MILLIMAN WHITE PAPER

IFRS 17: How simple is the simplified approach?

Considerations for general insurance actuaries

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IFRS 17 marks a fundamental shift in accounting principles. With this comes opportunities but also implementation challenges. In this paper, we present five key challenges that insurers will need to address when using the Premium Allocation Approach.

As noted above, the new insurance contracts accounting standard, International Financial Reporting Standard (IFRS) 17 (the Standard), will bring fundamental changes to the accountancy landscape. While it represents the biggest accounting change for insurers in many years, the impacts will be felt far beyond accounting and significant actuarial involvement is expected.

For entities with calendar year reporting periods, IFRS 17 has a likely implementation date of 1 January 2022. However, for comparative purposes, affected entities will also need to be able to show their accounts under the Standard as at the transition date of 1 January 2021. Therefore, entities need to be able to produce IFRS 17-compliant financial statements with effect from 1 January 2021. As many learnt from the implementation of Solvency II, implementation dates a long way in the future can seemingly suddenly become now—1 January 2021 is not as far away as it may sound.

Under IFRS 17, detailed reserving outputs and granular analysis of change will be disclosed publicly for the first time. Items such as discount rates and risk adjustments will have a direct impact on the reported profit in the accounts.

When moving to the new standard, many general insurance entities intend to qualify or become eligible to use the Premium Allocation Approach (PAA), a simplification in the measurement of liabilities that can be used for short-term insurance policies. At first inspection, this approach may appear similar to current accounting practices. However, once you dig a little deeper, a number of complexities emerge that will require careful consideration during transition to the new standard.

It is assumed for the purposes of this paper that the reader has a basic understanding of IFRS 17, the General Model (Building Block Approach) and Premium Allocation Approach.

1. Premium Allocation Approach eligibility

The International Accounting Standards Board (IASB) has been clear in all communication that there is only one model, the General Model (also known as the Building Block Approach, or BBA), that should be used to value insurance contracts. The Premium Allocation Approach (PAA) is a simplification of this basis, which an entity may use as an approximation for measuring contracts over the remaining coverage period (the BBA will be used for the liabilities for incurred claims).

An entity will be able to use the PAA for a group of contracts if, and only if, one of these conditions applies at the inception of the group:

- The coverage period of each contract in the group is one year or less and the group is not onerous.
- The entity reasonably expects that such simplification would produce a measurement of the liability for the remaining coverage provided by the group that would not differ materially from the measurement that would result from applying the full BBA.

Eligibility is therefore straightforward for contracts of less than one year in duration. However, many general insurers also have longer-term contracts (e.g., multiyear contracts or risk-attaching reinsurance). Using the PAA for these contracts might necessitate a significant amount of work to validate the required criteria.

Although the Standard does not explicitly require a test to demonstrate that the PAA is a reasonable approximation of the BBA, it seems reasonable to assume that some level of validation will be required to satisfy all stakeholders, particularly the entity’s auditor.

The degree of testing will likely depend on the specific circumstances, but, at its most extreme, could involve parallel calculations on the PAA and BBA bases using multiple scenarios to confirm that the PAA results are a reasonable approximation of the BBA results.

We emphasise that the use of the PAA is optional. If not all of an entity’s contracts are eligible, then consideration should be given as to whether it would be simpler to use the PAA for only part of the business or to implement the BBA for all contracts.

The PAA applies primarily to the liability for remaining coverage (LRC), the obligation that relates to the unexpired portion of the coverage period. With the exception of a couple of simplifications under the PAA, the liability for incurred claims (LIC) will still be measured under the BBA. Onerous contracts will also be measured under the BBA.

2. Groupings and onerous contracts

IFRS 17 requires that losses on unprofitable contracts are recognised in advance and that they are not offset by profitable contracts. Although, in principle, this is similar to some existing accounting practices, it is likely that the Standard will require entities to identify onerous business at a much more granular level than hitherto, limiting the extent to which profitable business can be used to subsidise loss-making contracts.

