IFRS 17: what to do now

Implications for European insurers

EY

Building a better working world

Executive summary

The International Accounting Standard Board (IASB or Board) issued the new Insurance Accounting Standard, IFRS 17 **Insurance Contracts** (the Standard) on 18 May 2017. The Standard will have to be applied for reporting periods starting on or after 1 January 2021.

This standard will represent the most significant change to European insurance accounting requirements in 20 years, requiring insurers to entirely overhaul their financial statements. Given the scale of this change, investors and other stakeholders will want to understand the likely impact as early as possible (see Exhibit 1).

The Standard uses three measurement approaches:

1. **General model or Building Block Approach (BBA)** – for most long-term contracts
2. **Premium Allocation Approach (PAA)** – for most short-term contracts (optional)
3. **Variable Fee Approach (VFA)** – for contracts with direct participation features

The principles underlying these measurement approaches result in a fundamental change to current practice, particularly for long-duration contracts. The requirements are markedly different to existing accounting in a number of critical aspects that will:

- Change profit emergence patterns
- Increase the frequency of loss recognition
- Add complexity to valuation processes, data requirements, assumption setting. The requirements for forecasting results of the new metric is even more challenging than analyzing current results

The IASB decided on a mandatory effective date of 1 January 2021 for the new standard. In the coming years, insurers will need to interpret and apply the requirements to their insurance contracts – a process involving significant time and effort. The major change program required will extend beyond finance and actuarial teams and its impacts will need to be communicated to a broad range of internal and external stakeholders.

In addition to the Standard, insurers will need to adapt to a wave of other accounting changes over the next five years, including:

- **IFRS 9 *Financial Instruments*** – effective 1 Jan 2018 (although most insurers will be able to defer this to 1 January 2021)
- **IFRS 15 *Revenue from Contracts with Customers*** – effective 1 January 2018
- **IFRS 16 *Leases*** – effective 1 January 2019

Given the scale of the Standard's impact, and the complexity of the implementation task, insurers should start formally assessing impacts and mobilize their organizations now – starting with these six actions.

Six actions to kick-start your implementation program:

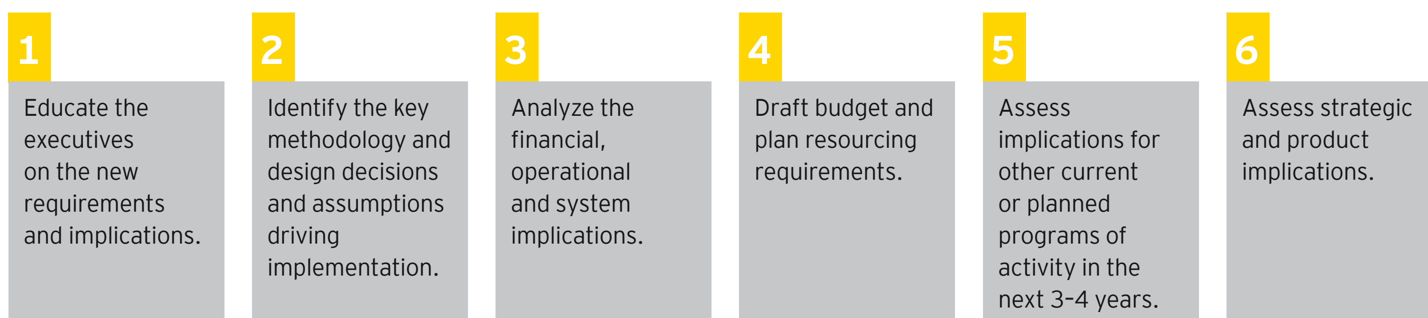
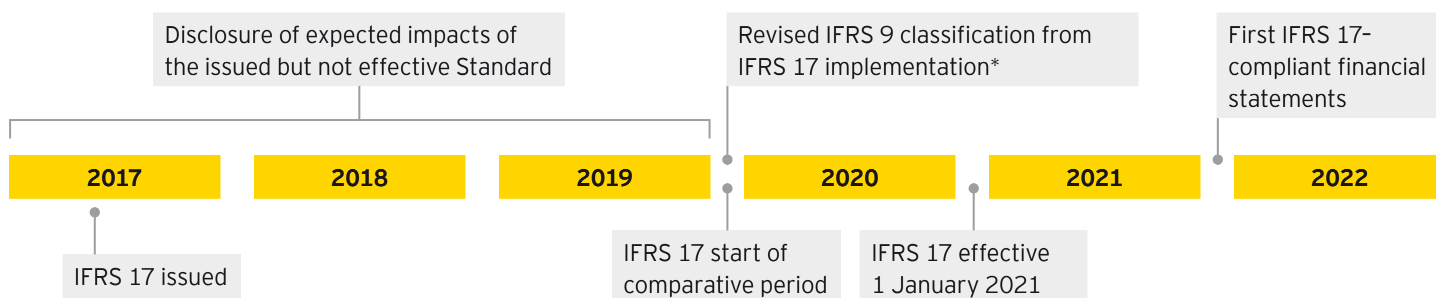


Exhibit 1: IFRS 17 timing (December year-end)



*Unless IFRS 17 will be deferred based on the conditional deferral option.

Proactive responses to IFRS 17

CFO

- Communicate early to key stakeholders, including market analysts and shareholders, providing clarity around the expected impacts to the financial statements and profit profiles
- Analyze current management reporting, key performance indicators and incentive frameworks for ongoing applicability, and incorporate necessary changes for analysing margins and volatility
- Update volatility and asset-liability management frameworks for measurement changes under IFRS 17 and assets under IFRS 9
- Evaluate any tax, capital or distributable profit implications

Controllership

- Update the chart of accounts and account mappings to cover new disclosures
- Prepare pro forma balance sheet, profit and loss (P&L) and note disclosure formats to meet new requirements
- Update accounting policies and practice manuals
- Analyze closing and reporting processes, including target operating model of finance function and updated responsibilities and timelines
- Engage with taxation authorities to discuss implications and transition approaches if taxable income calculations are based on current IFRS treatments
- Design specific controls to drive new process quality, robustness and integration into existing control frameworks enhancing efficiency to drive cost-effeciveness
- Update process and controls documentation and operating procedures
- Create new, or revise, existing internal (e.g., forecasts and other management reports) and external (e.g., investor and analyst packs) reporting templates
- Design and complete the significant note disclosures for each reporting period
- Focus on the auditability of reported figures – this will require a high level of interaction and consultation with the external auditor during the implementation process

Taxation

- Determine impacts of IFRS 17 on current tax and deferred tax
- Engage with local tax authorities to discuss treatment if tax follows IFRS financials
- Consider other impacts such as data requests for tax compliance, tax impacts of new KPI's and changes to reward plans.

Actuarial function

- Allocate time and resources to projects to design, build and test new data, modelling and systems capability
- Update methodology guidance for risk adjustment, discount curve and assumption setting
- Create a new calculation engine for amortizing and adjusting the contractual service margin (CSM)
- Work with the finance team to estimate impacts on transition and design optimal approaches
- Assist in making sure the reported figures are auditable
- Analyse of earnings volatility and how to mitigate
- Perform in-depth analysis on impacts on ALM strategies

Business finance and operations

- Assess current data availability against new data requirements for both model inputs and outputs
- Change the content and structure of data captured from business units to support group reporting
- Change the process for reporting that data to the group reporting team
- Enhance scrutiny of data quality, storage and archiving – given the retrospective transition requirements, this should happen ahead of the date of implementation
- Enhance data reconciliation based on new data needs
- Enhance scrutiny of data governance and management
- Design new target operating model for finance
- Select, design and implement new IT systems to facilitate efficient reporting

Pricing

- Perform detailed reviews of product offerings and pricing strategy to adapt to changes in profit profiles

Investing

- Review investment policies and asset liability management strategy based on the impacts of the new measurement models for both insurance contracts and financial instruments

A proven program

In the next four years, insurers will face significant technical and practical changes.

