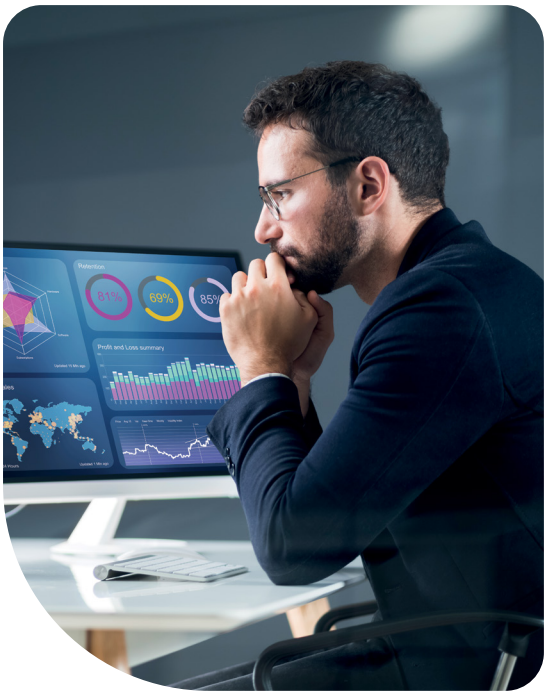
Grant Thornton



Insights into IFRS 17

Initial recognition and measurement

IFRS 17 'Insurance Contracts' (IFRS 17 or the Standard) introduces a comprehensive, principles-based framework for the recognition, measurement, presentation and disclosure of insurance contracts, introducing a globally consistent approach to accounting for insurance liabilities. The standard requires entities to measure insurance contracts using current estimates of future cash flows, an explicit risk adjustment and a contractual service margin, fundamentally changing the timing and pattern of profit recognition. As a result, IFRS 17 significantly enhances transparency and comparability in financial reporting, while also necessitating substantial changes to data, systems, processes and governance frameworks across reporting entities.

The articles in our 'Insights into IFRS 17' series explain the key features of the Standard and provide insights into their application and impact. This article explains the initial recognition and measurement of insurance liabilities under IFRS 17.

Understanding where to start – the level of aggregation IFRS 17 requires

As with many accounting standards, it is often necessary to understand what specifically needs to be measured. This concept is often referred to as the unit of account. For insurance contracts the unit of account might be a single insurance contract or an aggregation of similar insurance contracts. Understanding the level of aggregation that is permitted under IFRS 17 is an important first step in the recognition and measurement of insurance contract liabilities.

The risks underlying insurance contracts and the corresponding management practices adopted by reporting entities are the main factors that will determine the level of aggregation under IFRS 17.

"The articles in our 'Insights into IFRS 17' series explain the key features of the Standard and provide insights into their application and impact. This article explains the initial recognition and measurement of insurance liabilities under of IFRS 17."

Contracts that are subject to similar risks and are managed together as a single pool constitute a portfolio of insurance contracts. Portfolios are then divided into three groups of contracts if they are present in each portfolio. They are those contracts that are onerous at initial recognition, those contracts where at initial recognition there is no significant possibility of becoming onerous subsequently, and those contracts that have neither of the previous two conditions present (ie the remaining contracts on the portfolio). The purpose of these categories is to ensure that loss-making or onerous contracts are identified and recognised, and not subsidised or obscured by other profitable contracts. This categorisation for a reporting entity that has five identified portfolios can be illustrated as follows:

Portfolio 1: single premium life annuities

Onerous at initial recognition

No significant risk at initial recognition of becoming onerous

Remaining contracts

All contracts in a group should be issued no more than a year apart*.

Portfolio 2: regular premium term life

Onerous at initial recognition

No significant risk at initial recognition of becoming onerous

Remaining contracts

Portfolio 3: whole life

Onerous at initial recognition

No significant risk at initial recognition of becoming onerous

Remaining contracts

Portfolio 4: other products

Onerous at initial recognition

No significant risk at initial recognition of becoming onerous

Portfolio 5: reinsurance issued

Remaining contracts

* An exemption of the one-year rule is allowed only to contracts that would fall into different groups because law or regulation (eg for gender-neutral pricing) constrains the entity's ability to set a different price or level of benefits for policyholders with different characteristics.

