Insights into IFRS 17

Scope

The International Accounting Standards Board (IASB) published IFRS 17 'Insurance Contracts' (IFRS 17 or the Standard) which became effective on 1 January 2023. This Standard introduced insurance contract measurement principles that require the use of:

- current, explicit and unbiased estimates of future cash flows
- discount rates that reflect the characteristics of the contracts' cash flows, and
- an explicit adjustment to reflect the presence of non-financial risk associated with the timing and amount of cash flows anticipated during the contract period.

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 objective and scope of IFRS 17.

It is important to understand that IFRS 17 applies to all entities not just insurance companies that may be governed by legislation issued in the country the reporting entity operates in. It applies to all insurance contracts an entity issues (including those for reinsurance), reinsurance contracts it holds and investment contracts with a discretionary participation feature (DPF), provided the entity also issues insurance contracts.

All references to insurance contracts issued also apply to insurance contracts acquired in a transfer of insurance contracts or a business combination other than reinsurance contracts held.

Objective

The objective of IFRS 17 is to ensure that an entity faithfully represents in its financial statements the effect that insurance contracts have on its financial position, financial performance and cash flows.

When applying IFRS 17, an entity should consider its substantive rights and obligations from a contract, law or regulation, but should disregard terms that have no commercial substance.

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The blueprint for an entity to follow in applying IFRS 17 is outlined below:

1. Identify all contracts in scope

Insurance contracts issued (including reinsurance)	**Reinsurance contracts held**	**Investment contracts with DPFs**

2. Identify portfolios of insurance contracts and divide portfolios into groups for measurement

Onerous at initial recognition	**At initial recognition have no significant possibility of becoming onerous**	**Remaining contracts**

3. Recognise each group of contracts

Fulfilment cash flows Measured as risk adjusted present value of future cash flows expected to arise as an entity fulfils the contract.	**Contractual service margin (CSM)** Represents the unearned profit on a group of contracts the entity will recognise as it provides services in the future. Measured as the amount which results in no gain on initial recognition.	**Loss on initial recognition** Recognised if fulfilment cash flows on initial recognition are negative.

4. Initial measurement of each group of contracts

General measurement model (GMM), this is the default measurement model	**Variable fee approach (VFA), modifications to the GMM**	**Premium allocation approach (PAA), simplification to the GMM**

5. Re-measure each group of contracts

Fulfilment cash flows updated using current estimates	**Contractual service margin** Reflect changes in estimates of future contract profitability, time value of money effect, and profit earned as coverage is provided.
Modification and de-recognition	When the parties to an insurance contract agree to change its terms or the terms are modified by a change in regulation, the issuer should assess if the change qualifies as a modification or requires de-recognition.

6. Presentation of insurance contracts

Income and expenses from insurance contracts are separated into revenue and operating expenses attributed to the insurance risk of providing the service, the finance income and expense relating to associated finance risks of the contract and the time value of money.

Contract carrying value is the sum of:	=	**Liability for remaining coverage (LRC)** (expected to be covered by consideration)	+	**Loss component of the liability for remaining coverage (LC of LRC)** (for onerous groups; not expected to be covered by consideration)	+	**Liability for incurred claims**
Insurance services		Revenue		Losses on onerous contracts and reversal of such losses		Expenses
Passage of time and financial risk		Insurance finance income or expenses				

7. Disclose information on amounts, judgements and risks

Amounts from insurance contracts

- Disclose separately for portfolios of contracts which are assets and which are liabilities
- Disclose separately for insurance contracts issued, reinsurance contracts held and investment contracts with DPFs
- Reconcile opening to closing balances for each component of the carrying amounts of insurance contracts
- Analyse changes in the carrying amounts of contracts between insurance services and amounts not related to insurance services
- Analyse changes between those related to current, past or future coverage and services
- Disclose expected pattern for CSM allocation to profit or loss per type of contract

Key judgements and estimates

- Approach used to determine discount rates
- Method used to determine the risk adjustment and the corresponding confidence level
- Approach used to determine investment components in contracts
- Composition and fair value of underlying items for contracts with DPFs
- Exercise of discretion on contracts without DPFs
- Method for disaggregation (if option is taken) of insurance finance income or expenses between profit or loss and other comprehensive income (OCI)

Risks

- Policies, processes and methods to manage and measure risks
- Concentration and characteristics of risks across assets and liabilities
- Exposure and sensitivities (link to return on invested assets)
- Claims development reconciled to carrying values at reporting date
- Expected cash outflows for each of the five years post-reporting period end and in aggregate for periods beyond the first five years

Practical insight – IFRS 17 objective: an opportunity and a lever for change

IFRS 17 implementation follows a period when margins for all insurers have likely been under significant pressure from a number of factors, including:

- a prolonged period of low interest rates (although these have risen significantly more recently) and volatile equity prices
- rising prudential and conduct compliance standards being issued by regulators
- the ongoing cost of living crisis affecting individuals
- political instability, and
- economic uncertainty across the globe.