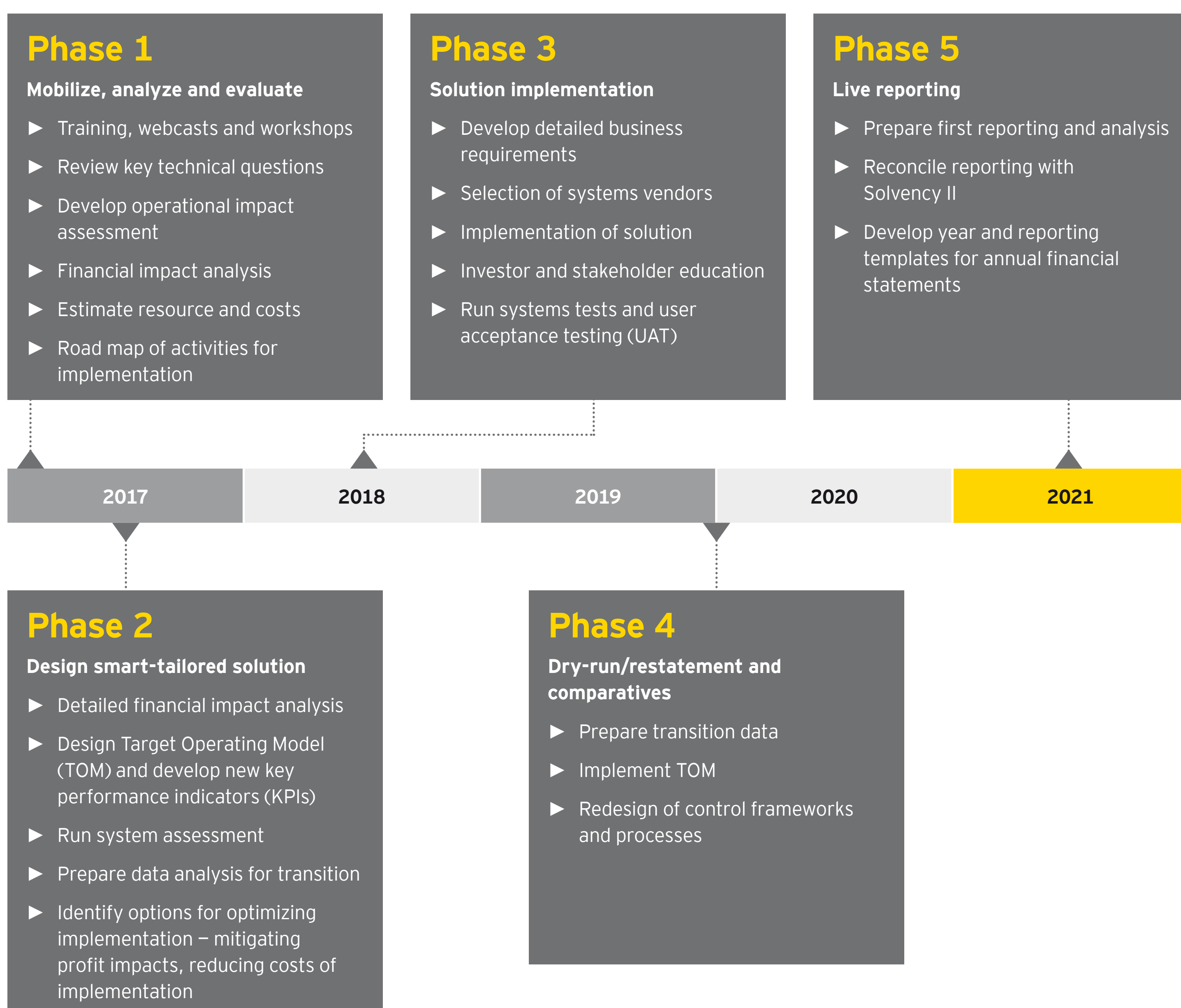
EY is already working with major insurers to assess the impacts of these changes on their business, mobilize their implementation programs and educate their stakeholders.

In our experience, proactively maintaining market confidence in an insurer's ability to execute these programs is essential.

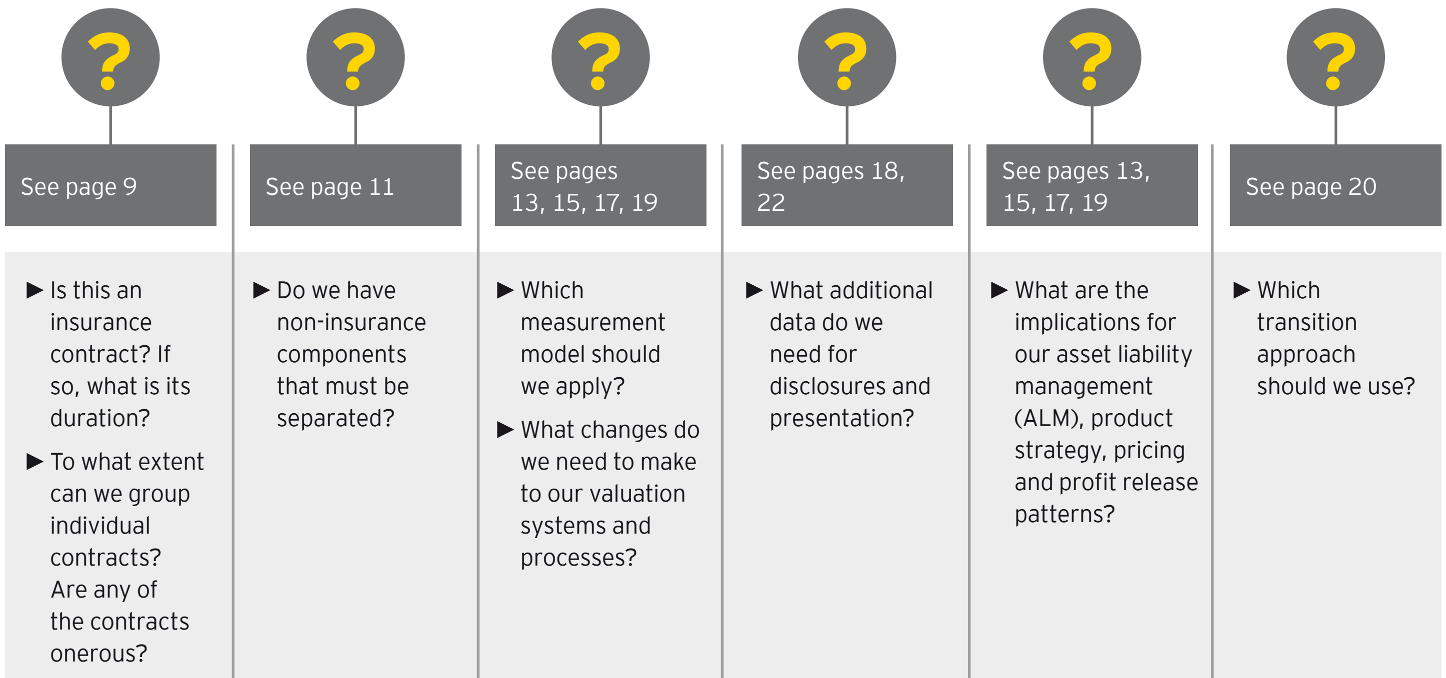
With the standard finalized and as the effective date approaches, external stakeholder interest will increase. Insurers must be prepared to educate stakeholders on the expected impacts and communicate their execution plans. This will require a well-planned program and a clear organizational view of the effects of the new standard.

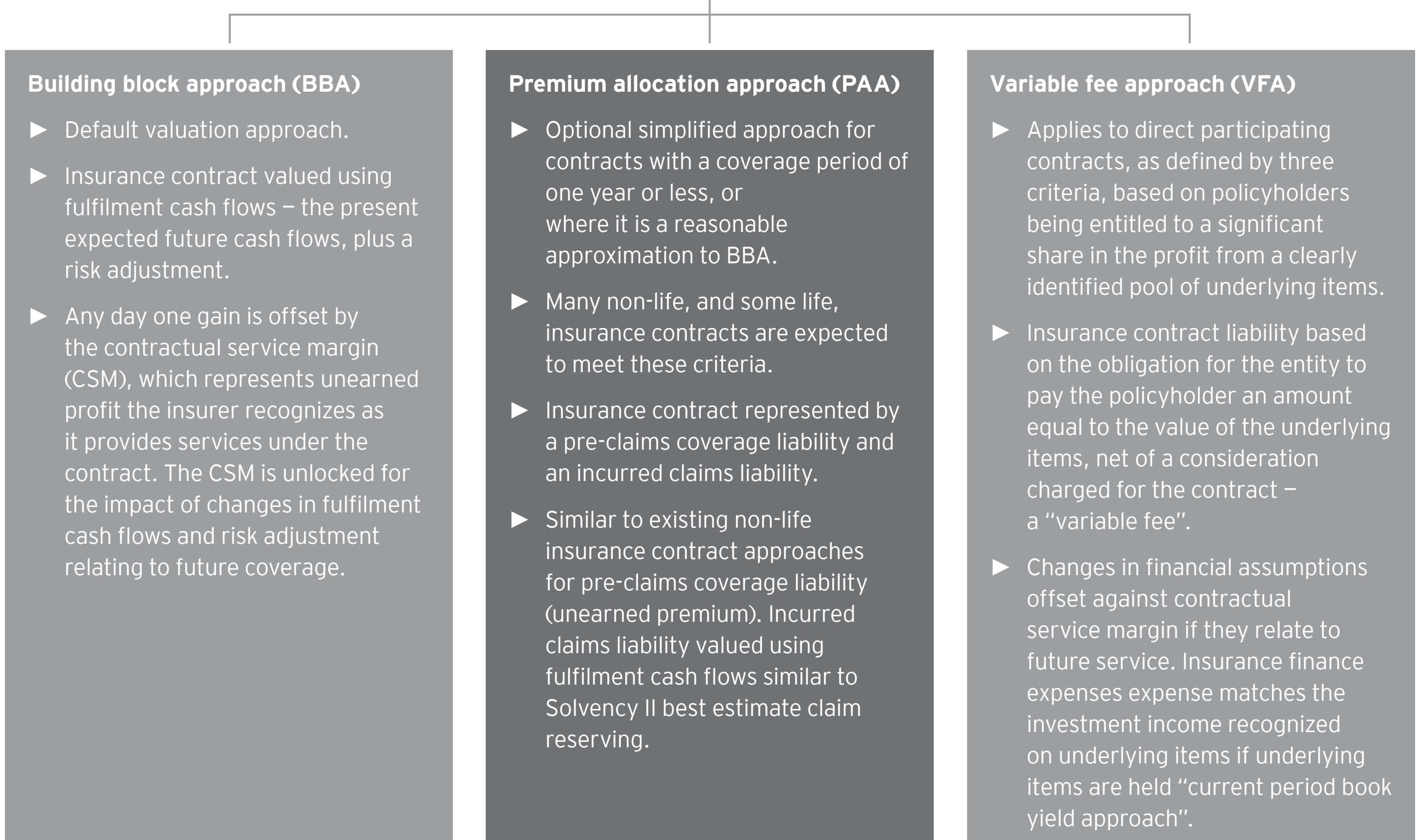
EY has the experience to help insurers assess these effects and design and implement a cohesive program – as illustrated in Exhibit 2. This timing is based on the application of the temporary exemption to defer the IFRS 9 effective date until 1 January 2021 (see IFRS 9 section).

