Natural Selection

Financial Services Forum

21-22 May 2018 • Hilton Sydney

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IFRS 17: an overview and update from the Actuaries Institute taskforce

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INTRODUCTION

Overview

- Brief introduction
- Overview including key changes from a Life perspective
  - Risk Adjustment
  - PAA
  - Contract Boundary
  - Profit Release
- Three areas of "uncertainty"
  - Premium received
  - Reinsurance
  - Unbundling
- Questions

About the taskforce

- Our **purpose** is to help prepare the actuarial profession for the implementation of IFRS 17
  - Includes releasing and updating Information Note
- Comprises ~20 taskforce members plus 30-40 additional workstream volunteers
- Joint practice areas (Life, Health, General)
- Our focus **today**
  - Life only
  - Not covering everything (only 40 minutes!)

Interpretation of the Standard

IASB TRG supports transition – education material, IFRIC, IASB Board

IFRS 17 published — 18 May 2017

Some entities begin implementation
General questions — Early 2018

Contentious/specific implementation questions — End 2019

Entities finalising implementation & comparatives — 2020

Effective date of IFRS 17 — 2021

- Who's who? IASB, IFRIC, TRG
- TRG process and timeframes
- Australian TRG
- What is the role for actuaries?

OVERVIEW –
FOCUS ON LIFE INSURANCE

Risk Adjustment

- New for Life Insurance (already in place for General Insurance)
- **Risk Adjustment** (AASB 17 Appendix A):
  - *The compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts.*
- Financial risk allowed for in discount rate or cash flows
- Separate from CSM – so CSM will be less than profit margin, hence group more likely to be in loss
- Profit each period will include release of the Risk Adjustment

Risk Adjustment

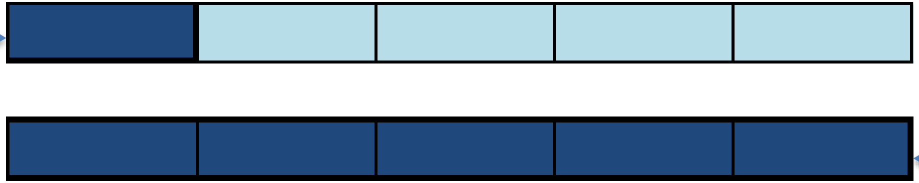
- **A good starting point** for this would be the **entity's risk appetite** - leverage APRA Risk Margin work, but not quite the same
- **How to do it in practice** – Leverage capital risk margin work? Cost of capital? Confidence interval?
- **Diversification** - Determine how & where you want it to sit – i.e. to what extent is allowance made for group diversification benefits? – IASB staff view at recent TRG meeting was that adjustment should be the same for group and individual entity – the 'entity' is the entity that is party to the contract
- Get it down to group of insurance contracts, then separately for:
  - Liability for Remaining Coverage; and
  - Liability for Incurred Claims
- **Disclose** – amounts & opening to closing reconciliation and "Equivalent confidence interval"

Use of the Premium Allocation Approach (PAA)

- PAA similar to current ‘unearned premium reserve’ approach
- If contract boundary is 12 months or less, then automatically eligible to use the PAA
- If contract boundary is > 12 months then liability determined using the PAA must “not differ materially” from liability measured under the general model
  - There must not be “significant variability” in cash flows (and risk adjustment) expected at inception
  - Variability likely to increase with extent of embedded derivatives and length of coverage period

Contract Boundary

< 12 mths
Entitled to
use PAA



>12 mths
PAA available if
additional
conditions met

- **Contract boundary**: *determines the contractual cashflows to be included in calculations*
- Contract boundary discussed further later

Use of the Premium Allocation Approach (PAA)

- Entity may take the view that YRT is a series of 1 year contracts
- Onerous contracts – high level facts and circumstances test
- Changes profit pattern – will make heavy loss in first year and profits subsequently – since unable to defer acquisition costs
- Changes risk adjustment – only needed for 1 year
- Changes grouping – first year business (loss making) will be in separate group from other years