It is generally recognised that this might not be possible at an individual contract level so contracts can be grouped together according to their risk characteristics. Those that are managed together should then be divided into annual cohorts (i.e., contracts cannot be grouped with each other if issued more than 12 months apart). Contract groups will need to be divided further into the following three categories:

- Contracts that are onerous at inception
- Contracts with no significant risk of becoming onerous
- Other 'profitable' contracts

Many insurers' current processes will not be aligned to these groupings and data might not be readily available at this level of granularity.

In addition to data, one of the main challenges is how to identify those contracts that are, or have a real risk of becoming, onerous.

Under PAA, the entity can assume that no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise. An entity will also need to assess whether contracts that are not onerous at initial recognition have any significant possibility of becoming onerous by assessing the likelihood of changes in applicable facts and circumstances.

The wording 'facts and circumstances' is open to significant interpretation and judgement. Entities are considering a range of metrics to identify onerous contracts, including splitting new and renewal business, pricing loss ratios, plan loss ratios, trends in the data, historical performance, reserving loss ratios, rating environment etc.

If, at any time during the coverage period, facts and circumstances were to indicate that a group of insurance contracts is onerous, then it would be necessary to recalculate the difference between the BBA valuation of the liability for the remaining coverage and the carrying amount, so as to recognise this loss immediately.

It should be noted that an onerous contract liability cannot arise for incurred claims, because these are not part of the liability for remaining coverage and are already valued at current fulfilment value under the BBA.

3. Cash flows, discounting and the Risk Adjustment

Under IFRS 17, the fulfilment cash flows consist of the following three components:

- The best estimate of the future cash flows payable within the contract boundary of the insurance contract
- The discounting effect of applying appropriate discount rates (as derived by the entity) to the best estimate cash flows
- A Risk Adjustment to the discounted best estimate cash flows that is sufficient to compensate the entity for taking on the nonfinancial risks inherent in the best estimate cash flows.

Under IFRS 17, the profit publicly reported will be directly impacted by the Risk Adjustment and the discounting applied. It will also be a requirement to disclose confidence levels of insurance liabilities along with much more granular analysis of change information. Any additional scrutiny as a result of such detailed disclosures should be considered as part of process design and governance.

IFRS 17 is largely principle-based rather than prescriptive. While this enables insurers to tailor calculations to the individual risks, it also introduces additional complexity around the selection of methods.

DISCOUNTING

Under the PAA, there are several simplifications allowed regarding discounting.

- It is not necessary to discount the LRC unless there is a significant financing component. When the period between premiums being due and the provision of coverage is one year or less, the group is deemed not to have a significant financing component.
- For the LIC, cash flows do not have to be discounted if they are expected to be paid within one year. For those cash flows of longer duration, the discount rate at the date that the claim is incurred should be used rather than the rate at the initial recognition of the contract.

Although these are significant simplifications, the Standard is based on the present value of future cash flows, so an element of discounting is usually still required for the LIC component. Unlike for Solvency II, entities will be given the freedom to decide how to estimate appropriate discount rates, provided that they:

- Reflect the time value of money, the characteristics of the insurance contract cash flows and the liquidity characteristics of the insurance contracts to which they are applied
- Are consistent with observable current market prices (if such prices exist) for assets with cash flows whose characteristics (such as timing, currency and liquidity) are consistent with those of the insurance contracts
- Exclude the impact of any factors that are inherent in the observable market prices but do not affect the cash flows of the insurance contracts.

Discount rates should only include factors relevant to the insurance liability cash flows to which the rates will be applied and should therefore not, as a default, be set equal to the expected yields on the assets that are actually held to support the insurance liability.

Further discussion on the derivation of discount rates in the context of IFRS 17 can be found in Milliman's White Paper 'IFRS 17: Discount Rates.'

RISK ADJUSTMENT

A Risk Adjustment is required to the discounted best estimate cash flows that is sufficient to compensate the entity for taking on the uncertainty in the amount and timing of the best estimate cash flows arising from nonfinancial risks.

Under the PAA, there is no explicit requirement to calculate a Risk Adjustment for the LRC component. However, as the LIC under the PAA makes use of the BBA, an explicit Risk Adjustment is required for this component.