Exhibit 2: IFRS 17 implementation program (illustrative)



Initial questions when analyzing your contracts





Features and challenges of the Standard

A marathon accounting project ...

The IASB's Insurance Contracts project has been a marathon not a sprint. However, we have passed the finish line now.

In 2013, the Board issued a revised exposure draft on the accounting for insurance contracts the exposure draft (ED).

The Board received extensive feedback on the ED, including concerns that it would result in:

- Volatility in results that did not appropriately reflect the underlying performance
- A profit release pattern for participating contracts that did not reflect underlying economics
- Increased complexity that outweighed benefits

In response to the industry's concerns, the Board recognized the need to revisit many aspects of the Standard.

Its deliberations led to a number of extensive changes to the measurement model. On a number of topics, the IASB appears to have selected a number of pragmatic solutions with the aim of developing a Standard acceptable to most in the international industry.

Between September and November 2016, the IASB conducted targeted field testing with 12 insurance groups to further look into the impact of their proposals.

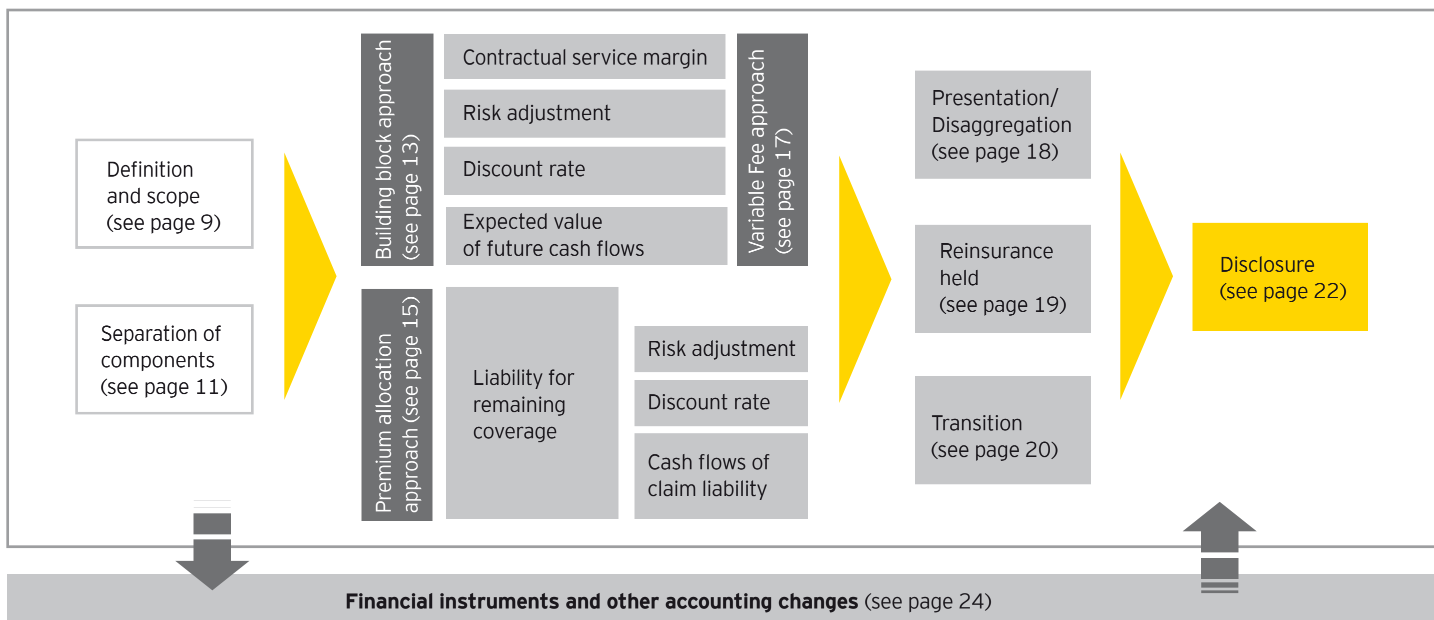
The Standard has 1 January 2021 as the mandatory effective date (with early adoption permitted).

Given this timing, insurers expressed concern that the introduction of the new Standard will be aligned with IFRS 9 Financial Instruments, which becomes effective from 1 January 2018. In response, the IASB issued amendments to IFRS 4, providing conditional options to address the issue of different effective dates of IFRS 9 and IFRS 17 (see IFRS 9 section for more detail). These will mean that most insurers will be able to defer implementation of IFRS 9 until the date that IFRS 17 has become effective.

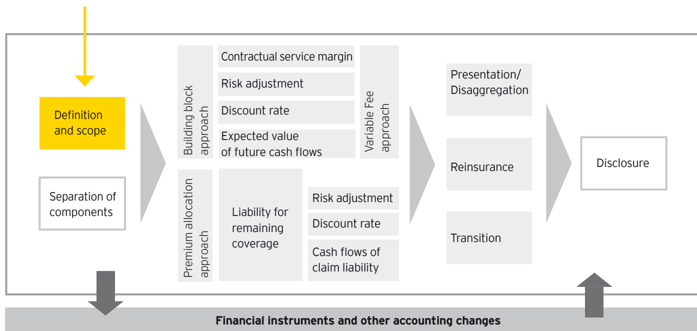
... leading to a new accounting landscape

The following sections take a deeper dive into the key features of the new accounting Standard (see Exhibit 3), their expected implications and implementation challenges they will present.

Exhibit 3: Key focus areas of IFRS 17



Definition and scope



Implications

- More granularity in contract groupings for valuation purposes will create additional complexity in the valuation models, process and data requirements.
- The Liability Adequacy Test (LAT) will be replaced by an "onerous contracts" recognition test. This new test is expected to be measured at a more granular level than the current LAT, in many cases, with the potential for certain contracts to enter into loss recognition.
- When law or regulation constrains the entity's ability to set a different price for policy holders with different characteristics, the entity may be able to include those contracts in the same group.
- Some life insurance contracts may be considered short-term, potentially accelerating profit recognition and amortization of acquisition costs.
- Some general insurance contracts may have to be treated as long-term, becoming subject to a more complex valuation methodology.
- Additional guidance on the "significant insurance risk" test means contracts that are currently borderline or with deferred payment features may not meet the insurance contract definition.

Definition of an insurance contract

Since the definition of an insurance contract under the Standard is unchanged from current IFRS 4, most contracts will not be impacted.

However, additional guidance on the "significant insurance risk" test states that it should be based on the present, rather than nominal value of future potential cash flows of a particular contract.

Contracts containing deferred payment features or those that are currently borderline may be at risk of failing this revised test and may need to apply IFRS 9.

Level of aggregation (unit of account)

The level of aggregation is not merely an esoteric accounting concept. It determines the level at which insurers apply the recognition and measurement requirements of the standard and directly affects insurers' ability to aggregate contracts for valuation purposes and the onerous contract test.

The level of aggregation is determined by the following hierarchy of groupings:

- Portfolio: a portfolio is a group of contracts which are subject to similar risks and are managed together. IFRS 17 provides guidance that contracts in different product lines, for example annuities compared with term life assurance, would not have similar risks and therefore would be in different portfolio's.
- Profitability "buckets": each portfolio is further split into at least three groups (to the extent relevant) depending on expected profitability at inception:
    - Onerous contracts which are expected to be unprofitable at inception
    - Resiliently profitable contracts that have no significant possibility of becoming onerous in the future
    - Remaining contracts in the portfolio
- Cohorts: cohorts are a breakdown of portfolios according to date of inception. The Standard prohibits entities from grouping contracts issued more than one year apart
- An entity may choose to divide a portfolio into more groups if the entity's internal reporting provides information to make such sub-divisions

Entities can measure sets of contracts together if the entity can determine that those contracts can be grouped with others based on reasonable and supportable information at inception. For contracts affected by rate regulation, aggregation into a single group will be permitted if these contracts would fall into different groups only because of such constraints. If a series of insurance contracts achieve, or are designed to achieve, an overall commercial effect, it may be necessary to treat the set or series of contracts as a whole to report the substance of the transaction.

This means that entities will have to evaluate when contacts can, or should be, combined and measured together as a single group.

