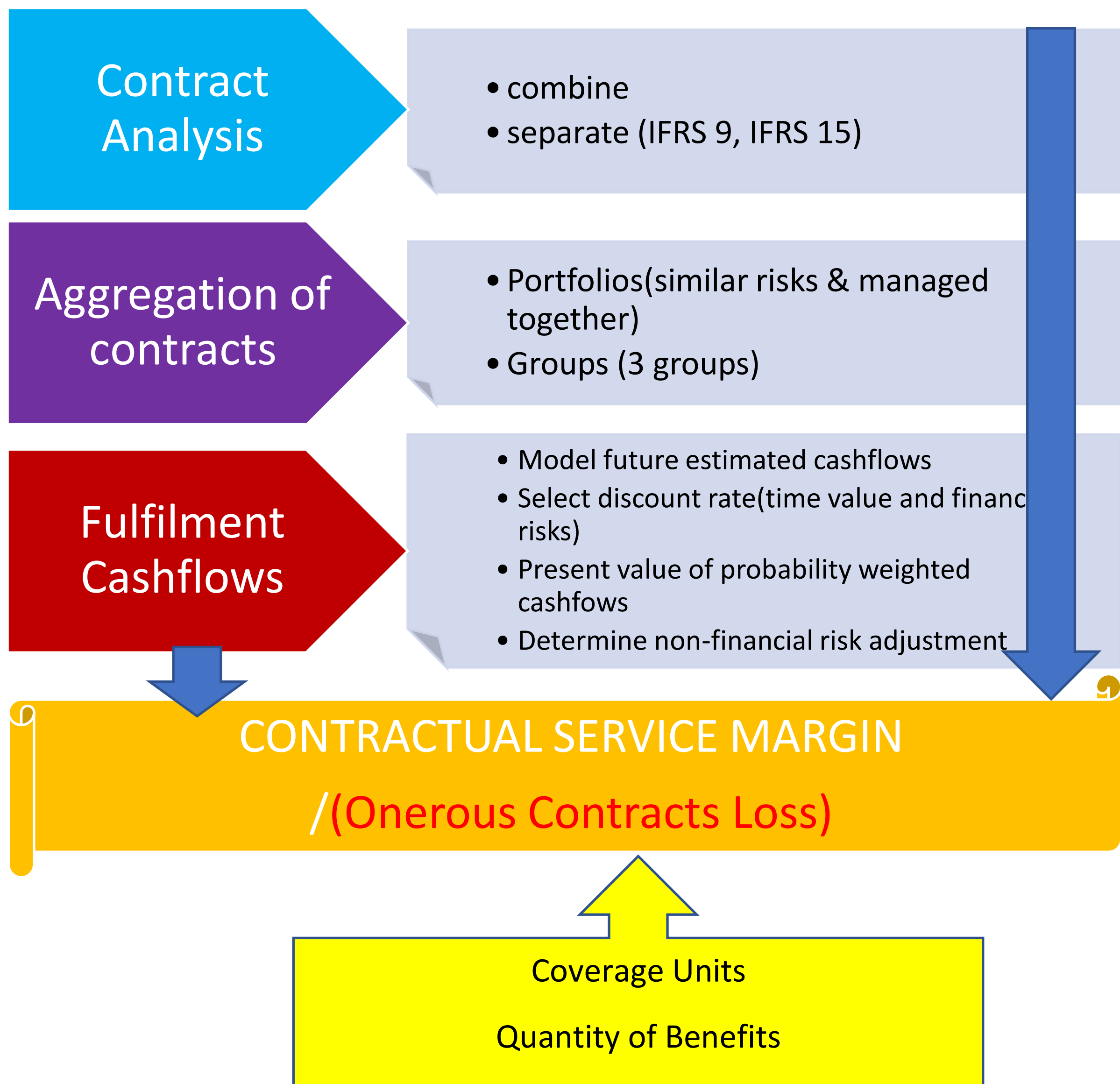
IFRS 17 INSURANCE CONTRACTS-FOCUS AREAS FOR THE CHIEF FINANCE OFFICERS AND CHIEF EXECUTIVE OFFICERS (LIFE INSURERS)

Introduction

The effective date for the implementation of IFRS 17 Insurance Contracts (IFRS 17) has been moved by the International Accounting Standards Board (IASB) to periods beginning on or after 1 January 2023 from the initial date of 1 January 2021. While this gives entities more time to prepare, we believe the shifting of the implementation date should serve as a warning to entities that there is a lot of work on the horizon. BAOA as the local standard setter for Botswana is championing the implementation of IFRS 17 by affected entities. As part of that process, we have started discussions with various insurance companies to establish their implementation status and strategy/roadmap. This article serves to support the efforts of entities as they prepare by highlighting some of the key focus areas which we believe the leadership of these entities need to be aware of and possibly track. The analysis below applies more to long term insurers. A separate article relating to short term insurers will be circulated.