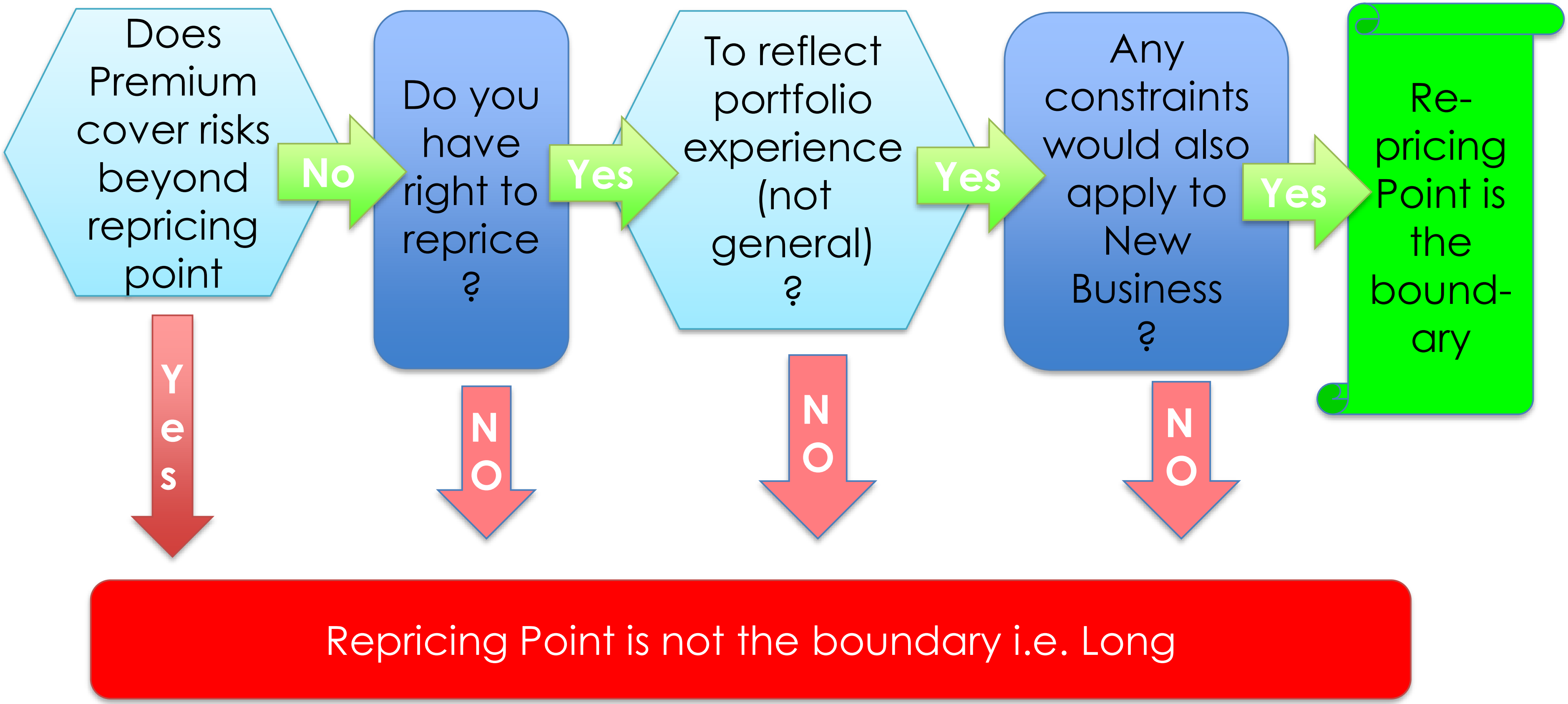
Use of the Premium Allocation Approach (PAA)

- Not just lump sum YRT – other contracts may also now be considered short term:
  - Group contracts
  - Some reinsurance
  - Stepped premium disability income
- Some group contracts may be short term, but longer than a year (3 year re-tender) so will need to test eligibility
- Group risk par – currently a 'bonus reserve' is just added on to the liability - PAA doesn't cater for bonus reserves, so business may not be eligible to use the PAA
- If can use PAA then liability and profit release is similar to current MoS simplification (with addition of RA on Incurred Claims)
- Will need to take future service into account when assessing if onerous (if line ball now, most likely will be onerous in future)