Mutualization

Entities should consider whether the cash flows of insurance contracts in one group affect the cash flows to policyholders of contracts in another group. In practice, this effect is referred to as "mutualization". Contracts are "mutualized" if they result in policyholders subordinating their claims or cash flows to those of other policyholders, thereby reducing the direct exposure of the entity to a collective risk. The standard includes guidance on how to take the corresponding effects into account when determining the future cash flows for the affected groups.

Conclusion

We generally expect these aggregation rules to result in more granular groupings than current European practice, necessitating more complex modelling, valuation processes and data requirements.

This is particularly the case for long-duration participating business, with certain options and guarantees requiring stochastic valuation as in Solvency II.

Derecognition and the contract boundary

Derecognition timing and the contract boundary is critical as it determines which valuation approaches are available, the periods over which profits are released and which future cash flows should be included for valuation purposes.

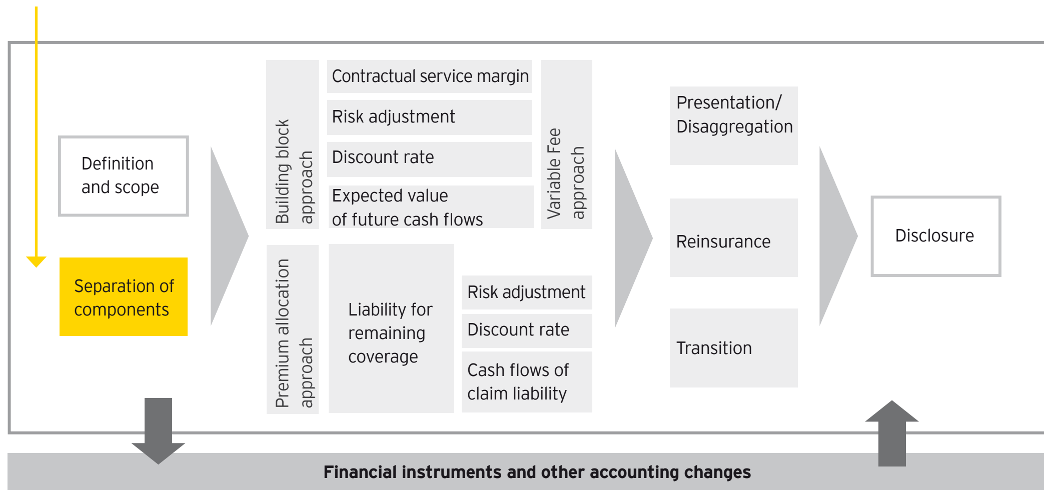
Cash flows are within the boundary of an insurance contract when the entity "can compel the policyholder to pay the premiums or has a substantive obligation to provide the policyholder with coverage or other services." The insurer's substantive obligation ends when it can set a price or level of benefits that fully reflects the risk of the particular policyholder (or the portfolio of insurance contracts that contains that contract) and the pricing of the premiums for coverage up to the date when risks are reassessed does not take into account the risks that relate to future periods.

This means insurers will need to assess contract boundaries for all their contracts. For European companies, some **life insurance** products, such as stepped premium Yearly Renewable Term, or regular premium unit linked contracts, could be subject to a one-year boundary. Depending on the relative size of acquisition costs, some may fail the onerous contracts test in their first year, and will have accelerated amortization of their acquisition cash flows.

Some **general insurance** contracts, such as engineering, construction or lenders mortgage insurance, are expected to have a contract boundary greater than one year and therefore may need to apply the building block approach rather than the premium allocation approach.

The requirement to be able to set a price or benefits that "fully reflects the risk of that portfolio" also raises the issue whether some regulated or community-rated products have a one-year contract boundary or a boundary greater than one year.

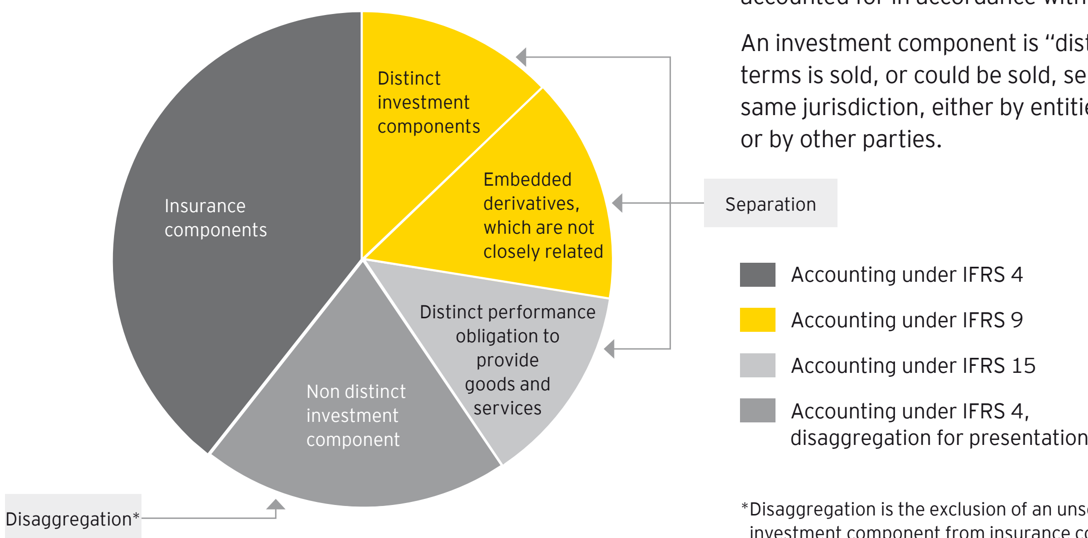
Separation of components (unbundling)



Implications

- The embedded derivative separation requirements are largely unchanged from current requirements.
- The investment component separation requirements are different, with no option to unbundle voluntarily, and separation and accounting under IFRS 9 required if the investment component is "distinct" from the insurance component.
- If a contract provides goods and services not related to insurance risk (e.g., preventative or lifestyle benefits), separation may be required and some allocated revenue recognized under IFRS 15.
- Contract features will require analysis. If separation is required, this will add to the data requirements and accounting complexity.

Exhibit 4: Separation and disaggregation



*Disaggregation is the exclusion of an unseparated investment component from insurance contracts revenue.

Current unbundling requirements

Under IFRS 4, in certain circumstances, embedded derivatives and deposit (investment) components are unbundled from the host insurance contract and accounted for separately. In other circumstances, insurers have the option to voluntarily unbundle deposit components.

As shown in exhibit 4, the new Standard retains the concept of unbundling, described now as "separation and disaggregation". However, the option to voluntarily separate components has been removed and new components have been added.

Embedded derivatives

The new Standard has retained the current requirements to unbundle (or separate) embedded derivatives, so no major changes are expected in this area.

Investment components

"Distinct" investment components should be separated and accounted for in accordance with IFRS 9.

An investment component is "distinct" if a contract with equivalent terms is sold, or could be sold, separately in the same market or same jurisdiction, either by entities that issue insurance contracts or by other parties.

However, it is not considered distinct if the investment and insurance components are highly interrelated (i.e., if one cannot be measured without considering the other).

Products with both insurance and investment components, such as unit-linked products and with profits, are common in the European market.

Non distinct investment components (defined as the amount policyholders will receive from the insurer regardless of whether an insured event happens) are disaggregated. This means that any premiums and claims amounts related to the component are accounted for directly in the balance sheet, not through the income statement.

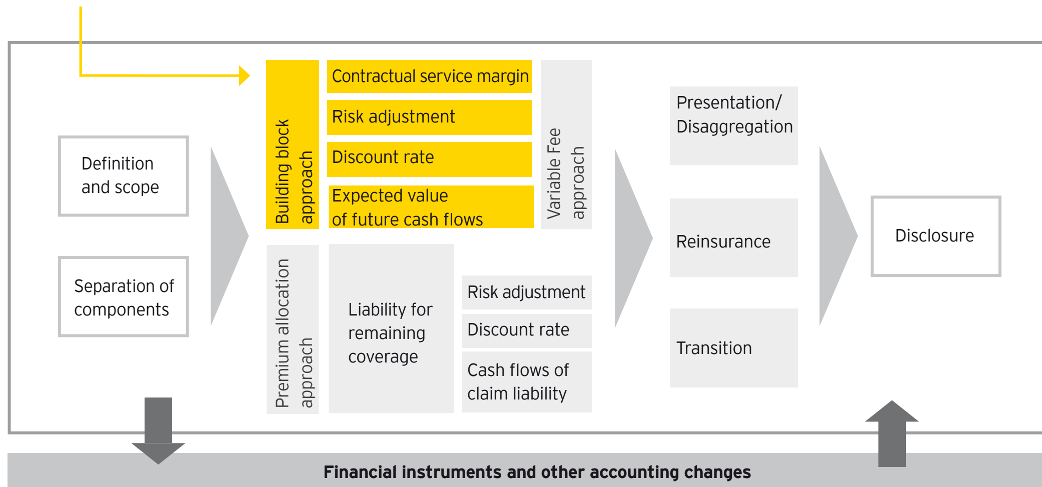
Performance obligations to provide goods or services

Distinct performance obligations to provide goods or services — defined in IFRS 15 as "a promise in a contract with a customer to transfer a good or service to the customer" — must be separated from the host insurance contract.

