January 2020 for those using calendar year reporting periods who are not early adopters).
- **Initial recognition date**: For directly written business, this is the date on which a group of insurance contracts is sold and initially recognised on the balance sheet.

Entities are required to apply IFRS 17 for annual reporting periods beginning on or after 1 January 2021, although early application is permitted for entities that apply IFRS 9 and IFRS 15 on or before the date of initial application of IFRS 17. Entities need to restate the balance sheet on the transition date by applying retrospective application. This means that for a (re)insurer with a financial year starting on 1 January who does not adopt the standard early, the opening balance sheet of 1 January 2020 needs to be restated.

(Re)insurers are allowed, but not required, to present adjusted comparative information applying IFRS 17 for any earlier periods presented.[2] If a (re)insurer chooses to present any unadjusted comparative information, this should be disclosed and explained.

We have summarised the required presentation for certain items on the balance sheet at transition date in the following table:

FIGURE 1: REQUIRED PRESENTATION ON THE TRANSITION DATE BALANCE SHEET FOLLOWING THE FULL RETROSPECTIVE APPROACH

ITEMS	FULL RETROSPECTIVE APPROACH
Best estimate of fulfilment cash flows	Expected present value for the insurance portfolio using the discount curve and best estimate assumptions as per the transition date.
Risk adjustment	Based on the RA calculations using the assumptions as per the transition date.
Contractual service margin	Based on the calculations of the best estimate and RA at the initial recognition date and taking into account developments to the transition date as if IFRS 17 had always been applied.
Discount rate effect	Expected present value of the insurance portfolio using yield curve and best estimate assumptions as per the transition date minus the expected present value of the insurance portfolio using the curve on initial recognition date and the best estimate assumptions as per the transition date. Note that this effect can be reflected in the CSM (if the variable fee approach applies), in the OCI or in the statement of profit and loss.

It can be concluded from the table above that the discount rate effect and the contractual service margin require a complicated retrospective analysis that can be burdensome to implement. It requires the discount rate at initial recognition date and all assumption changes between initial recognition date and transition date to determine the level of the CSM or, if experience has reduced the CSM to zero for a group of policies, reflected in the fulfilment cash flows determined for that policy at transition date.

Alternative approaches are allowed where a (re)insurer can demonstrate that the full retrospective approach is impracticable. In the following section we discuss the steps required to determine this.

2 Local regulators might require more comparative information to be included in the annual account.

Practicability of the full retrospective approach

Applying IFRS 17 is a change of accounting standard, and therefore IAS 8, *Accounting Policies, Changes in Accounting Estimates and Changes in Accounting Policies* applies.

According to IAS 8, a full retrospective approach is required to determine the financial position for the earliest prior period presented. IAS 8 specifies that it is impracticable to apply a change in an accounting policy retrospectively where:

- The effects of the retrospective application or retrospective restatement are not determinable (for example, data may not have been collected in the prior periods in a way that allows retrospective application of the new IFRS 17 Standard and it may be impracticable to re-create the information)
- The retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period
- The retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:
  - Provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed
  - Would have been available when the financial statements for that prior period were authorised for issue from other information

When it is impracticable for a company to apply the new IFRS 17 standard retrospectively because it cannot determine the cumulative effect of applying the policy to all prior periods, the company should apply the new standard prospectively from the start of the earliest period practicable.

Hindsight should not be used when applying the new IFRS 17 standard to a prior period, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period.

With respect to IFRS 17, it is not necessary to undertake exhaustive efforts to obtain objective information for the full retrospective approach. Companies should take into account all objective information that is reasonably available.

If it is practicable, (re)insurers need to apply a full retrospective approach. Therefore, companies are allowed to apply a simplified approach only if they can show that the full retrospective approach is impracticable. If this is the case, it is permissible to choose between a modified retrospective approach and a fair value approach to implement the new IFRS 17 standard.

In the following sections we discuss these simplified approaches separately.

Modified retrospective approach

When applying a modified retrospective approach, the entity is required to try to achieve the closest outcome to the full retrospective application that is possible using reasonable and supportable information at the transition date. Certain modifications are allowed, but their use should be limited. Furthermore, the entity has to maximise the use of information that would be used in a full retrospective application where such information is available without undue cost or effort.