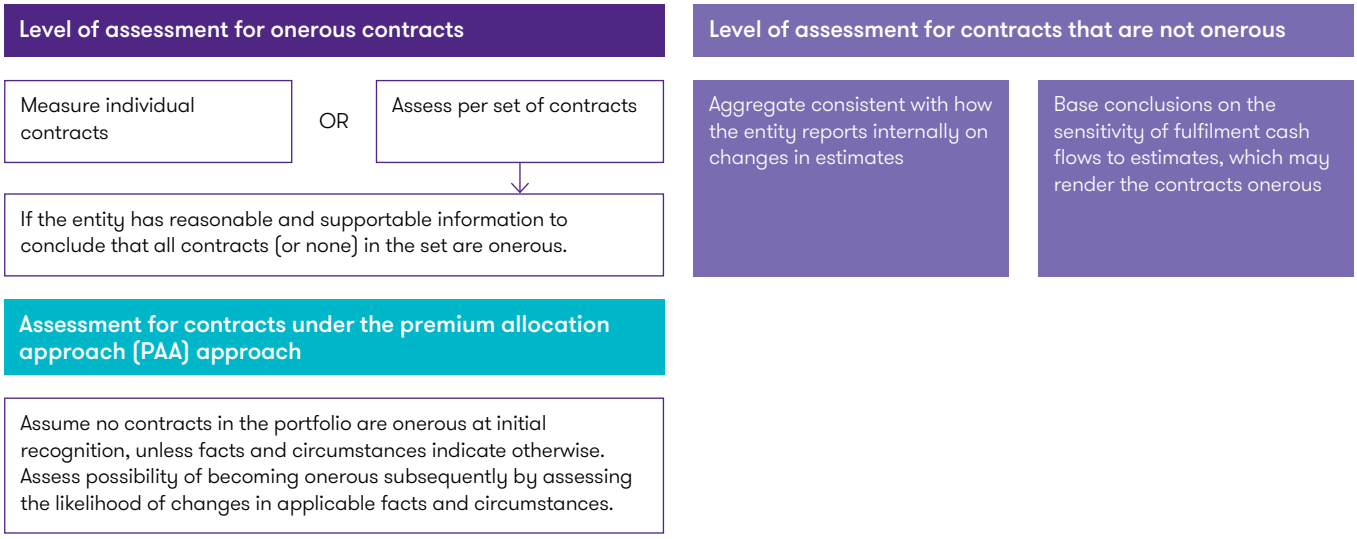
A group may comprise a single contract, if this is the result of applying IFRS 17's aggregation rules. A reporting entity is permitted to divide portfolios in more than three groups of contracts, if internal reporting and performance monitoring distinguishes at a more granular level the risks of contracts becoming onerous, or it can measure at more granular level the extent to which the contracts are onerous.

Practical insight – contract grouping

The more groups created by a reporting entity, the more operationally onerous it will be to maintain, track and report on complex components such as contractual service margin (CSM).

Based on our experience most insurers are applying the minimum grouping requirements at this stage. However, once IFRS 17 is fully embedded and has become business as usual, we would expect insurers may divide portfolios in more groups to gain valuable information for business decisions and measuring performance.

Diagramatically, the level of assessment on initial recognition should be as follows:



Once the groups are established at initial recognition, their composition should not be reassessed subsequently.

Practical insight – aggregation approach

Entities should allocate sufficient time and resources when deciding on their unit of account approach. It will impact profoundly not only the pattern of future profit emergence, but also it may require many changes to be made to operational data collection solutions as well as any measurement and disclosure routines that currently might be in place (eg the number of discount rates to be calculated).

Furthermore, insurers may need to update their existing processes to identify loss-making or onerous contracts in order to meet IFRS 17 requirements.

When does IFRS 17 require recognition of the insurance contract?