However, similar to the investment component, separation is not required if the cash flows and risks associated with the good or service are highly interrelated with the cash flows and risks associated with the insurance components in the contract.

Where goods and services are being provided outside of delivering a benefit related to insurance risk (preventative or lifestyle benefits for example), insurers may need to separate these components and account for an allocated revenue component in accordance with IFRS 15.

Building block approach (BBA)



Implications

- The BBA is different to many existing European insurance accounting models and will result in different profit outcomes and require new modelling, data and processes.
- Contract aggregation at a cohort level or contractual service margin (CSM) group is expected to be much more granular than current practice in many cases. Combined with the need for probability-weighted expected cash flows, this will add significant effort and complexity to the valuation.
- Calculating the discount rate and risk adjustment will involve estimations and require new techniques. The explicit risk adjustment is a new requirement compared to many existing models although certain synergies with Solvency II might arise.
- The release of the CSM, based on coverage units will affect profit emergence patterns.

The BBA (or General Model) will be the core measurement model, with the insurance contract liability comprising fulfilment cash flows and the CSM.

The **fulfilment cash flows** include:

- **The expected, probability-weighted, discounted cash flows within the contract boundary**. The objective is to determine the expected value, or statistical mean, of the full range of possible scenarios, which will be discounted to present value at a discount rate that reflects the characteristics of those cash flows. This scenario-based approach is more complex than current "best estimate" approaches. If the scenarios represent a normal distribution, then a more deterministic approach may still be possible. However, the proposed discount rate will not be directly observable in the market. As such, it will need to be calculated with reference to other financial instruments and adjusted to the characteristic of the liability (especially with respect to illiquidity) applying judgement.
- **A risk adjustment** reflecting the level of compensation the insurer would demand for bearing the uncertainty about the amount and timing of cash flows arising from non financial risks. The technique used to determine the risk adjustment is not specified, but the result will need to be translated into a disclosed equivalent confidence level.

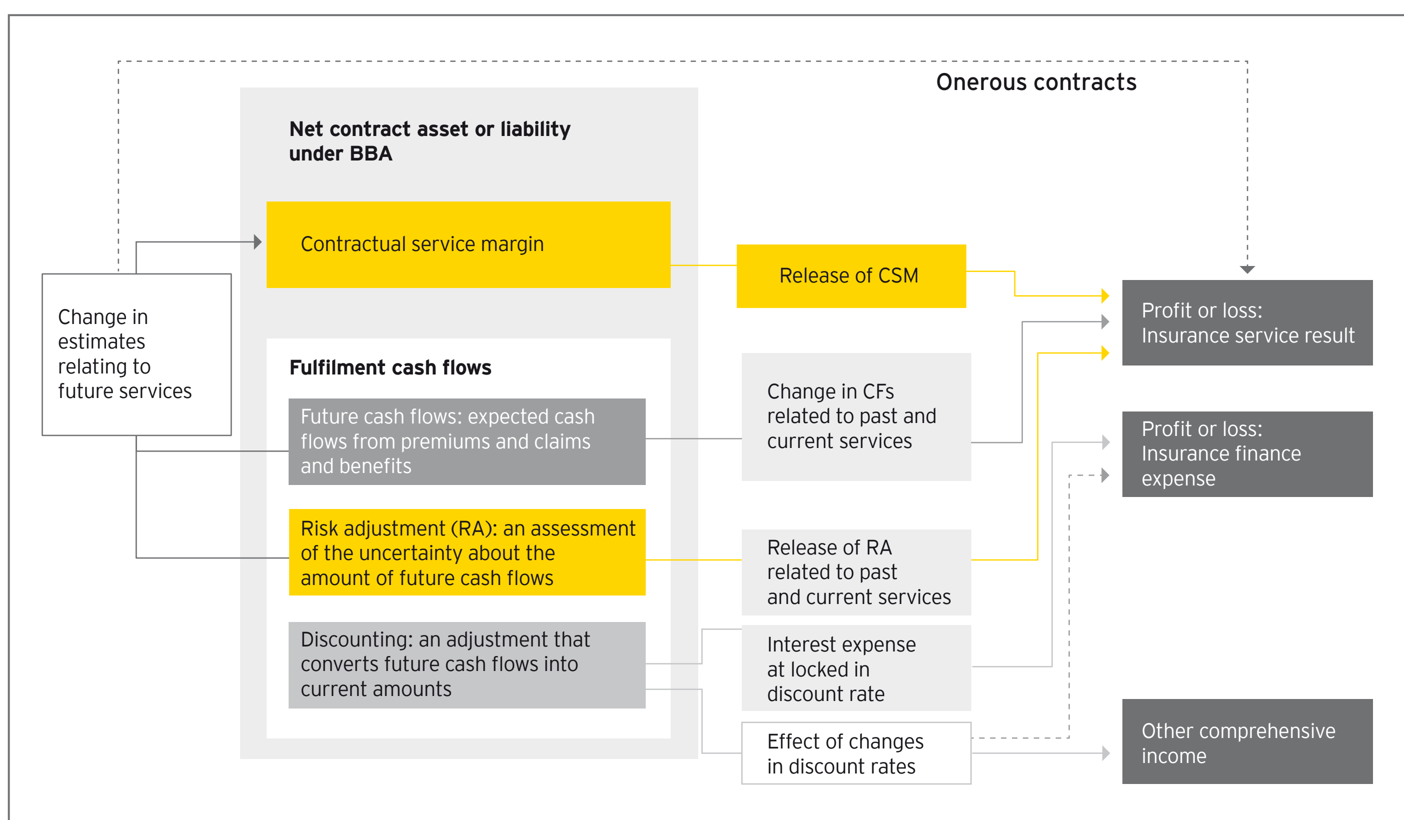
The **CSM** is the expected unearned contract profit in an insurance contract. At inception, it will be equal and opposite to the fulfilment cash flows plus any pre-coverage cash flows (i.e., acquisition costs). Interest will accrue on the CSM based on the discount rate locked in at inception. In principle, CSM will be released into P&L in a way that best reflects the transfer of services under the contract, based on coverage units reflecting the quantity of benefits provided and the expected coverage duration of the remaining contracts in the group.

All fulfilment cash flow assumptions will be updated each reporting period. Changes in fulfilment cash flows that relate to future services will be added to or deducted from the remaining CSM (i.e., unlocking of the CSM). Examples of such effects are changes in assumptions causing a change in the estimate of the future cash flows of the liability for remaining coverage. Changes relating to past and current services (e.g., differences between actual and expected claims incurred in the current period, and changes in estimates of fulfilment cash flows of the liability for claims incurred in previous periods) should be recognized in profit or loss as part of the insurance service expenses for the period. The CSM cannot become "negative" subsequently. If the CSM has become nil, any further unfavorable changes in estimates of the present value of future cash flows are recognized in profit or loss.

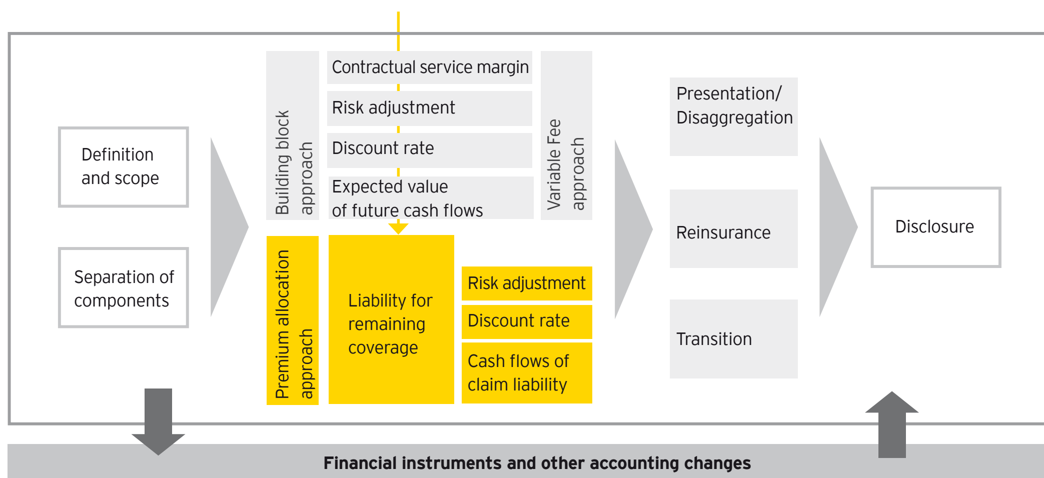
The CSM aggregration requirements mean contracts are expected to be aggregated into groups of contracts based on annual cohorts and considering the expected profitability at inception. This is much more granular than current European practice. It will bring increased requirements for data and modelling, assumption setting and valuation processes, and the manner in which results are analyzed and explained.

Insurers will be able to make an accounting policy whether the effect of changes in market discount rates are recognized fully in P&L or in Other Comprehensive Income, with interest accrued to the P&L at the locked-in discount rate at inception. Specific requirements for the presentation of insurance finance income or expense apply to participating contracts.