For those insurers which have historically under-invested in data and systems, applying the above implementation blueprint can result in significant operational challenges. Policy choices and underlying judgements will be challenging to embed. We have observed that IFRS 17 is not being approached as 'yet another accounting conversion exercise'. Instead, it is proving to represent a powerful lever for change around how reporting entities that issue insurance contracts can use financial information and technology to enhance their business strategy, and attract new investors and customers. For entities it is creating an opportunity to harness the talent of insurers' finance, actuarial, data and technology teams via a new collaborative operating culture.

Scope

The scope exclusions are summarised in the table below:

Scope exclusion	Standards to apply
Warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer	IFRS 15 'Revenue from Contracts with Customers'
Employers' assets and liabilities from employee benefit plans	IAS 19 'Employee Benefits' and IFRS 2 'Share-based Payment'
Retirement benefit obligations reported by defined benefit retirement plans	IAS 26 'Accounting and Reporting by Retirement Benefit Plans'
Contractual rights or contractual obligations contingent on the future use of, or the right to use, a non-financial item	IFRS 15, IAS 38 'Intangible Assets' and IFRS 16 'Leases'
Residual value guarantees provided by a manufacturer, dealer or retailer, or provided to a lessee (when embedded in a lease)	IFRS 15 and IFRS 16
Financial guarantee contracts (unless a prior explicit assertion has been made by the issuer and insurance accounting has been applied)*	Choice to apply either IFRS 17 or IAS 32 'Financial Instruments: Presentation', IFRS 7 'Financial Instruments: Disclosures' and IFRS 9 'Financial Instruments'
Contingent consideration in a business combination	IFRS 3 'Business Combinations'
Insurance contracts where the entity is the policyholder (unless these contracts are reinsurance contracts held)	Amounts payable and receivable as a policyholder will be recognised in accordance with IFRS 9 based on the contractual obligations of the policy
Credit card contracts that provide insurance coverage (only where the insurance coverage is not separately identifiable or priced; where distinct insurance components exist entities should separate those components and apply IFRS 17 to them)	IFRS 9
Loan contracts that transfer significant insurance risk by providing insurance coverage only for the settlement of the policyholder's obligation created by the contract**	Choice to apply either IFRS 17 or IFRS 9

* For financial guarantees contracts where no prior explicit assertion has been made, an entity can make the choice between IFRS 17 and the Financial Instruments standards noted above on a contract-by-contract basis. Such choice is irrevocable.
** For loan contracts that transfer significant insurance risk, an entity can make the choice between IFRS 17 or IFRS 9 irrespective of whether it has already applied IFRS 9 before it first applies IFRS 17. Such choice is irrevocable and is made separately for each portfolio of insurance contracts.

Some contracts meet the definition of an insurance contract but limit the compensation for insured events to the amount otherwise required to settle the policyholder's obligation created by the contract (eg loans with death waivers).

Compensation is limited to the amount required to settle obligation

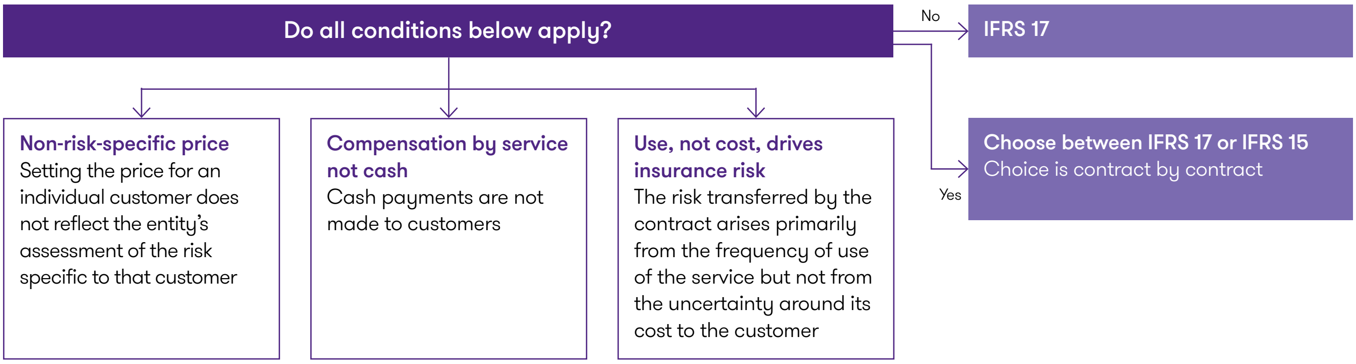
Is the contract excluded from the scope of IFRS 17 paragraph 7?