The point of recognition for contracts within the scope of IFRS 17 should be:

Earliest of the following dates:

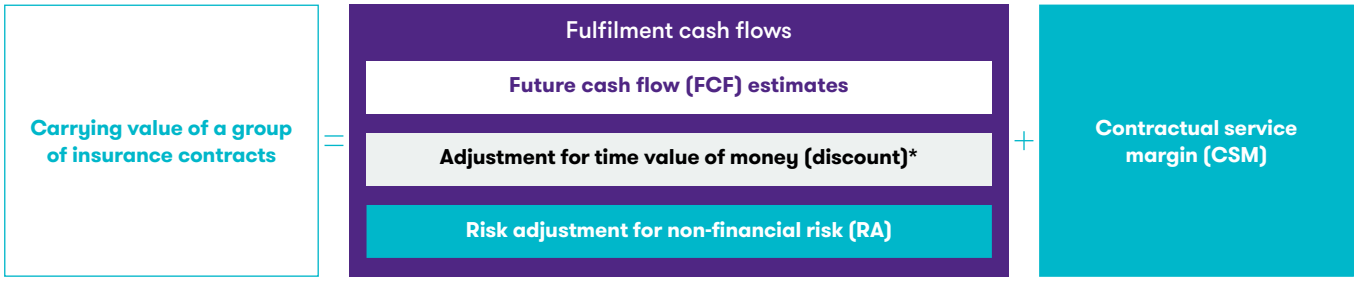
Beginning of the coverage period	First payment due by the policyholder*	Facts and circumstances first indicate the group is onerous

* or first payment made if no contractual due date

An entity should recognise an asset or a liability for any insurance acquisition cash flows, which the entity pays or receives before the related group of contracts is recognised. Note that when an entity is applying the PAA, it can choose to expense these cash flows in profit or loss. Such an asset or liability from pre-coverage cash flows should be de-recognised when the group of insurance contracts to which the cash flows are allocated, is recognised.

Measurement principles present in IFRS 17

The following measurement principles apply to all groups of contracts within IFRS 17's scope, except for contracts measured under the premium allocation approach, reinsurance contracts held, and certain recognition and measurement aspects of investment contracts with a discretionary participation feature.



* should also reflect financial risk associated with FCF to the extent not included in the estimates of FCF

A group of contracts should include only contracts issued by the end of the reporting period (subject to the aggregation rule of 'issue within 12 months apart'). Such contracts should be added into the reporting period in which they are issued. This may result in a change in the determination of discount rates at the date of initial recognition. An entity should apply the revised rates from the start of the reporting period in which the new contracts are added to the group.

Future cash flow estimates

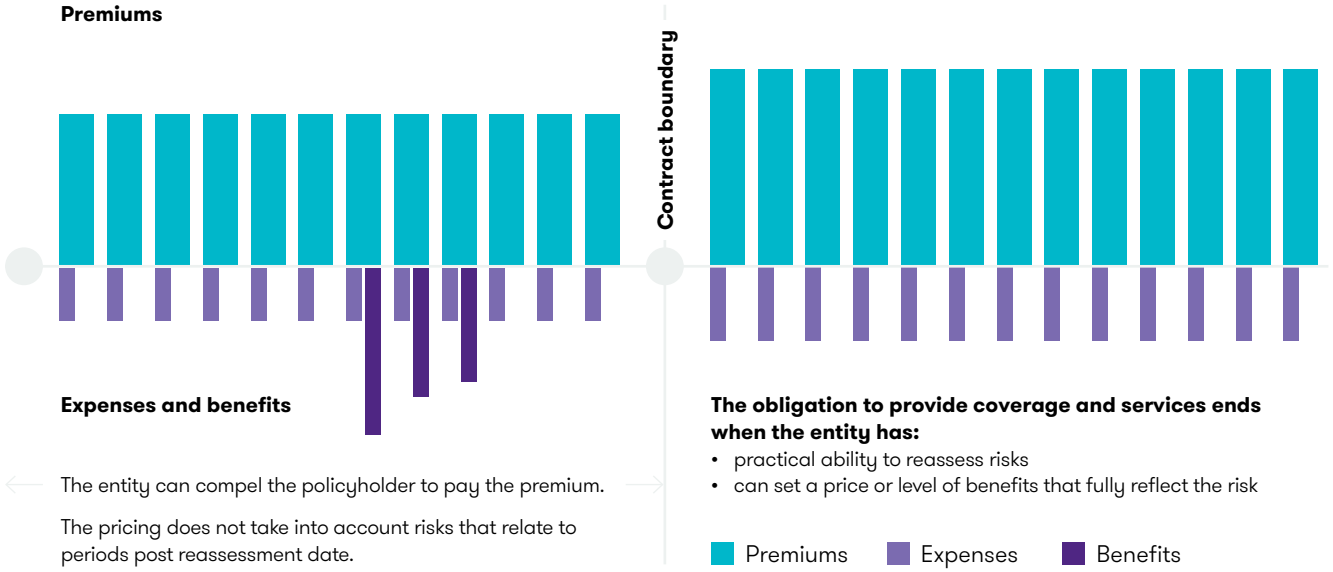
The recognition and measurement requirements of IFRS 17 should be applied at the aggregation levels as specified above. However, to measure a group of contracts, an entity may estimate the fulfilment cash flows at a higher aggregation level, as long as it is able to allocate such estimates to groups of contracts. When measuring a group of insurance contracts a reporting entity should include all cash flows within the contract boundary and ensure the FCF estimate has the following characteristics:

Future cash flows – characteristics to take into consideration:

Neutral probability weighted mean of all possible outcomes	**Entity perspective** but consistent with observable market prices	**Current** estimate at the measurement date	**Explicit** cash flows estimated separately from discount rates

A reporting entity should incorporate in the future cash flow estimates all reasonable and supportable information available without undue cost or effort. The estimate should capture the full range of possible outcomes about the amount, timing and uncertainty of the cash flows. Any market variables underlying the estimates should be consistent with observable market prices. The estimates should reflect the conditions existing at the measurement date and should include explicit adjustments for non-financial risk separately from other estimates (ie rather than doing this implicitly via the estimates of the discount rate).

The future cash flow estimates should only include cash flows, which are in the boundary of an insurance contract as illustrated below:



A reporting entity should not recognise as an asset or a liability any amounts related to expected premiums or claims outside the boundary of the insurance contract.

Cash flows within the contract boundary include:

- premiums, claims/benefits (including those paid in kind), claims handling costs
- attributable acquisition expenses, policy administration and maintenance costs (including trailing commissions)
- payments to policyholders which vary depending on the returns of underlying items
- cash flows from options and guarantees embedded in the contract (if not separated)
- premium taxes and taxes paid in fiduciary capacity for the policyholder
- potential cash inflows from recoveries from salvage and subrogation
- allocation of fixed and variable overheads (following systematic and rational methods consistently applied)
- other costs specifically chargeable to the policyholder per contract terms

Cash flows that should not be included in contract:

- cash flows outside the contract boundary
- investment returns
- cash flows under reinsurance contracts held (reported separately)
- costs that cannot be directly attributed to the portfolio comprising the contract (reported in P/L when incurred)
- cash flows that arise from abnormal or wasted labour or other costs used to fulfil the contract
- income tax payments not made in a fiduciary capacity (ie not on behalf of policyholders)
- cash flows between components of the reporting entity
- cash flows arising from components separated from the insurance contract and accounted for under different standards

A group of contracts that generate cash flows in a foreign currency should be treated as a monetary item (including the CSM) when applying IAS 21 'The Effects of Changes in Foreign Exchange Rates'. The fulfilment cash flows should not reflect the entity's own non-performance risk (as defined in IFRS 13 'Fair Value Measurement').

Discount rates

When measuring insurance contracts, a reporting entity should adjust the estimates of the future cash flows to reflect the time value of money and financial risks associated, including policyholder credit risk where appropriate, with those cash flows (to the extent not already included therein). The discount rate should have the following characteristics:

Discount rates should reflect:

Characteristics of the cash flows and the liquidity of the insurance contracts

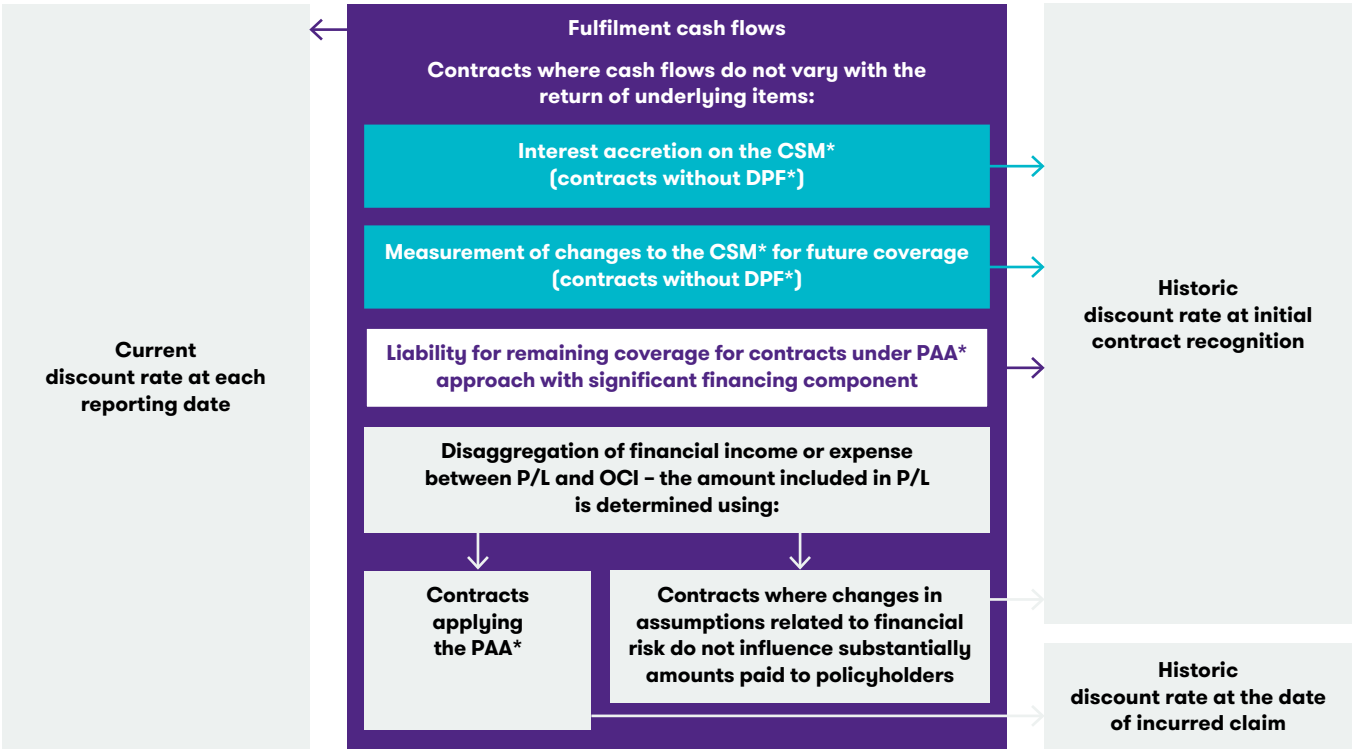
Observable current market prices of financial instruments with cash flows consistent with those of the insurance contracts (timing, currency, liquidity)

Exclude market price factors which do not affect the fulfilment cash flows of the insurance contracts

The discount rate estimates should be consistent with the characteristics of the cash flows to avoid duplication or omission as follows:

Cash flow characteristics	Discount rates to be used
Do not vary based on the returns of any underlying items	Rates that do not reflect such variability
Vary based on the returns of underlying financial items (regardless of whether contractual or due to entity's discretion): • not adjusted for such variability • adjusted for the effects of that variability	 Rates that reflect that variability Rates that reflect the adjustment to the variability that is present
Nominal cash flows (ie include the effects of inflation)	Rates that include the effects of inflation
Real cash flows (ie exclude effects of inflation)	Rates that exclude the effects of inflation

IFRS 17 requires that fulfilment cash flows are remeasured at current discount rates at each reporting period end. The historic rates, also called locked-in rates, should be used only to contractual service margin accretion and, where applicable, insurance finance income presented in profit or loss. This is illustrated by the following diagram:



• CSM – contractual service margin
DPF – discretionary participation features
PAA – premium allocation approach
OCI – other comprehensive income
P/L – profit or loss

Determining the discount rate

When determining the discount rates at initial recognition, an entity may use weighted average discount rates over the period that the contracts in the group (as per the Standard's aggregation principles) are issued. The entity is allowed to estimate the appropriate discount rates using estimation techniques when observable market rates for instruments with cash flow characteristics similar to those of the insurance contract are not readily available, or cannot be approximated by adjustments based on market observable inputs. Determining the discount rate should not reflect the entity's own non-performance risk (as defined in IFRS 13).

Estimation techniques should:

Maximise the use of observable market inputs and should not contradict observable market variables

Reflect current market conditions from the perspective of a market participant

Use judgement to adjust observable market prices for differences between a market instrument and the insurance contract

Reflect the yield curve in the appropriate currency for instruments that expose the holder to **no or negligible credit risk**, adjusted to reflect the **liquidity characteristics** of the insurance contract.

For cash flows of insurance contracts that do not vary based on performance of underlying items, an entity is allowed to choose between a bottom-up or a top-down approach to estimate the discount rate as outlined below.

Bottom-up approach	Determine the discount rate by adjusting a liquid risk-free discount rate for the differences between the liquidity characteristics of the financial instrument that underlie the market observable rate and the liquidity characteristics of the insurance contract.
Top-down approach	Determine the discount rate by using a yield curve that reflects current market rates of return implicit in a fair value measure of a reference portfolio of assets. Adjust to eliminate any factors that are not relevant for the insurance contract but not required to adjust for differences in liquidity characteristics between the insurance contracts and the reference portfolio. ADJUST EITHER APPROACH FOR Differences between the amount, timing and uncertainty of cash flows of the reference assets and the insurance contracts. Risk premium (exclude) for credit risk relevant only to the reference assets.

IFRS 17 does not specify restrictions on the reference portfolio of assets used in applying the top-down approach where there are observable market prices in active markets for those assets. An entity is not required to reconcile the discount rate determined under its chosen approach with the rate that would have been determined under the other approach.

Practical insight – the opportunity to leverage existing capabilities

Determination of the discount rate is a highly judgemental area with profound effect on the measurement of insurance contracts. IFRS 17's principles for determination of the discount rate are different from those under Solvency II or existing embedded value reporting frameworks. However, subject to a robust gap analysis of current methodologies and practices, entities may be able to utilise effectively their existing modelling capabilities and reference data. Additional IT systems investment may be required, so that entities can track historic discount rates at contract inception and perform calculations (subject to policy choice) to disaggregate the impact of discount rate changes between other comprehensive income and profit or loss.

Where entities adopt a top-down approach, the choice of reference portfolios will be crucial in order to minimise the required adjustments and controls burden over calculation routines and data quality.

Risk adjustment for non-financial risks

The risk adjustment to the estimates of future cash flows reflects the compensation a reporting entity expects for bearing the uncertainty about the amount and timing of the cash flows that arise from non-financial risks.

Risk adjustment = compensation that makes an entity indifferent between:

Fulfilling a liability with a range of possible outcomes eg 50% probability for CU 50 and 50% probability for CU 500	AND	**Fulfilling a liability with the same expected present value** (which is CU 275 in this example) **but generating fixed cash flows**

The purpose of the risk adjustment is to measure the effect of uncertainty in the cash flows of insurance contracts that arise from risks other than financial risks. It should not reflect risks that do not arise from the rights and obligations created by an insurance contract, eg general operational risks. The risk adjustment is an entity-specific measure of uncertainty and should have the following characteristics:

Characteristics of the risk adjustment:

Explicit The risk adjustment is separate from the estimates of the cash flows or the discount rate. It should not result in double counting.	**Reflects entity's risk diversification** The entity should allow for its own risk profile and any benefits arising from diversification in its management of nonfinancial risks.	**Reflects entity's risk appetite** Both favourable and unfavourable outcomes should be reflected in a way that reflects the entity's degree of risk aversion.