Exhibit 5. The building block approach and presentation of changes in the insurance liability



Premium allocation approach (PAA)



Implications

- The PAA is similar to existing approaches for non-life insurance products.
- Defining the contract boundary is critical to analyzing whether an insurer can use the PAA for some contracts – either due to having a coverage period of one year or less, or because the PAA reasonably approximates the BBA results.
- Some life insurance contracts currently using long duration measurement models may qualify to be able to use the PAA approach, which would simplify the modelling required but may also lead to unexpected results.
- Longer-term non-life contracts, such as construction, engineering and lenders mortgage insurance, may not meet the criteria. As a result, the insurer will face additional complexity in its valuation, modelling and associated processes.

The PAA, or simplified approach, may be used where:

- Contract coverage period (including premiums included in the contract boundary) is one year or less

  Or

- Use of the PAA produces a liability which will not differ materially from of the BBA for the group of contracts

The first step to assess its use is to define the contract boundary – and hence the coverage period. Many non-life insurance contracts meet the first criteria by having a coverage period of one year or less.

However, contracts with longer coverage periods, such as surety, engineering, construction or lenders mortgage insurance will need to demonstrate they meet the second criteria. If not, they will have to use the BBA instead. Non-life insurers in this scenario will need to develop more complex modelling than they currently apply, requiring more data and the development of long-term assumptions. This also means insurers will present financial statements with a mix of valuation techniques, complicating the way results are analyzed and communicated.

The PAA is similar to existing European non-life insurance accounting and incorporates two elements to measure the insurance contract liability:

- **A liability for the remaining coverage,** which measures the insurer's obligation to provide coverage to the policyholder during the coverage period
- **A liability for incurred claims,** which measures the insurer's present value obligation to investigate and pay claims that have already occurred – whether reported or not. The liability for incurred claims will be calculated using the BBA methodology

If the coverage period is less than or equal to one year, the insurer may choose to immediately expense directly attributable acquisition costs.

The PAA measures the liability for remaining coverage by allocating the contract premiums over the coverage period, with revenue recognized either:

- On the basis of the passage of time

  Or

- If the expected pattern of release of risk differs significantly from the passage of time, then on the basis of expected timing of incurred claims and benefits

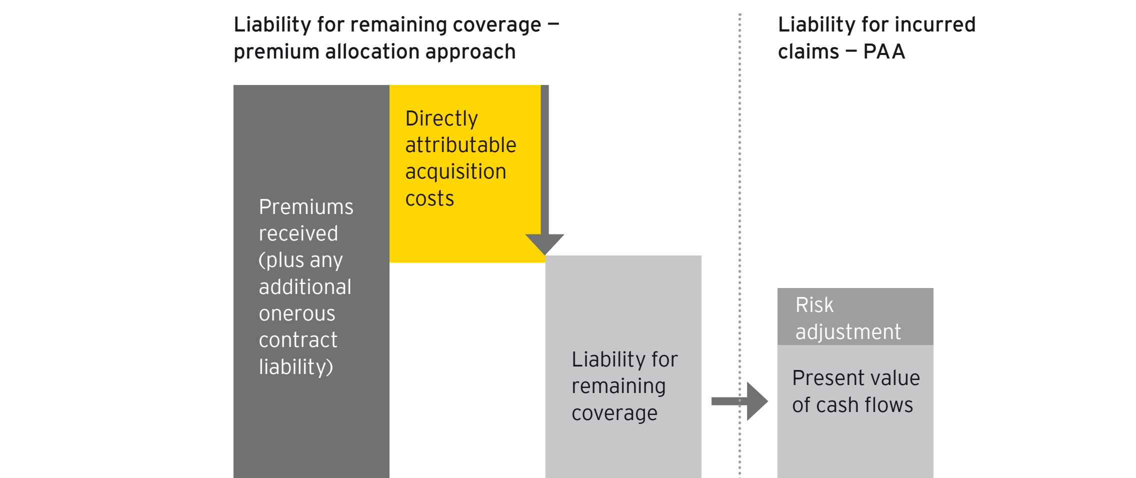
This revenue recognition allocation approach differs from the BBA, which is based on the passage of time and coverage units, and prima facie results in a more appropriate profit release pattern.

For this reason, as well as the simplified measurement approach and reduced effort compared to the BBA, we expect many insurers, particularly non-life companies, will elect to apply the PAA if its criteria are met.

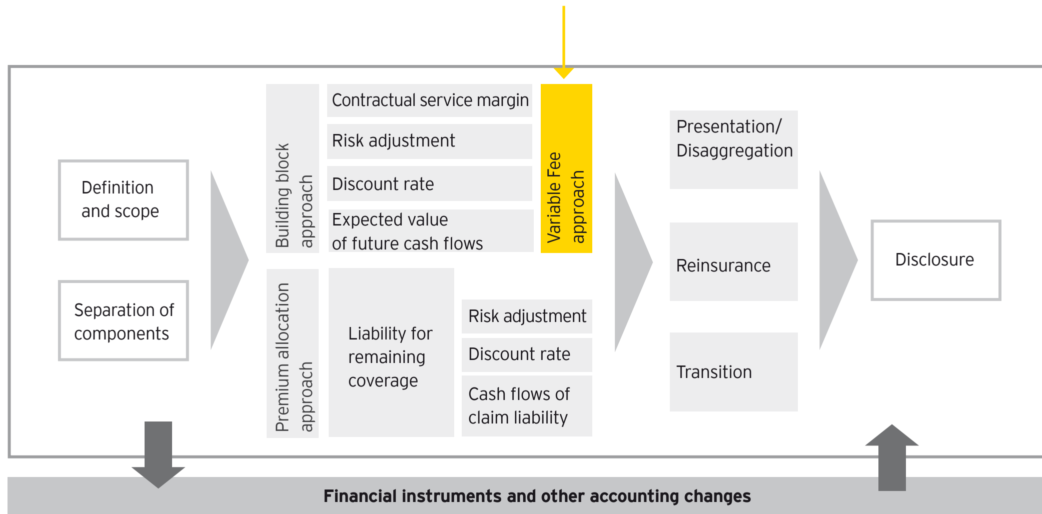
For short duration contracts, the inclusion of discounting be discounting and adding a risk adjustment on claims and liabilities will be significantly different to current practice. This provides opportunity to leverage Solvency II but will present new challenges for financial reporting.

Furthermore, for contracts for which the entity applies the premium allocation approach, an entity must assess whether a group of contracts are onerous at inception, if facts and circumstances indicate this.

Exhibit 6: The premium allocation approach (PAA)



Variable fee approach (VFA)



Implications

- VFA is to be used for contracts with direct participation features, representing a variation on the BBA.
- It will require an evaluation of terms and conditions to determine whether participating contracts meet the criteria to apply this approach, although several types of European participating contracts are expected to do so.
- This approach has generally been welcomed by the industry as it appears to lead to a more appropriate measurement and profit emergence pattern than many alternatives.
- The use of the CSM as a buffer for changes in future estimates of fee expected to be earned will reduce earnings volatility.

The VFA is the measurement approach for direct participating contracts that meet three criteria:

1. The contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items.
2. The entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns from the underlying items.
3. The entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.

The VFA assumes that a participating contract creates an obligation for the entity to pay the policyholder an amount equal to the fair value of the underlying items, net of a consideration charged for the contract – a "variable fee".

Accordingly, the entity's interest in the contract would represent a variable fee for the service of managing the underlying items on behalf of a policyholder. At inception, this fee comprises the expected share of the fair value of the underlying items to which the participating contracts have a participation right, less any expected cash flows that do not vary with the underlying items.

This approach requires that changes to the estimate of the future fees an entity expects to earn from direct participating contract policyholders are adjusted against the CSM. The CSM on direct participating contracts would be recognized in profit or loss as part of the entity's insurance service results on the basis of the passage of time. Two main differences will arise between contracts measured under the VFA versus the BBA:

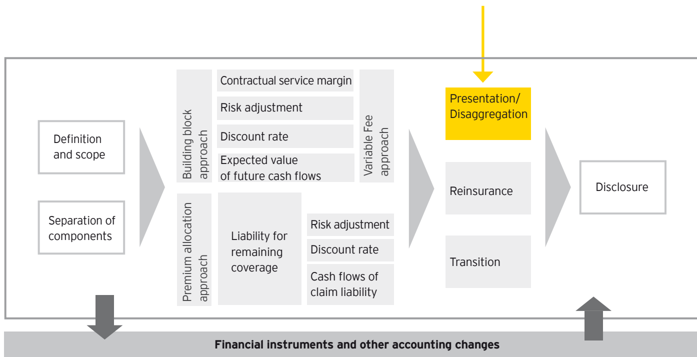
Non-participating	Indirect participating	Direct participating
BBA or PAA		Variable fee model
General model – effective yield		Current period book yield

For some types of contracts, insurers are concerned that these differences will lead to a "cliff effect", whereby two economically similar contracts may report quite different results if one does not qualify to use the variable fee approach.

If certain conditions for hedging as risk-mitigation techniques are met, insurers may opt to recognize the changes in the fulfilment value of financial risk features (such as interest rate guarantees) in profit or loss.

Differences	General Model	Variable fee approach
Subsequent measurement – financial variables	PL or OCI, following the general model	CSM (PL if risk-mitigated)
Accretion of interest on CSM	Locked-in rate	Based on current rate included in the balance sheet measurement

Presentation and disaggregation



Implications

- Premium revenue will no longer appear on the face of the P&L, replaced by "insurance contracts revenue". This is calculated based on movements in a number of different elements, requiring stakeholder education about its meaning and importance.
- There is a risk that, if the new format does not provide useful information to investors, further supplementary information outside the financial statements will proliferate.