SUMMARY OF WHAT YOU NEED TO KNOW UNDER IFRS 17 INSURANCE CONTRACTS



1. Insurance Contract analysis

Insurance Contracts under IFRS 17 will need to be reviewed with a view to combining certain contracts and or/ separating certain contracts into its different components:

(i) ***Combining contracts*:** a set or series of insurance contracts with the same or related counterparty may achieve or be designed to achieve an overall commercial effect. Such a set or series of contracts may be treated as a whole.[1]

(ii) ***Separating components from an insurance contract*:** An insurance contract may contain one or more components which when separated, will be accounted for within the scope of another IFRS, for example, some contracts will have investment components which are distinct and when separated will be accounted for under IFRS 9 and some will contain promises to transfer distinct goods or non-insurance services which when separated will be accounted for under IFRS 15.[2]

Entities need to set up a process that ensures that contracts are combined and separated according to the criteria noted in IFRS 17.

2. Aggregation of contracts

Once insurance contracts have been appropriately separated into their various components and/or merged as appropriate, the next stage is to aggregate the contracts. Two levels of aggregation are required, starting with establishing portfolios of contracts and then splitting the portfolios into a minimum of three groups :

(a) Portfolios

Identify portfolios of different insurance contracts. Insurance contracts will fall into the same portfolio if (a) they have similar risks and (b) they are managed together.[3]

(b) Groups

Once different portfolios have been identified, IFRS 17 requires ***each*** portfolio to be divided into a ***minimum*** of three different groups:

(i) a group of contracts that are onerous (loss making) on initial recognition;

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[1] IFRS 17 .9

[2] IFRS 17.10-13

[3] IFRS 17.14

(ii) a group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently *(in their lifetime)* and

(iii) a group of remaining contracts in the portfolio.[4]

IFRS 17 notes that contracts cannot be grouped together if they were issued more than one year apart[5]. The implication of this statement is that these portfolios and groupings are done once for each reporting period and will need to be maintained for the lifetime of the groups (cohorts). Consequently, each financial year will have its own set of portfolios and groups of insurance contracts and these are never mixed with portfolios and groups of insurance contracts from subsequent years.

This stage is critical because it involves assessing all groups of contracts for profitability at initial recognition. The process involves modelling future estimated cashflows (fulfilment cashflows) and deciding whether contracts have an unearned profit (contractual service margin) or onerous (loss making) at initial recognition. For onerous contracts, a loss is recognised immediately in profit or loss. For the other two groups which are not onerous, a contractual service margin representing the future unearned profits on the groups of contracts is quantified and recognised as a liability (see contractual Service Margin recognition below). The contractual service margin will be released(amortised) to profit or loss as the insurance company discharges its obligations under the contracts over the lives of the related groups of insurance contracts. The contractual service margin is technically where the allocation of future annual insurance profits will come from through periodic releases during a reporting period (see below).

Again, this process is critical and requires meticulous record keeping and tracking and updating estimates of future cashflows of the various groups and portfolios of insurance contracts until they are derecognised. We emphasize that the composition of portfolios and groups of insurance contracts are not reassessed in subsequent years[6], hence insurance contracts from different financial years should not be mixed.

[4] IFRS 17.16
[5] IFRS 17.22
[6] IFRS 17.24

3. Modelling for fulfilment cashflows

Fulfilment cashflows refers to the total of the following for a group of insurance contracts:

(a) present Value of estimated future cash Inflows
(b) present Value of estimated future cash Outflows
(c) risk adjustments for (i) Financial Risks (if not already factored for in (a) and (b) above and (ii) Non-financial risk[7]

The process will involve the following key steps;

(i) Defining contract boundaries correctly before assembling the cashflows related to the groups of contracts[8]
(ii) Forecasting huge amounts of cashflow data over the lives of different groups of contracts
(iii) Modelling probability distributions for the cashflows and calculating weighted averages of the cashflows above
(iv) Modelling an appropriate discount rate that complies with IFRS 17 (top-down approach or bottom -up approach) and discounting all the forecasted cashflows[9].
(v) An appropriate quantification of non-financial risk adjustment determined. There is not much guidance available

4. Contractual Service Margin recognition

The ***contractual service margin*** represents the unearned profit the entity will recognise as it provides services in the future for a group of insurance contracts. It is recognised as part of the insurance liability or asset[10].

