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IFRS 17 INSURANCE CONTRACTS MEASUREMENT AND APPLICABILITY

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Introduction

As more and more insurance companies start to consider the monumental change that IFRS 17 represents, BWCI is starting a series of short articles on this mammoth of an accounting standard.

We start with perhaps the two most fundamental questions that needs to be asked when working towards IFRS 17:

- What contracts are covered by IFRS 17?
- How to measure the value of those contracts?

What's in and what's out

IFRS 17 covers all insurance contracts, and reinsurance contracts (inwards and outwards) and any investment contracts with discretionary participation features (provided that the entity also writes insurance contracts[1]).

That said, there are some contracts that may fall under either IFRS 17 or IFRS 9 at the entity's discretion[2]. For example:

- Insurance contracts that are really credit-related guarantees
- Contracts that transfer significant insurance risk, e.g. a loan with a death waiver.

As with all discretion exercised in IFRS 17, the choice of Standard applied will have to be justified.

An entity must also separate from any insurance contracts the impact of embedded derivatives which are to be valued under IFRS 9. This also include weather derivatives and CAT bonds.

Units of Account

Insurance contracts are far more uncertain than other contracts providing services. Depending on whether a claim is paid out, any single insurance contract could result in a profit or a loss, but the outcome is not known at the time of issuing the contract.

To overcome this uncertainty and to improve the usability of accounts, the IFRS 17 standards require the grouping of contracts into units of account which are considered together. The requirements are that all policies in one unit are:

- of similar risks
- managed together
- not more than 12 months apart in inception date

The units are further subdivided into three groups:

1. strongly expected to be unprofitable, or "onerous" in IFRS 17 parlance
2. strongly expected be profitable
3. having a significant possibility of becoming onerous

As the grouping of contracts is for accounting purposes only, the total profit at the end of the contract will not be affected, but rather the emergence of profits over time will be.

IFRS 17 Liabilities

IFRS 17 makes a distinction between liabilities emerging from events covered by earned premium (the *Liability for Incurred Claims,* LIC) and events expected to arise between the balance sheet date and the end of the contract (the *Liability for Remaining Coverage*, LFRC). These are similar to the Solvency II Claims Provision and Premium Provision respectively.

Whichever measurement model is applied, the LIC will be the same; the choice of model affects only the calculation of the LFRC. The LIC comprises of the dismounted value of best estimate cash-flows, plus a Risk Adjustment for non-financial risk (see GMM model below).

[1] Paragraph 3 of the standards
[2] Paragraph 8A of the standards
[3] Paragraph B29 of the standards

The Three Measurement Models

When it comes to actually value an insurance contract under IFRS 17, the entity must ascertain which of three models are applicable.

- The default for all contracts is to apply the **General Measurement Model** (GMM).
- If there are direct participation features, then the entity *must* apply the **Variable Fee Approach** (VFA).
- The simpler **Premium Allocation Approach** (PAA) *may* be applied if the policies are less than one year in duration and the entity can demonstrate that doing so would not lead to materially different results than applying the GMM.

Premium Allocation Approach

This is the simplest of the three approaches, and is the most similar to the existing IFRS 4 insurance accounting principles. In short, at inception of a contract the LFRC is the premiums received less any acquisition costs, adjusted for any impacts of decreognitions - very similar to existing concepts of the unearned premium reserve.

At subsequent periods, the LFRC is adjusted based on changes in relevant acquistion costs, any additional premium cash flows and any changes to the insurance revenue. Over time it will decrease as the period of remaining coverage elapses.

While the PAA doesn't involve a Contractual Service Margin, contracts valued under this method are still required to be grouped at the same level of granularity as for the GMM. The PAA is a simpler approach, but if there are many different groups of contracts, it may still involve significant work.

General Measurement Model

Under this approach the entity calculates best estimate future cashflows ("Fulfilment cashflows"), in a similar way to Solvency II, though there are some differences.

The entity must also set up a *Contractual Service Margin* (CSM) for all applicable groups of contracts which must be tracked in detail over successive periods. The CSM represents the future profits expected to arise on these contracts. Holding the CSM as a liability on the balance sheet and running it off over the lifetime of the contract has the effect of recognising profits over the term of the contract - a key aim of the Standard.

In addition to the CSM, an insurer also needs to establish a "Risk Adjustment for non-financial risk". In short, this is the compensation that the entity requires for taking on uncertain cashflows. It is intended to reflect the risk appetite of the entity.

Variable Fee Approach

The VFA differs from the GMM only in the way that the contractual service margin changes over time. This difference arises from an appreciation that contracts with direct participation features generally have profitability that is heavily dependent on market movements. Therefore, for these contracts only, economic movements in value of the entity's share of underlying items are incorporated into the CSM.

Wrapping Up

Whichever approach is used, IFRS 17 will require significant work; both at initial implementation and on an ongoing basis. Depending on the features of the contracts, there may be significant work in determining whether or not IFRS 17 even applies. The importance of detailed tracking of period-to-period changes over all portfolios of contracts will be critical. IFRS 17 is a data-heavy Standard.

It is never too early to prepare and BWCI is ready to help you plan your route to compliance with this challenging accounting standard.

Contact Details

Jonathan Kemp
jonathan.kemp@bwcigroup.com

Clair Le Poidevin
clair.lepoidevin@bwcigroup.com

PO Box 68, Albert House
South Esplanade, St Peter Port
Guernsey, GY1 3BY

+44 (0) 1481 728432
insurance@bwcigroup.com
www.bwcigroup.com