The Standard includes specific requirements for presenting insurance-related balances in the financial statements. The biggest change for some insurers will be seen in the Statement of Comprehensive Income (SCI), which will now separate investment performance explicitly from an insurance services (or underwriting) result.

Exhibit 8 provides an example of which line items certain income and expense items will be recognized in. An entity will be prohibited from presenting premium information in the statement of comprehensive income if that information is not consistent with the commonly understood notion of revenue, governed by IFRS 15 Revenue from Contracts with Customers. However, premium-related information could still be disclosed in the notes to the financial statements or in the Segment Reporting.

Rather than premium revenue, insurance revenue will be shown and calculated as described in Exhibit 8. This represents a fundamental change from today's top-line income statement presentation for life insurance contracts.

Claims and other expenses related to the insurance contracts will then be disclosed, leading to an underwriting result for the entity.

Exhibit 8: Illustrative statement of comprehensive income

Statement of comprehensive income	
Insurance revenue	X
Insurance service expenses	(X)
Insurance service result	**X**
Investment income	X
Insurance finance expense	(X)
Finance result	**X**
Other profit and loss	**X**
Corporate tax	(X)
Profit after tax	**X**
Other comprehensive income	(X)
Total comprehensive income	**X**

Insurance revenue:
- Release in contractual service margin
- Change in risk adjustment
- Expected claims (in fulfilment cash flows)
- Expected expenses (in fulfilment cash flows)
- Allocating premium relating to the recovery of directly attributable acquisition costs
- **Excluding investment components**

Insurance service expenses:
- Actual claims incurred
- Actual expenses incurred
- Allocating premium relating to the recovery of directly attributable acquisition costs
- Onerous contracts
- **Excluding investment components**

Insurance finance expense:
- Calculated using locked-in rates (if the OCI option is selected)

Other comprehensive income:
- Effect of discount rate changes on fulfilment cash flows (if the OCI option is selected)

Reinsurance

Definition and scope
Separation of components
Building block approach
Contractual service margin
Risk adjustment
Discount rate
Expected value of future cash flows
Variable Fee approach
Premium allocation approach
Liability for remaining coverage
Risk adjustment
Discount rate
Cash flows of claim liability
Presentation/ Disaggregation
Reinsurance
Transition
Disclosure
Financial instruments and other accounting changes

Implications

- Reinsurers will measure insurance contracts issued under the Standard insurance contract models (the BBA or PAA).
- Cedants have some additional specific areas of guidance.
- The reinsurance assets will use the same inputs and assumptions in valuing the underlying contracts to value the reinsurance asset. However, some mismatches will still occur, as outlined below.

Reinsurers will measure reinsurance contracts applying the same principles as those for all insurance contracts. As such, the requirements and observations made throughout this document apply to them as well.

On the other hand, cedants holding reinsurance contracts have particular requirements to consider:

- When measuring the reinsurance assets, cedants should use assumptions that are consistent with those used to measure the corresponding part of the underlying contracts reinsured.
- The recognition requirements for insurance contracts are modified such that the CSM is calibrated to the expected present value of the net cash flows – effectively spreading any gain or loss on reinsurance over the period of the contract. However, for retroactive contracts, a negative "day one difference" (cost of reinsurance) must be recognized immediately in P&L if it relates to past events.
- The reinsurance asset will include an allowance for reinsurer's default in the expected fulfilment cash flows.
- If the underlying direct contract is considered onerous at inception, even if the reinsurance arrangement is profitable for the direct insurer, the two cannot be offset.

These requirements could lead to a number of accounting mismatches between measurement of the reinsurance contract and that of the related direct insurance contracts.

To take an extreme example, an entity with 100% quota share reinsurance and no retained risk or profit share may still report an underwriting profit or loss due to accounting mismatches from one period to the next. Over the life of the contracts, this will even out, but it will impact profits from one period to the next.

The variable fee approach cannot be applied to reinsurance contracts held and reinsurance contracts issued.

Exhibit 9: Reinsurance measurement for cedants (BBA)

Calibrated to the reinsured portion of the premium of the (direct) insurance contract
Reinsured part of the cedent's lability (gross)
CSM
Risk adjustment
Present value of future cash flows
Same inputs and assumptions plus reinsurance default
Cedant's reinsurance asset
Risk adjustment
Expected future cash outflows
CSM
CSM
Calibrated to the reinsured portion of the premium of the (direct) insurance contract

Transition

Definition and scope
Separation of components
Building block approach
Contractual service margin
Risk adjustment
Discount rate
Expected value of future cash flows
Variable Fee approach
Premium allocation approach
Liability for remaining coverage
Risk adjustment
Discount rate
Cash flows of claim liability
Presentation/ Disaggregation
Reinsurance
Transition
Disclosure
Financial instruments and other accounting changes

Implications

- As 1 January 2021 is the effective date, the opening balance sheet for December reporters is 1 January 2020.
- Recognizing the challenges that insurers, particularly life insurers, will face in sourcing reliable data to apply a full retrospective approach, a number of transition options have been provided to simplify the approach.
- Nonetheless, preparing to apply and transition to the new Standard will be an enormous effort, affecting many parts of the organization, particularly finance and actuarial resources.
- Taxation implications, both on transition and for ongoing calculations, will need to be addressed.

In principle, the new Standard will need to be applied retrospectively as if the standard has always applied, with entities required to restate comparative information about insurance contracts.

For each portfolio, the cumulative effect of transition will be recognized in:

- Opening retained earnings
- Accumulated OCI for changes in interest rates since the beginning of the contract

In addition, insurers will be able to make some limited redesignations of financial asset classifications previously made under IFRS 9 (see further discussion on the interaction with IFRS 9 on page 25).

From a corporate tax perspective, the application of IFRS 17 and IFRS 9 by IFRS reporting groups may give rise to cash tax and/or deferred tax consequences.

Where taxable profits are calculated based upon an accounting profit calculated in accordance with IFRS, or with a local GAAP basis which is aligned to IFRS and will therefore adopt IFRS 17 and IFRS 9, then the adoption of the new standards will have cash tax consequences. This will also be the case where the tax regime specifies the basis for calculating taxable profits, and that tax base invokes IFRS or an IFRS-aligned local GAAP as the measurement basis for items whose accounting treatment will be impacted by IFRS17 or IFRS 9. In cases where taxation is not based on the IFRS profit, deferred tax will arise on consolidation on application of IFRS 17 and IFRS 9 by IFRS reporting groups. Multinational groups may find that implementation of the new standards has different impacts in different territories.

For entities where the adoption of IFRS17 and IFRS 9 will have a cash tax impact, there will be:

- A transitional impact from the adjustment to opening retained earnings or OCI on implementation, plus
- An ongoing impact on periodic tax calculations

It is not yet clear how tax authorities in the various European jurisdictions will respond to these changes. In some territories, there is precedent for spreading the taxable income consequences of the introduction of new standards over a number of years but this may not automatically be the case and may require negotiation between the industry and the tax authority to gain certainty prior to transition.

Tax teams will also need to consider other potential implications of the implementation of the new standards – for example, any implications for wider finance system changes of the data requirements for tax compliance, or the tax implications of changes to KPIs, reward or incentive plans.

To fully retrospectively apply the BBA, an insurer would need to determine the original fulfilment cash flows for each group of insurance contracts – including the inception discount rate and the original CSM – and then roll this forward for each portfolio to the transition date.

Apart from the difficulty of sourcing data for this exercise, it may be difficult to retrospectively determine the expected fulfilment cash flows for some, perhaps even many, groups as they would have to be calculated at inception date applying hindsight. This may make full retrospective application impracticable for those groups.

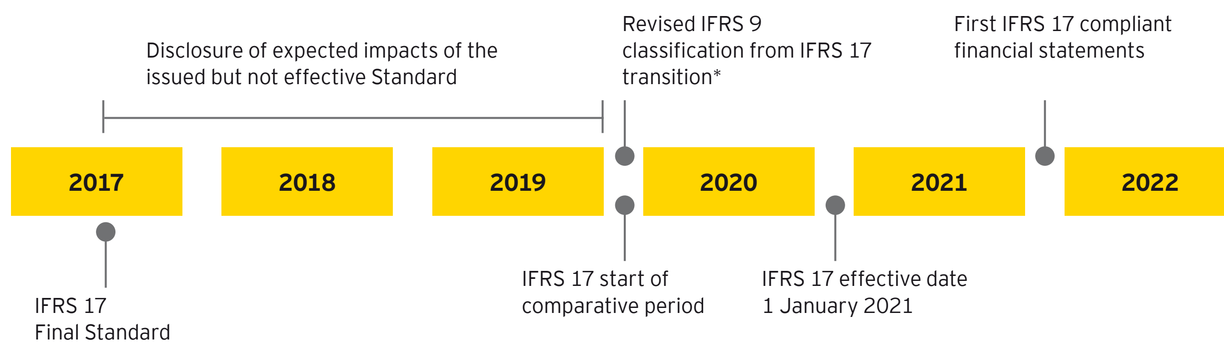
If full retrospective application is impracticable in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, two alternative methods are allowed:

- Modified retrospective application (with specific adaptations for contracts accounted for under the variable fee approach)
- Fair value approach

Insurers should carefully determine which mix of methods to apply in order to determine an optimized approach to transition.