By definition, the contractual service margin at initial recognition of a group of insurance contracts equals the fulfilment cashflows such that at that date, there is no income or expenses. In short, at Initial recognition, fulfilment cashflows equals the contractual service margin. The exception to note is that of onerous contracts-if a group of insurance contracts reflect a loss on initial recognition, then no contractual service margin is recognised and the total loss is recognised in profit or loss immediately.

The concept of contractual service margin is a key feature of IFRS 17 and is totally new to the industry. Every reporting period, a certain amount of contractual service margin representing the insurance services provided

[7] IFRS 17.32a
[8] IFRS 17.33
[9] IFRS 17.B80-B81
[10] IFRS 17.38

(or obligations discharged) by the entity to its policyholders during the reporting period is released (amortised) to profit or loss. The release of the contractual service margin to profit or loss is determined by the number of ***coverage units*** which in turn is determined by the ***quantity of benefits*** provided under the group of contracts.[11] The two concepts of coverage units and quantity of benefits are not clearly defined in IFRS 17 and they are left to the entity's judgement. This is probably one of the most difficult areas of the standard.

The leadership of the entities need to make sure that there is consensus with the Actuarial team over the two concepts of coverage units and quantity of benefits since this is an area of significant judgment by the Actuarial team and a key driver to the release of unearned profits.

5. Insurance Contract Liability

Subsequent to initial recognition, the insurance contract liability in the balance sheet will be a sum of the following:

(a)Liability for remaining coverage (will be measured as the sum of fulfilment cashflows and contractual service margin Future service at year end) and

(b)Liability for incurred claims[12]
Once the modelling process for fulfilment cashflows, adjustment for non-financial risks and contractual service margin is complete, the computation and various reconciliations for the liability for remaining coverage at the end of each reporting date will be fairly less complex to prepare.

The finance team needs to be aware of all the reconciliations and disclosures required by IFRS 17 in preparation for financial reporting.

6. Coordination of Actuarial function with Accounting function

The output from the actuarial projections noted above for fulfilment cashflows, risk adjustments and contractual service margin will ultimately need to be recorded in the ledger. Consequently, a close working relationship between the accounting function and the Actuarial function becomes a key feature of IFRS 17. The accounting function

[11] IFRS 17 .B119.
[12] IFRS 17.40

needs to understand fully the requirements of IFRS 17 to be able to deliver the required disclosures

7. Transition provisions and comparative information

7.1 Transition choices

The transition requirements of IFRS 17 gives insurers three choices: (a) Full retrospective application (b)modified retrospective application and ((c) Fair value. The full retrospective approach is unlikely to be a favourite for many long term insurers because it requires insurers to apply IFRS 17 as if IFRS 17 had always applied and derecognise all existing balances that would not exist if IFRS 17 had always applied. The modified retrospective approach has a list of allowed modifications which try to achieve the closest result to full retrospective approach without undue cost or effort. Under the fair value approach, an entity determines the contractual service margin or loss component at date of transition for a group of contracts based on the difference between the fair values (mostly using IFRS 13) of the group and fulfilment cashflows at transition date. The key issue is for the entity to assess availability of historical information and decide on which approach to take.

7.2 Comparative information on transition

An entity is required to present ***three balance sheets*** in the year of initial application, being balance sheets for the year of initial application, the immediately preceding year and the beginning of the preceding year. This requires a lot of work for insurers

8. Conclusion

These notes have been prepared based on the general measurement model for insurance contracts with a coverage period of more than one year which would primarily be life insurers.

Disclaimer: The information and expressions of opinion contained in this presentation are not intended to be a comprehensive study, nor to provide actuarial advice or advice of any nature and should not be treated as a substitute for authoritative guidance from IFRS 17. BAOA accepts no responsibility or liability to any person for loss or damage suffered as a consequence of their placing reliance upon this article. Readers are encouraged to seek more authoritative information from IFRS 17.

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