Determining the Contract Boundary

- **Individual Contract** (*17.34(a)*)– can *reassess risks* and *fully reprice*
- **Portfolio** (17.34(b)) **–** when both the following are meet:
  - a *practical ability* to *reassess risks* of the portfolio and *fully reflect in repricing*: and
  - premium *pricing* for coverage to repricing point *does not reflect risks beyond*
- Discussed at IASB TRG Feb 18 *(AP02)* & May 18 *(AP03)* & noted that:
  - *risks* are those transferred from policyholder (staff noted these are *only insurance and financial risks*, not lapse and expense
  - *fully reprice* means reflecting *specific experience* of portfolio not general
  - *Practical ability* is not affected by commercial *constraints* that *apply* equally *to new business*
  - *Continuation options* and resulting cash flows *are within* unless contract as whole meets criteria above at point of exercise
  - *Not an accounting choice*, application of judgement and careful assessment to facts and circumstances of each contract

Determining the Contract Boundary

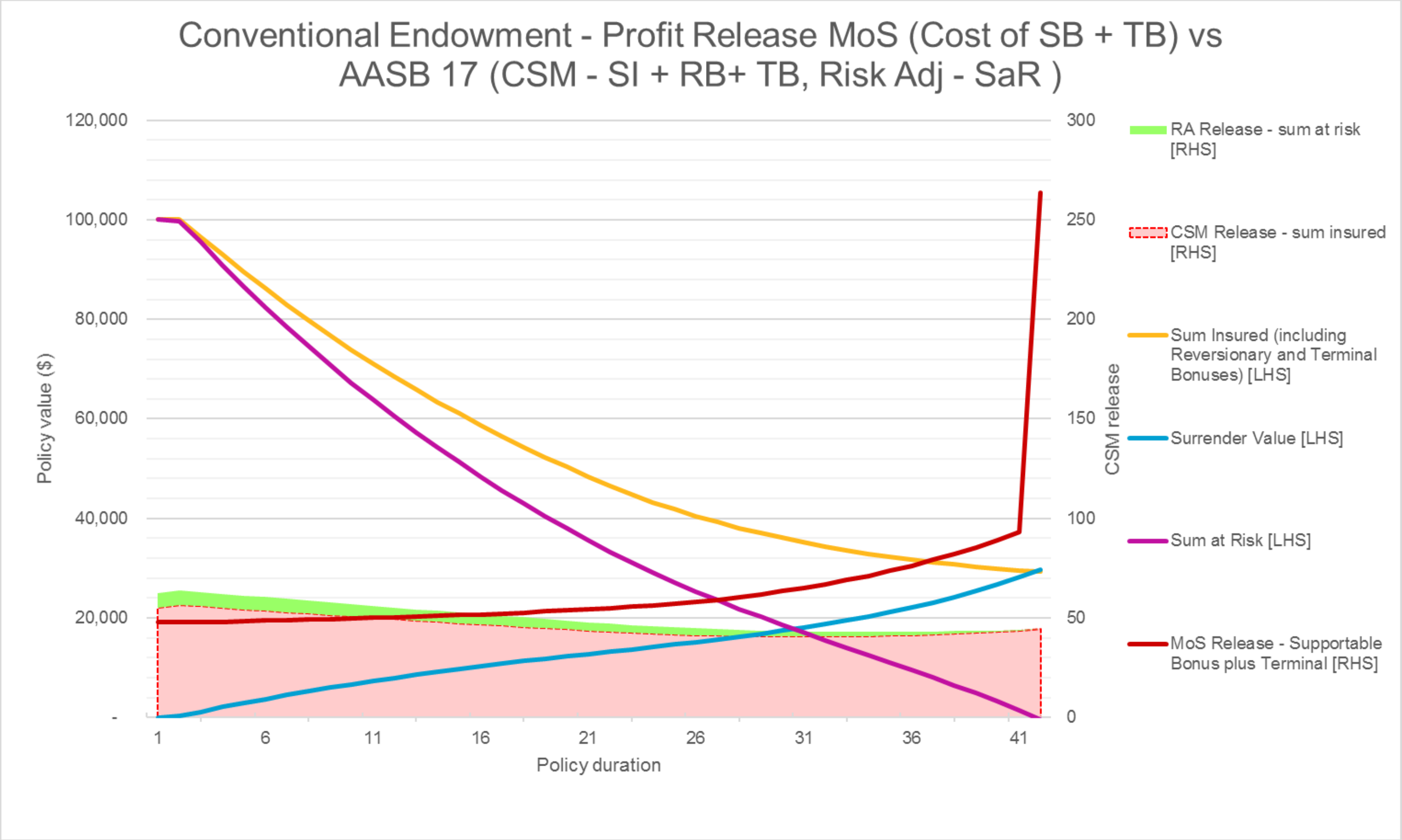


Profit Release - Drivers

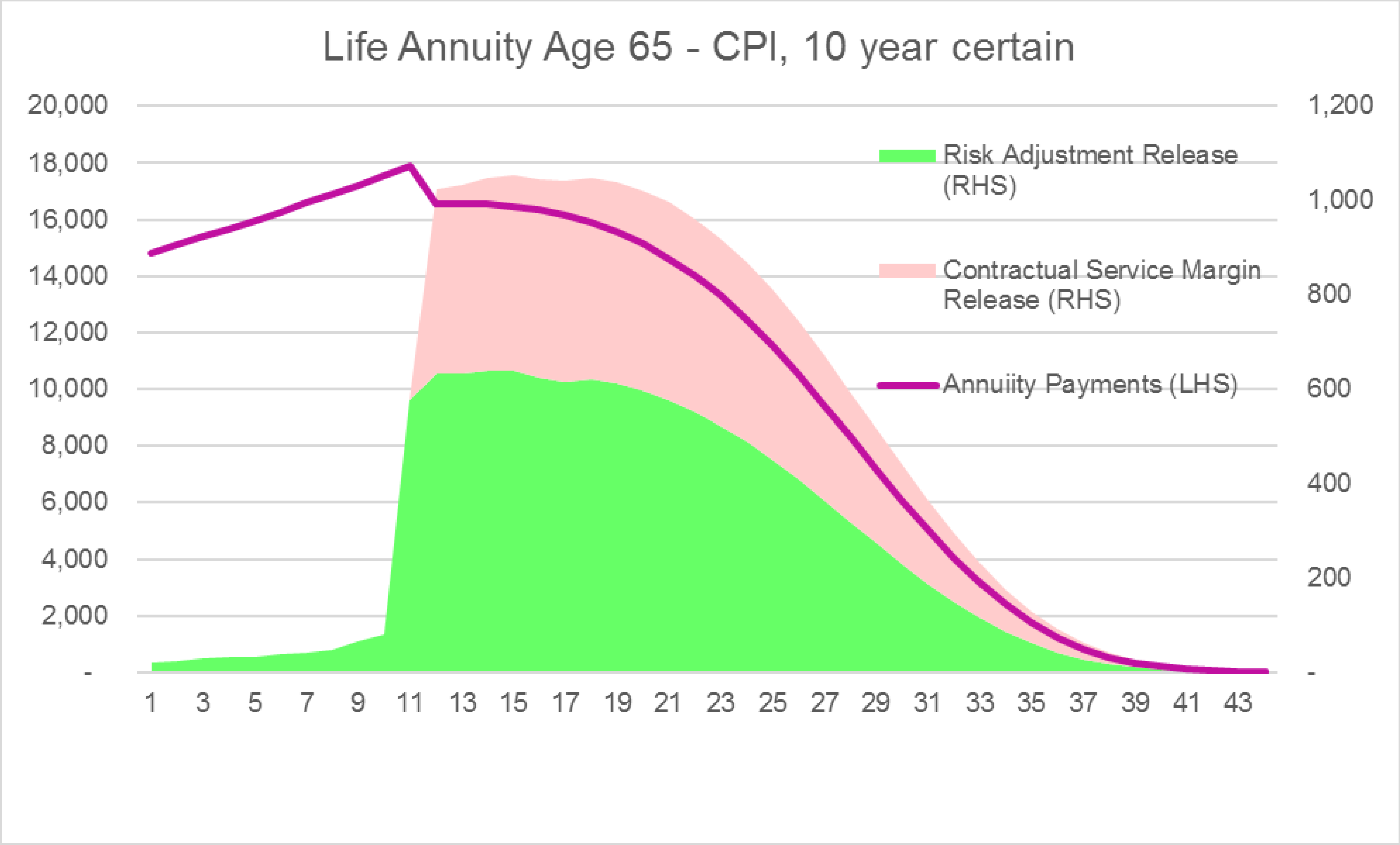
- Contractual Service Margin
  - Release based solely on insurance coverage (quantity of benefits and expected duration) unless qualifies for VFA (use insurance and investment)
  - Updated for:
    - change in present value of expected cash flows at end of period; and
    - premium and investment component experience
  - Likely to be major source of profit for participating business and profitable risk business