No → **Apply IFRS 9**

Yes → **Choose between IFRS 17 and IFRS 9**
Choice is for portfolio of insurance contracts

Some contracts meet the definition of an insurance contract but their primary purpose is to provide services for a fixed fee (eg roadside/breakdown recovery contracts). An entity issuing such contracts may choose to apply IFRS 15 to them if, and only if all of the following conditions are met:

Fixed fee contracts for services



What is an insurance contract?

IFRS 17 provides a definition of an insurance contract and sets out additional guidance on how to assess the significance of insurance risk based on the possibility of a loss on a present value basis (rather than nominal), and how to evaluate changes in the level of insurance risk.

Insurance contract definition

A contract in which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

IFRS 17's application guidance draws a specific distinction between insurance risk and other risks, and defines insurance risk as other than financial risk transferred from the holder of a contract to the issuer.

Lapse (persistency) or expense risks are not insurance risks because the resulting variability in the payments to policyholders, or the unexpected increase in contract servicing costs, are not contingent on uncertain future events which adversely affect the policyholders. However, if an entity transfers lapse or expense risk to another party (eg a reinsurer), the second contract exposes the other party to insurance risk.

An entity should assess the significance of insurance risk contract by contract. IFRS 17's application guidance explains that insurance risk is significant, if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance. Insurance risk can be significant even if there is minimal probability of significant losses for a portfolio or group of contracts (eg due to risk diversification across a portfolio).

The following considerations should be made when assessing if insurance risk is significant:

Insurance risk is significant if:

- There is a scenario with commercial substance which exposes the issuer to a possibility of a loss on a present value (PV) basis. However, even if a reinsurance contract does not expose the issuer to the possibility of a significant loss, that contract is deemed to transfer significant insurance risk if it transfers to the reinsurer substantially all the insurance risk relating to the reinsured portions of the underlying insurance contracts.
- An insured event could cause the issuer to pay additional amounts that are significant in any single scenario, ie:

PV additional amounts paid* > PV amounts payable if no insured event occurred

*Include claims handling and assessment costs

Changes in the level of insurance risk

A contract that meets the definition of an insurance contract remains an insurance contract until all rights and obligations are extinguished (ie discharged, cancelled or expired) or the contract is derecognised as a result of contract modification.

Amounts excluded from the assessment of significant insurance risk

Loss of the ability to charge for future services
Eg loss of unit-linked management charges on the death of a policyholder – this economic loss for the entity doesn't result from insurance risk.

Waiver on death of charges made on cancellation or surrender
The waiver does not compensate a pre-existing risk for the policyholder.

Payments conditional on events that do not cause a significant loss to the policyholder
Eg an insignificant loss of currency unit (CU) CU1 triggering a CU 1 million payment to the policyholder.

Possible reinsurance recoveries
They are accounted for separately.

An entity can accept significant insurance risk only if it is separate from the policyholder. Therefore, as noted below, self-insurance does not constitute an insurance contract. However, IFRS 17 clarifies that for mutual entities, although policyholders bear the pooled risk collectively because they hold the residual interest in the entity, the mutual entity is a separate entity that has accepted the risk.