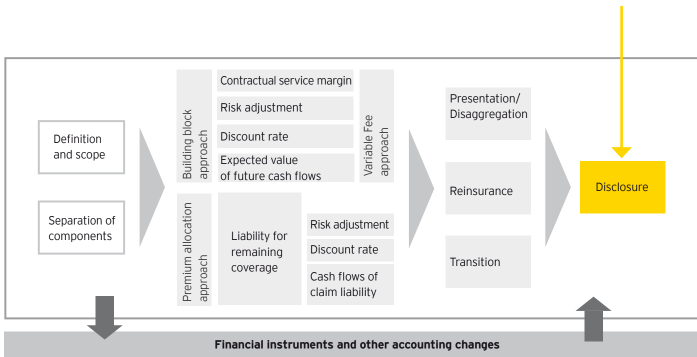
Modified retrospective application	**Adaptations for direct participating contracts**	**Fair value approach**
Simplifications will be allowed for: ▶ Estimated cash flows ▶ Risk adjustment ▶ Discount rate at initial recognition	▶ CSM at initial application should be measured as: ▶ The total fair value of the underlying items, less ▶ The fulfillment cash flows adjusted for past cash flows not updated for the underlying items, less ▶ The accumulated CSM for service provided in past periods	▶ CSM at the beginning of the earliest period presented equals the difference between the fair value of the insurance contract and the fulfilment cash flows

Exhibit 10. IFRS 17 transition (December year-end)



*Unless IFRS 9 will be deferred based on the conditional deferral option.

Disclosures



Implications

- Some of the required disclosures are similar to the current disclosures insurers provide.
- Extensive new disclosures showing how the components of recognized amounts have moved during the period.
- Judgement will be needed to determine the appropriate level of disaggregation for the disclosures.
- It is likely that insurers will need to provide reconciliations to Solvency II information, embedded value reporting and cash metrics – both externally and for internal review purposes. Reconciliation between different reporting bases will be a key control over the accuracy and completeness of information provided.

One of the primary objectives of the IASB's project on insurance contracts is to increase transparency in insurers' financial statements.

This includes providing information about: how much risk the insurer has taken on, how much uncertainty is contained in the amounts reported, what drives performance, how much an insurer expects to pay to fulfil its insurance contracts, and the value of embedded options and guarantees.

Although some of this information can be provided on the face of the financial statements, much will come in the form of more detailed disclosures in the footnotes. Exhibit 11 provides a summary of these new disclosure requirements.

Some disclosure requirements are comparable to existing requirements under IFRS 4. However, new and more extensive disclosures are required for recognized amounts and roll-forwards.

Furthermore, the guidance and discussion provided to date by the IASB suggests more granularity is expected than is currently the practice.

In particular, the entity will need to determine the appropriate level of disaggregation of these disclosures, which might include:

- Type of contract (e.g., major product lines)
- Geographical area
- Reportable segment

Insurers will need to develop systems, source data and valuation models to meet detailed and granular disclosure requirements about how insurance contract liability and asset balances have moved during the period. These are comparable to Analysis of Movement disclosures reported by those adopting Embedded Value reporting measures.

In any case, insurers will need to be able to reconcile between the different reporting bases. Management and external stakeholders are likely to be interested in why reported asset and liability balances, profit and equity/capital are different when measured under IFRS, Solvency II, Embedded Value and other reporting regimes.

Exhibit 11
Balance sheet and P&L items

Development of B/S items	Valuation methods and inputs used	Analysis of insurance revenue recognised	Interest curve for discounting

Type and extent of risks

In general	Insurance risks	Other risks
Risk appetite	Risk exposure	Risk exposure
Risk management	Risk concentrations	Risk concentrations
Regulatory law	Claims settlement	Maturity analysis
	Sensitivity analysis	Sensitivity analysis concerning market risks

Explanation of recognized amounts

Insurance finance income or expenses

Significant judgments

Exhibit 12. How presentation will change: Balance sheet

IFRS 4	IFRS 17
Assets	**Assets**
Reinsurance contract assets	Reinsurance contract assets
Deferred acquisition costs	Insurance contract assets
Value of business acquired	
Premiums receivable	
Policy loans	
Liabilities	**Liabilities**
Insurance contracts liabilities	Insurance contracts liabilities
Unearned premiums	Reinsurance contracts liabilities
Claims payable	

Key changes

- Groups of insurance (or reinsurance) contracts that are in an asset position presented separately from groups of insurance (or reinsurance) contracts that are in a liability position
- Acquisition cost cash flows, premiums receivable and unearned premiums are included in the measurement and presentation of the insurance contract liability

IFRS 9 implementation

IFRS 9 implementation considerations

Our point of view

- Most European insurers are expected to align the adoption dates of IFRS 9 and IFRS 17 by using the conditional deferral option.
- Some of the other measurement classifications, when considered in conjunction with the IFRS 17 liability measurement approaches, may reduce profit volatility. Insurers should make this assessment early on in their implementation projects.
- Key to the link between IFRS 9 and IFRS 17 is evaluating whether to use the OCI option for the insurance liabilities, and how to best align this with the mixed measurement model for the assets.

As shown in Exhibit 13, IFRS 9 will become effective from 1 January 2018. IFRS 9 comprises of three topics:

- Classification and measurement
- Hedge accounting (micro)
- Impairment

Based on a business model test and cash flow characteristics test, financial instruments will be classified as one of the following:

- Debt instruments at amortized cost
- Debt instruments at fair value through other comprehensive income (FVOCI) – with gains and losses reclassified to P&L
- Debt instruments, derivatives and equity instruments at fair value through profit or loss
- Equity instruments designated at FVOCI (without gains and losses reclassified to P&L)

That said, the option of a conditional fair value through P&L will still be available to mitigate the accounting mismatches.

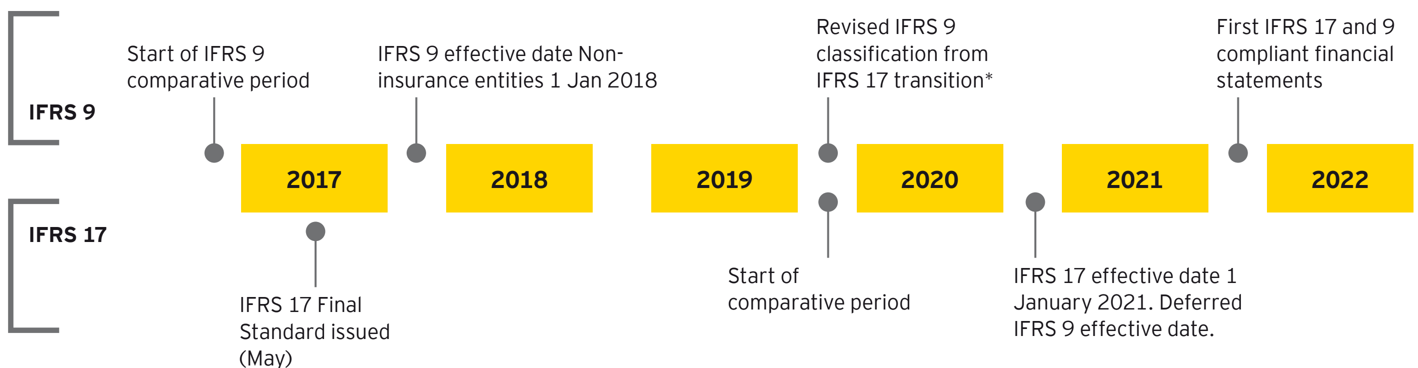
If not measured at fair value through P&L, a significantly different impairment testing model will apply. This will be an expected loss model, reassessed at each reporting period, compared to today's incurred loss model.

Implications for insurers

Most insurers will have the option of implementing IFRS 9 at the same time as IFRS 17 is implemented. Those that do implement IFRS 9 in 2018, will have the option of reassessing their business model for IFRS 9 classification and measurement purposes when the IFRS 17 is implemented and make designations and dedesignation under the conditional fair value option. A key consideration for implementation will be to ensure that the suitable accounting policy choices are made for both assets and liabilities. Insurers will be able to choose whether to report the impact of changes in market discount rates arising on insurance contract liabilities in profit and loss, or directly in equity through Other Comprehensive Income (OCI). However, IFRS 9 only allows assets which meet specific criteria to be classified as at fair value through other comprehensive income (FVOCI). This means that accounting mismatches could arise from the way that changes in market interest rates are reported on assets and liabilities.

Another key consideration will be the extent to which implementation projects should consider both standards together. Changes which will need to be made to accounting manuals, charts of accounts and financial statements should consider the impact of both standards together In addition, financial impact analyses would need to consider impacts on both assets and liabilities under the new standards. However processes for managing and reporting investments are often undertaken by different departments within insurance groups from those who are responsible for reporting and measuring liabilities. This would imply that part of the projects may be delegated to separate teams.

Exhibit 13: IFRS 9 effective date compared to IFRS 17



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Notes

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