IFRS 17 does not specify what estimation technique entities should use when calculating the risk adjustment. However, the following guidelines apply:

Risk adjustment for:	GENERALLY >	Risk adjustment for:
Contracts with: • low frequency and high severity of claims • longer duration for similar risks • wider probability distribution • emerging experience increases the uncertainty on nonfinancial risks.		Contracts with: • high frequency and low severity of claims • shorter duration for similar risks • narrower probability distribution • emerging experience decreases the uncertainty on nonfinancial risks.

A reporting entity should disclose the technique used in the estimation of the risk adjustment and the confidence level corresponding to the result of that technique.

Practical insight – an entity's own view on risk and diversification for risk adjustment

IFRS 17 allows a choice of estimation method and gives the reporting entity an opportunity to eliminate the high interest rate sensitivity from the cost of capital approach mandated by Solvency II. An entity specific pattern of risk release could also prove a useful basis for revenue recognition under the premium allocation approach. Subject to the operational challenges of confidence level disclosures, an entity with insurance contracts could align their financial reporting to their own risk appetite.

This is the first time that insurers are required to disclose the confidence level used for the calculation of the IFRS 17 risk adjustment and will be critically reviewed by competitors as well as investors and analysts. It therefore requires careful attention.

Contractual service margin (CSM)

The contractual service margin is a component of the asset or liability for a group of insurance contracts and represents the unearned profit the entity will recognise as it provides services in the future. The determination of CSM is covered more fully in our article '**Insights into IFRS 17 – Subsequent measurement**', but in essence, unless a contract is onerous, on initial recognition (see example below) the CSM is measured as follows:

Fulfilment cash flows on initial recognition = FCF + discount + risk adjustment + **De-recognition of assets or liabilities for pre-contract cash flows** + **Cash flows arising on date of initial recognition** + **CSM** = Zero income or expense on initial recognition

In case of business combination or group contract transfers, the above principle for measuring the CSM on initial recognition is modified as follows (unless the contracts are accounted for under the premium allocation approach):

Consideration received or paid = Premium proxy* (excludes any element related to any other acquired assets or liabilities) – **Fulfilment cash flows on date of business combination or group transfer** = **CSM**

* In a business combination the consideration received or paid is the fair value of the contracts at that date

If the contracts are onerous, the following principle will apply instead:

Fulfilment cash flows on date of business combination or group transfer – **Consideration received or paid = Premium received** = **Goodwill or gain on a bargain purchase**** OR **Loss in profit or loss***

** in a business combination
*** in a group transfer. The entity should establish a loss component of the liability for remaining coverage and allocate subsequent changes in fulfilment cash flows to it.

Example 1: Initial measurement

An entity issues 100 three-year contracts of product A and 50 three-year contracts of product B with the following terms.

	Product A	Product B
Expected total premiums, payable immediately after initial recognition	CU 13,500	CU 13,500
Annual expected cash outflows (assumed paid immediately when incurred)	CU 3,000	CU 6,000
Estimated risk adjustment for non-financial risk on initial recognition	CU 1,800	CU 1,800
Estimated discount rate on initial recognition	2.50%	2.50%
The entity has concluded that the contracts meet the conditions to be combined in a group for product A and for product B.		

Analysis

The measurement of the contracts on initial recognition is as follows:

	Product A CU	Product B CU
Expected present value of cash inflows (premiums) over 3 years	(13,500)	(13,500)
Expected present value of cash outflows over 3 years	8,568	17,136
Expected present value of net future cash flows (FCF)	**(4,932)**	**3,636**
Risk adjustment for non-financial risk (RA)	1,800	1,800
Fulfilment cash flows	**(3,132)**	**5,436**

Summary:

	FCF CU	RA CU	CSM CU	Total liability CU	Insurance service expenses (P/L) CU
Product A	(4,932)	1,800	3,132	–	–
Product B	3,636	1,800	–	5,436	(5,436)

Contracts from product B represent a group of onerous contracts resulting in a loss on initial recognition of CU 5,436.

How we can help

We hope you find the information in this article helpful in giving you some detail into aspects of IFRS 17. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit **www.grantthornton.global/locations** to find your local member firm.