Examples of insurance contracts

- Insurance against theft or damage
- Liability insurance (product, professional, civil, legal expenses)
- Life insurance and prepaid funeral plans
- Life contingent annuities and pensions (including those linked to a cost-of-living index)
- Insurance against disability and medical costs
- Surety bonds, fidelity bonds, performance bonds and bid bonds
- Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer
- Title insurance
- Travel insurance
- Catastrophe bonds if a specified event adversely affects the issuer and creates significant insurance risk
- Insurance swaps that depend on changes in climatic, geological or other physical variables specific to a party to the contract

Examples of items which are not insurance contracts

- Investment contracts with a legal form of an insurance contract but do not transfer significant insurance risk
- Financial reinsurance (return the insurance risk to the policyholder by non-cancellable adjustments of future policyholder payments based on insured losses)
- Self-insurance*
- Contracts (eg gambling) that do not have as a contractual precondition for payment that an event adversely affects the policyholder
- Derivatives that expose a party to financial risk but not insurance risk
- Catastrophe bonds or weather derivatives with variables not specific to a party to the contract
- Credit-related guarantees that require a payment even if the holder has not incurred a loss on the failure of a debtor to make payments when due

* Self-insurance does not constitute an insurance contract because there is no agreement with another party. Therefore, from the point of view of consolidated financial statements, there is no insurance contract for the group when an entity issues an insurance contract to its parent, subsidiary or a fellow subsidiary. However, in the individual or separate financial statements of the issuer or holder, there is an insurance contract. Local statutory reporting may require a different assessment in the separate financial statements depending on the legal structure.

Practical insight – impact for entities, which are not insurers

IFRS 17 does not constitute industry-specific guidance (unlike the equivalent ASC 944 in US GAAP), but instead specifies the principles which should be applied to contracts that meet the definition of an insurance contract, irrespective of the legal and regulatory status of their issuer.

Therefore, entities issuing warranties, credit-related guarantees, guarantees of pension obligations of group entities, bonds related to participation in tenders or for contract execution, weather derivatives, etc. should analyse carefully the terms of such arrangements, even when they do not have the legal form of an insurance contract. Such analysis should establish the existence and extent of insurance risk transfer in order to achieve correct accounting treatment in accordance with the applicable IFRS Accounting Standard. Where non-insurance entities conclude that they have issued contracts within the scope of IFRS 17, they need to consider their staff and senior management's understanding of this Standard, information systems, data requirements and preparedness for much more complex measurement routines and demanding disclosures.

Combination of insurance contracts and separation (unbundling) of contractual components

When a set of insurance contracts with the same or a related counterparty achieves, or is designed to achieve, an overall commercial effect, it may be necessary to treat the set as a single contract in order to report the substance of the arrangement.

An insurance contract may contain one or more components that would have been in the scope of another standard if they were separate contracts. In accordance with IFRS 17, an entity identifies and accounts for the components of a contract as outlined below:

Practical insight – contract management

IFRS 17's requirement to combine contracts which achieve common overall commercial impact may influence the way certain fronting arrangements are reported.

For example, where an insurer issues a contract to a direct policyholder or assumes reinsurance but at the same time enters into a mirroring back-to-back outwards reinsurance contract, when combined, these arrangements may not meet the criteria for significant insurance risk transfer for the fronting cedent. As a result, unforeseen impacts may arise on key performance indicators (KPIs) or capital and risks management targets (eg from additional counterparty risk).

Insurance contract

Embedded derivative → Apply IFRS 9 to determine if an embedded derivative exists, if it should be separated and how it should be accounted for.

Investment component → Separate from the host insurance contract if the investment component is distinct. Apply IFRS 9 as if it were a separate financial instrument, unless it is an investment contract with DPFs within the scope of IFRS 17.

An investment component is distinct only if:

- The insurance and investment components are not highly interrelated*
- A contract with equivalent terms is sold or could be sold separately in the same market or jurisdiction.

*Such components are highly interrelated if the entity cannot measure one component without considering the other, or the policyholder cannot benefit from one component unless the other is also present.

Promise to transfer distinct goods or non-insurance services → Apply IFRS 15 and attribute cash flows between the insurance component and the promise to provide distinct goods or non-insurance services.

Apply IFRS 17 to all remaining components of the host insurance contract.

Practical insight – product development

IFRS 17 may pose a challenge to existing interpretations of contract clauses or certain products' terms and conditions. If IFRS 17 is applicable, entities may have to revisit prior analysis before they confirm or rebut decisions previously made on unbundling. Entities may have to redesign controls around future product development and approval to achieve sufficient rigour over the identification of components outside IFRS 17's scope. The same applies to IT systems' capability for processing and appropriate data capture for measurement and disclosure. Much closer collaboration will be needed between financial reporting specialists, actuaries and underwriters.

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.

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