FIGURE 2: PERMITTED MODIFICATIONS

ITEM	FULL RETROSPECTIVE APPROACH	MODIFIED RETROSPECTIVE APPROACH
Expected cash flows at the date of initial recognition	Based on the calculations of the best estimate and risk adjustment at initial recognition date.	Combination of 1) Realised cash flows that are known to have occurred between the date of initial recognition and the transition date 2) Expected cash flows by using current assumptions as per the transition date
Discount rate at the date of initial recognition	Based on the calculations of the best estimate and risk adjustment at initial recognition date.	Estimate the yield curve at date of initial recognition by using an observable curve that approximates the required yield curve for at least three years before the transition date, if available. Otherwise, estimate the yield curve at the date of initial recognition using an average spread over an observable yield curve. The appropriate average spread should be determined over the three years immediately preceding the transition date.
Risk adjustment at initial recognition	Based on the calculations of the best estimate and risk adjustment at initial recognition date.	Estimate the RA at initial recognition by adjusting the RA determined at transition date with the expected release between the initial recognition date and the transition date.
Developments between the initial recognition date and the transition date	Takes into account all developments between initial recognition date and the transition date as if IFRS 17 had always been applied.	Estimate the contractual service margin at the transition date by taking into account the cash flows that are known to have occurred between the date of initial recognition and the transition date. In case of grouping of contracts issued more than one year apart, there is an option to apply the discount rate at the transition date instead of the discount rate per inception to determine the CSM accrual and adjustments.
Grouping of contracts	Contracts issued no more than a year apart which have similar risk characteristics and are managed together can be grouped together. There should be at least three groups at inception: onerous, profitable with no significant risk of becoming onerous, and other profitable contracts. Note that some of these groups may not contain any policies. Regulatory-affected pricing can be ignored in this grouping.[3]	Contracts issued more than a year apart can be grouped together. Grouping of contracts and assessing whether the variable fee approach applies can be done at contract inception date or at the transition date. Grouping of contracts issued more than a year apart might result in counterinuitive results, as there might be a big timing difference between the initial recognition date of the group (the date at which the CSM should be determined) and the actual initial recognition dates of the individual contracts.

[3] For example, where gender-neutral pricing is required by regulation, policies sold to males may be grouped with policies sold to females.

Modified retrospective approach for direct participating contracts

As mentioned above, direct participating contracts are accounted for under the variable fee approach. Entities need to apply the full retrospective approach to such contracts if practicable. If the full method is deemed impracticable, entities are allowed to determine the contractual service margin at the transition date as:

- Total fair value of underlying items at that date, less:
- The fulfilment cash flows at transition date, less:
- An adjustment for amounts charged by the entity to the policyholders (including amounts deducted from the underlying items) before that date, amounts paid before that date that would not have varied based on the underlying items, and the change in the RA for non-financial risk caused by the release from risk before that date.

Fair value approach

Under the fair value approach, the contractual service margin at the transition date is determined as the difference between the fair value (which is computed in accordance with IFRS 13) of the insurance contract and the sum of (i) the present value of fulfilment cash flows (which are determined in accordance with IFRS 17) plus (ii) the risk adjustment measured at that date. The fair value may differ from the fulfilment cash flows for a number of reasons:

- The fulfilment cash flows do not reflect the non-performance risk of the entity that issues the insurance contract, whereas it is included in the fair value.
- The fulfilment cash flows exclude overhead expenses which are not directly attributable to the contracts, whereas an overhead allowance is included in the fair value.
- The discount curve used for the fulfilment cash flows should exclude the effect of any factors that influence observable market prices but that are not relevant to the cash flows of the insurance contract.
- The fulfilment cash flows and the RA reflect the entity's own perception of risks, taking into account the entity's diversification benefit and degree of risk aversion, whereas the fair value is based on the exit value principle (*the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date*).
- The fair value of a financial liability with a demand feature is not less than the discounted amount payable on demand, whereas such a floor does not exist for fulfilment cash flows.

The grouping requirements for the fair value approach are the same as the modified retrospective approach.

