Publication of IFRS 17 Insurance Contracts Standard

May 2017

INTRODUCTION

On 18 May 2017 the International Accounting Standards Board (**IASB**) published its new standard on accounting for insurance contracts: **IFRS 17**. The Standard will apply for accounting periods starting on or after 1 January 2021, but prior year comparative figures will be required.[1]

The Standard is directed at insurance contracts, rather than insurance entities. So it will apply, for example, to equity-release mortgages written by banks, as well as to those listed insurers required to report under IFRS and to those insurers that adopt IFRS voluntarily.

The publication was accompanied by webinars conducted by members of the IASB Staff, including Q&A sessions.[2] The responses provided by the Staff were caveated as being their own views, and not necessarily those of the IASB Board. Nevertheless, the answers offer some interesting insights, which we briefly summarise in this e-Alert.

OVERVIEW

The aim of the Standard is consistent accounting for all insurance contracts, increased transparency in financial information reported by insurance companies and reported information based on current estimates. However, the Staff acknowledge that the Standard is not directionally convergent with the aims of the Financial Accounting Standards Board (**FASB**), the standard setter for the US.

In summary, the principle-based Standard requires an assessment of the profitability of insurance contracts when they are first issued and, if positive, recognition of that value (the **Contractual Service Margin** or **CSM**) over the lifetime of the contracts in a manner that reflects the timing of the insurance services being provided by the insurer.[3]

The Staff expect firms to incur significant implementation costs.

AGGREGATION

The manner in which policies are grouped (**aggregated**) for the purposes of determining expected profitability is key, as any expected losses must be recognised immediately in the p&l account.

Aggregation is a top-down process determined at the time policies are issued and fixed thereafter:

- policies with similar risks that are managed together form a separate portfolio;
- the policies forming a portfolio are then split into three groups:
  - → those contracts expected to be unprofitable (**Group 1**);
  - → those for which there is no significant risk of becoming unprofitable (**Group 2**); and
  - → other contracts (**Group 3**),

A further constraint is that no group may contain policies issued more than 12 months apart. (Companies may choose to further subdivide contracts).

The Staff indicate that the purpose of requiring separate groups for policies deemed to have a significant risk of becoming unprofitable is so that the Contractual Service Margin for such policies can be excluded if it falls to zero during the term of the policies. If this occurs, subsequent losses on the policies will be accounted for through the p&l account. (If the CSM for the policies recovers a positive value it can be included once again).

The Staff expect that in the vast majority of cases there will be no policies classified as belonging in Groups 1 or 3.

TRANSITION

A key challenge will be applying the Standard to insurance business that has already been written.

Companies may want to use a full retrospective approach as much as possible to maximise the CSM, which will provide a buffer to absorb future losses but may reduce retained earnings at date of the transition to IFRS 17[4].

[1] In certain circumstances it can be adopted from an earlier date.
[2] Recordings of the sessions are available at : http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Pages/Implementation.aspx

[3] A simplified methodology, referred to as the Premium Allocation Approach, may be applied to certain short term business.
[4] The transition date is the beginning of the annual reporting period immediately preceding the date of initial application of IFRS 17.

Where a full retrospective calculation of the CSM is not practicable, a modified approach or a fair value approach[5] may be taken.[6]

Considering the availability of the necessary historical data, it appears likely that the fair value approach will be applied by many insurers to much of their back book. There is no immediate intention to provide additional guidance on the meaning of "fair value" for insurance contracts, as the general concept of fair value is covered by IFRS 13, which has applied for some time. However, the Staff will wait to see how the process develops before considering whether there is need for further guidance on its meaning.

The Staff expect that insurers will be able to apply the full retrospective methodology at least to business written after the necessary systems have been built to capture the necessary data, and not just to business written from the transition date.

IMPLEMENTATION

The IASB is planning a number of initiatives to assist with implementation, including publishing educational material and worked examples, and providing webcasts focussing on specific areas. Information aimed at investors and their advisers will also be developed.

A Transition Resource Group (**TRG**), staffed by preparers and auditors of financial statements, will be created. The purpose of the TRG will be to consider potential implementation issues, and assist where necessary with interpretation of the IASB's intent. It will be a public forum, so interested parties can follow developments and be aware of any consequential actions that have been taken.

The role of the TRG is not to reconsider decisions taken by the IASB, but there may be instances where issues are directed to the Interpretations Committee, or to the IASB for consideration.

Based on the corresponding processes for IFRS 9 and IFRS 15, the Staff expect the EU process for endorsing the Standard will take between 24 and 28 months.

They also expect implementation to be similar to that for IFRS 9, where bank regulators issued guidance to help banks implement the standard consistently. The IASB was involved in the development of that guidance, and expects to be involved in the development of guidance issued by insurance regulators.

The Staff expect implementation will be effected by accountants and actuaries working together closely. They noted that IFRS 17 is an accounting standard, and they expect the preparation of annual reports to remain the domain of accountants, with heavy reliance on actuarial data. As the actuarial data will be based on methodologies and assumptions determined by the actuaries, a significant role will be played by actuaries.

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[5] The CSM is set equal to any excess of the fair value of the liabilities determined in accordance with IFRS 13 and the fulfilment cashflows (the IFRS 17 term used for the reserves held for the liabilities). If the fair value is lower than the fulfilment cashflows then the shortfall must be recognised in retained earnings at the transition date.

[6] Certain modifications apply to the grouping criteria under the modified retrospective and fair value approaches. In particular, there is no requirement for back book policies written more than 12 months apart to be in different groups.