This Risk Adjustment can be compared with the Risk Margin as defined within Solvency II. However, the definitions do differ, among other differences, the Risk Margin is defined in the context of a transaction value whereas the Risk Adjustment represents an entity's internal view of the nonfinancial risk inherent in the liability cash flows and excludes general operational risk. In addition, IFRS 17 differs from Solvency II in that it allows entities free choice over the method to use to calculate the Risk Adjustment whereas under Solvency II the Risk Margin is calculated using a prescribed cost of capital method.

There are a number of methods that could be used to derive the Risk Adjustment, some of which are discussed in Milliman's White Paper 'IFRS 17: Risk Adjustment.'

4. Acquired claims liabilities

Another issue that some insurers might face when using the PAA is how to model claims liabilities that are acquired, such as those taken on through a portfolio transfer.

The Standard permits the PAA to be applied to those policies written by a general insurer that move into its settlement period, but not to those policies acquired (but not originally written) by the insurer that are already in its settlement period.

It is possible that general insurers intending to apply the PAA to all contracts that they issue will have to build systems to support the BBA approach purely to model contracts that they expect to acquire during their settlement periods.

This could involve significant complexity and additional work for any future mergers and acquisitions (M&A) activity.

5. Reinsurance

ACCOUNTING MISMATCH

IFRS 17 requires that reinsurance contracts are to be accounted for separately from the underlying insurance contracts to which they relate. This approach to reinsurance gives rise to several accounting mismatches, meaning that the financial statements might not appropriately reflect the net risk position after reinsurance. Consequently, a distorted profit recognition pattern may emerge. Such differences include:

- Contract boundaries for reinsurance might be inconsistent with those of the underlying insurance contracts
- For an underlying contract that is onerous, a cedent has to recognise a loss component through the profit and loss (P&L) statement immediately, whereas the relief from a corresponding reinsurance contract has to be deferred over the coverage period.

Intragroup reinsurance is another area to consider. The complexity of dealing with the elimination of intragroup reinsurance on consolidation will increase considerably under IFRS 17.

PRACTICALITY

As well as accounting differences, there are also a number of practical difficulties. For example, risk-attaching reinsurance business will often fall outside of the 'one-year coverage' definition required for automatic use of the PAA. Therefore, insurers will need to demonstrate that using the simplified approach would produce a result that would not differ materially from that which would be produced by applying the BBA; otherwise, they will have to run their reinsurance business using the full General Model approach. In addition, there are likely to be considerable data challenges faced by insurers in order to model fully their reinsurance cash flows.

It is perhaps not surprising that, in a recent letter to the Chair of the IASB, the European Financial Reporting Advisory Group (EFRAG) highlighted reinsurance as one of the topics that would merit further consideration by the IASB.

Conclusion

As discussed in this paper, IFRS 17 has allowed some respite for general insurers with the introduction of the PAA approximation. However, even if intending to make use of this approach, implementation will not be as straightforward as it may first appear, with significant changes to current processes still required.

There are many other challenges for insurers adopting IFRS17—we have not even mentioned in this paper areas such as packaged products, acquisition costs, balance sheet presentation, volatility of results and transition arrangements—but it is clear that, even with the PAA 'simplified' approach, there remains much for insurers to consider and much work for them to do.

There are some positives emerging from the work being done in preparation for IFRS 17 implementation, with entities using the new standard as an opportunity for transformation; to redefine their requirements; to refresh their data systems; to streamline processes; and to explore new methods such as artificial intelligence and individual reserving.

How Milliman can help

Milliman has a depth of experience and expertise in IFRS 17 having closely followed its development over the past 20 years.

We are well placed to offer the following services:

- Training on IFRS 17 concepts
- IFRS 17 gap analysis through the use of our readiness assessment tool
- Assistance with the transition, including impact analysis, scoping and planning
- Review of calculations and methodology (including PAA eligibility and onerous contracts)
- Technical guidance (including discounting and the Risk Adjustment)
- Product and profitability evaluations
- Assistance with modelling
- Implementation of an IFRS 17 systems solution through our award-winning Integrate platform, which can be implemented with cash flow output from any actuarial system

If you have any questions or comments on this paper or any other aspect of IFRS 17, please contact any of the consultants below or your usual Milliman consultant.

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