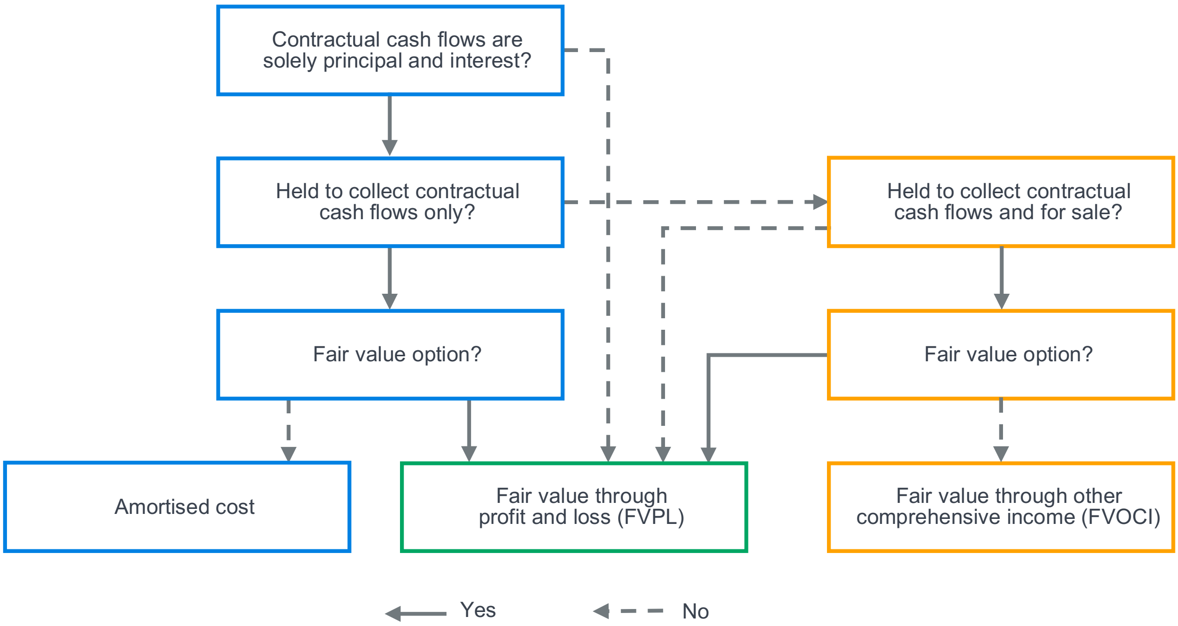
IFRS 9 and IFRS 17

IFRS 9, *Financial instruments*, is effective for annual periods starting from 1 January 2018. However, for (re)insurers having insurance as predominant activity, a deferral approach is allowed in order to align the introduction of IFRS 9 for these entities with the introduction of IFRS 17. IFRS 9 comprises three areas:[4]

- Classification and measurement
- Impairment
- Hedge accounting

Classification and measurement contains three possible accounting options: fair value through profit and loss (**FVPL**), fair value through other comprehensive income (**FVOCI**) and amortised cost, of which the applicability depends on the characteristics (solely principal and interest) and the business model of the asset (hold to collect, hold and sale, other business models). This is illustrated in the following diagram, which contains an overview of the classification and measurement for instruments within the scope of IFRS 9.

FIGURE 3: CLASSIFICATION AND MEASUREMENT FOR INSTRUMENTS WITHIN THE SCOPE OF IFRS 9



Both IFRS 17 and IFRS 9 have different accounting options for the insurance liabilities and the financial assets backing these liabilities, respectively. Not aligning the accounting will result in a possible accounting mismatch. It is crucial for (re)insurers to carefully align the application of both standards.

At the IFRS 17 transition date, an entity that is already applying IFRS 9 is allowed to reassess the classification criteria (business model test and cash-flow characteristics test) for assets held in relation with contracts in scope of IFRS 17, effectively reassessing the applicable measurement approach of the financial asset (FVPL, FVOCI, amortised cost). Furthermore, an entity is allowed to apply or revoke an FVPL or FVOCI option within IFRS 9 at the transition date if initial application of IFRS 17 eliminates the accounting mismatch that led to that previous designation.

[4] We will only discuss the first area, classification and measurement, in this paper for its relevance regarding IFRS 17.

Transition challenges

(Re)insurers and other issuers of insurance contracts face a number of challenges following the upcoming introduction of IFRS 17. These include:

1. Applying the full retrospective approach, or demonstrating the impracticability of applying the full retrospective approach
   a) The full retrospective approach requires a lot of historical information.
   b) Although the IASB mention that an exhaustive effort to show impracticability is not required, no consensus has been reached on the procedures necessary to show impracticability.
2. Applying the modified retrospective approach
   a) Historical cash flows will be derived from the financial administration records. Very often the financial administration system doesn't contain the entire history of a contract or portfolio, and hence there will be an incomplete data set.
   b) The financial administration system may not have information about the details of contracts, such as the issue year. That means that it will be very difficult to allocate the cash flows to the different issue years and to determine the CSM at inception.
   c) Given the current low interest rate environment, the option to apply the discount rate at transition, reduces the future insurance finance expenses, but will likely also reduce the level of the CSM at transition.
3. Determine the methodology/drafting the accounting polices
   a) The new IFRS 17 standard is principle-based, and different interpretations are possible. It will take time and multiple iterations to finalise the accounting policies for this standard. Given that the timeframe for the transition is only about three years, a lot of resources will be needed within a short period.
4. Data handling and storage
   a) The transition requires the company to retrospectively gather and process information from policy inception, which involves a lot of effort. Due to conversions in administration systems, migrations and portfolio developments, it may be difficult to gather this information.
   b) Policies need to be grouped into cohorts for the CSM calculations and corresponding data, and results need to be tracked on a group-by-group basis. The discount rate used to determine the initial CSM is locked in over the lifetime of the contract (with the exception of contracts for which the VFA is applied). So, on top of current information, a substantive amount of historical information needs to be available.
5. Governance, IT and systems
   a) Transforming the existing actuarial modelling framework to a fully operational IFRS 17 model is not straightforward with respect to the incorporation of the CSM in the calculations and specific requirements with respect to the Analysis of Change under IFRS 17.
   b) Unlike Solvency II, IFRS 17 directly impacts the financial statements, which will require more attention from an auditor's perspective. This requires high standards of governance around the calculations.
   c) IAS 8 classifies refinements to actuarial models as changes of estimates. Following implementation of the new standard, frequent improvements of the models will consequently lead to more disclosures. The period to prepare for IFRS 17 should be used to reduce the number of improvements that are outstanding, and to avoid future changes in estimates and potential errors as far as is reasonably possible.
   d) From a data management perspective, a robust system design combining significant data storage requirements with a high degree of computational complexity is required.
   e) In addition, most publicly listed companies inform their stakeholders within six to ten weeks after closing, requiring calculations and analysis to be completed very quickly.

6. Presentation of the financial statements and disclosures

   There is no prescribed template for the presentation of results and accompanying disclosures. Companies will have to develop templates applicable for all lines of business. Complexities will arise from the following areas:

   a) Fundamentally different income statements and significant changes to balance sheets are required.

   b) The calculation of the interest expense in the profit and loss account, which should be based on the rate locked-in at inception under the general model, and a current rate under the VFA.

   c) Experience variance/change in assumptions/change in economic environment: These items will need to be explained carefully and will need to be split in terms of items with an impact on the CSM and other items.

   d) Recognition of the interest expense in both the profit and loss and OCI.

   e) Specific disclosures for the transition approaches, which will affect the annual accounts for the duration of the run-off of policies in force at the transition date.

   f) Education of the management, board members, investors, accounting and actuarial staff about the new presentation.

7. Avoiding mismatches between the accounting of insurance liabilities and associated assets

   a) IFRS 9 allows for various accounting options for financial instruments covering insurance liabilities (amortised cost, fair value through profit and loss and fair value through OCI).

   b) The company needs to consider the interaction between the accounting treatment for financial assets and insurance contract liabilities in performance reporting.

   c) Insurers will need to assess how the new rules will impact their asset and liability management. In particular, they will need to produce additional analyses to further understand the impact on net income and OCI.

   d) An entity is required to revoke previous designations of financial assets as measured at fair value through the profit and loss account if initial application of IFRS 17 eliminates the accounting mismatch that led to that previous designation.

   e) Due to the different valuation approaches for regulatory solvency purposes and IFRS, companies may face a difficult dilemma: manage the volatility of the IFRS result or protect the solvency position.

8. Initial determination of the contractual service margin, other comprehensive income and the risk adjustment

   a) IFRS 17 does not prescribe a specific confidence level at which the RA should be calculated, as the degree of risk aversion of the entity should be reflected in the choice. Furthermore, diversification benefits of the entity should be reflected in the RA.

   b) Entities have some freedom to set the RA. Initially, the amount of the RA reduces the amount of the corresponding contractual service margin. Entities may therefore be able to strategically set these amounts to make optimal use of the different accounting treatment of the RA and the contractual service margin.

   c) Reinsurance is treated separately from the policies subject to reinsurance. In particular, the contractual service margin for a reinsurance treaty is calculated from the inception date of the treaty, and the manner in which the RA is calculated may be different from the corresponding calculation for the policies to which the treaty applies.

   d) Different levels of diversification benefits and risk aversion can result in different results between solo reporting and group reporting.

   e) The treatment of business where the outcome of risks are shared in the first instance between policies, rather than by the insurer is complex. Fulfilment cash flows and the contractual service margin must be calculated allowing for the cross-policy cash flows expected to arise from such mutualisation.

   f) The treatment of acquired business is complex. For example, an acquired subsidiary's solo reporting must reflect contractual service margin calculated from policy inception for directly written business. However, its parent must include the subsidiary's business using CSM calculated from the acquisition date.

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