IFRS 17 – "Hard to Digest?"

"Early engagement with auditors should result in a smoother journey towards implementation"
Graydon Bennett

KEEP CALM
and
Countdown
to
01 - 01 - 2021

Jargon Buster

BBA : Building Block Approach

CSM : Contractual Service Margin

IFRS : International Financial Reporting Standards

PAA : Premium Allocation Approach

BWCI

Location | PO Box 68, Albert House, South Esplanade, St Peter Port, Guernsey, GY1 3BY
Tel | +44 (0)1481 728432
Fax | +44 (0)1481 724082
Web | www.bwcigroup.com

Following our previous article on insurance accounting, the International Accounting Standard Board ("IASB") has at long last issued the final version of IFRS17: Insurance Contracts – a standard 20 years in the making.

The publication provides some welcome clarity and sounds the starting gun for what will require detailed preparation to achieve a successful implementation on 1 January 2021.

Insurers will be required to make choices which will have material implications for their financial results. Early engagement with auditors should result in a smoother journey towards implementation and will assist insurers in making the best choices for their business.

IFRS17 is extensive and demands more than a page to describe its requirements and potential impact fully. Nevertheless, there are a few aspects of the new standard which we highlight in this "digest" below.

Building Block Approach and the CSM

For most contracts, IFRS17 mandates the use of the Building Block Approach ("BBA") to value insurance contracts. The BBA requires that the entity calculate a discounted best estimate of fulfilment cash flows and a risk adjustment (which are analogous to, but may well differ from, the Solvency II best estimate liability and risk margin respectively), as well as a contractual service margin ("CSM") defined as "the unearned profit the entity will recognise as it provides insurance services in the future".

The CSM is designed to eliminate any initial profit recognition and is released as profit over the life of the contract as the risk runs off. The details relevant to the calculation of the CSM are outside the scope of this article, but it is worth mentioning that adjustments in respect of interest accretion, cash flow changes, and others will need to be calculated at every reporting period until the policy has run off.

Premium Allocation Approach

While the BBA is the default approach under IFRS17, an alternative methodology is permitted in certain cases. The Premium Allocation Approach ("PAA") will be of particular interest to general insurers writing yearly renewable contracts and insurers writing group protection policies.

This simplification applies only to the unexpired portion of the contract, or the "liability for remaining coverage", and replaces the complicated calculation of the CSM with a liability that is broadly determined as premiums received less associated acquisition costs.

The liability for incurred claims, however, does not benefit from any simplification and is thus determined as the discounted best estimate of fulfilment cash flows plus a risk adjustment to account for uncertainty.

Onerous Contracts

The new standard requires onerous contracts to be identified at initial recognition (i.e. the earlier of the start of coverage and premium receipt) and any loss to be recognised immediately.

By contrast, any unearned profit for profitable contracts will be recognised as a liability to be released as insurance services are provided. Unlike the current onerous contracts test, IFRS17 will not permit profitable contracts to offset unprofitable contracts and therefore the entire loss attributable to an onerous contract must recognised at initial recognition.

Unit of Account

The level of granularity required is also prescribed by the new standard. The primary requirement is to identify portfolios, which are defined as groups of contracts exposed to similar risks and managed together.

The portfolios must then be divided into groups comprising contracts issued within the same 12-month period. However, because of the onerous contracts test, these groups must also be sub-divided according to their expected profitability.

The increased level of granularity will doubtless have an impact on data system requirements and processes, as well as on financial results themselves. Users of financial statements will need to understand the implications of the grouping requirement, and this is one area where agreement with auditors will be essential.

Actuarial Support

IFRS17 will require a collaborative approach across a company's finance, actuarial and support functions.

The new standard brings with it not only a change in calculation methodology, but also an increase in disclosure requirements. Entities will be required to reconcile the opening and closing CSM balances for each group of contracts and will likely look to their actuarial functions to assist with this and other analyses.

Lastly, the requirement for retrospective application of the standard is likely to be a challenge for most insurers, although some simplifications are permitted. Nevertheless, the volume of data and complexity of the calculations required are expected to be tremendous. Insurers would be wise to start planning sooner rather than later.

Conclusion

While implementation is still around three years away, we now have a clear view of what the new standard will mean. Insurers will need to start considering the issues raised by IFRS17 and begin making plans for implementation. Early engagement with auditors and close collaboration with other stakeholders including actuaries will be vital to a smooth transition.