- Risk Adjustment:
  - As released from non-financial risk
    - For future service; and
    - For incurred claims
  - Source of profit when:
    - Group is Onerous;
    - Insurance coverage ended
  - Likely to be major source of profit for annuities and income protection

Profit Release - Endowment



Profit Release – 10 yr certain Life Annuity

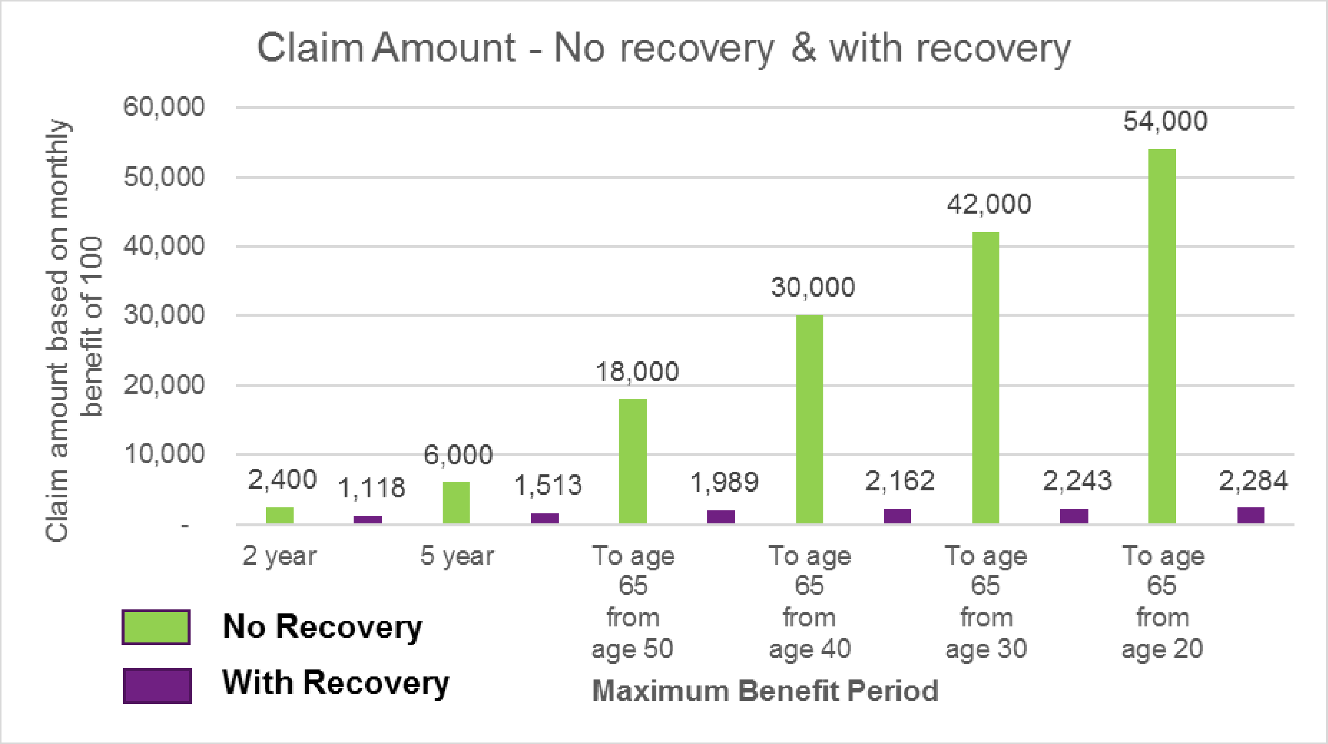


Profit Release – Income Protection

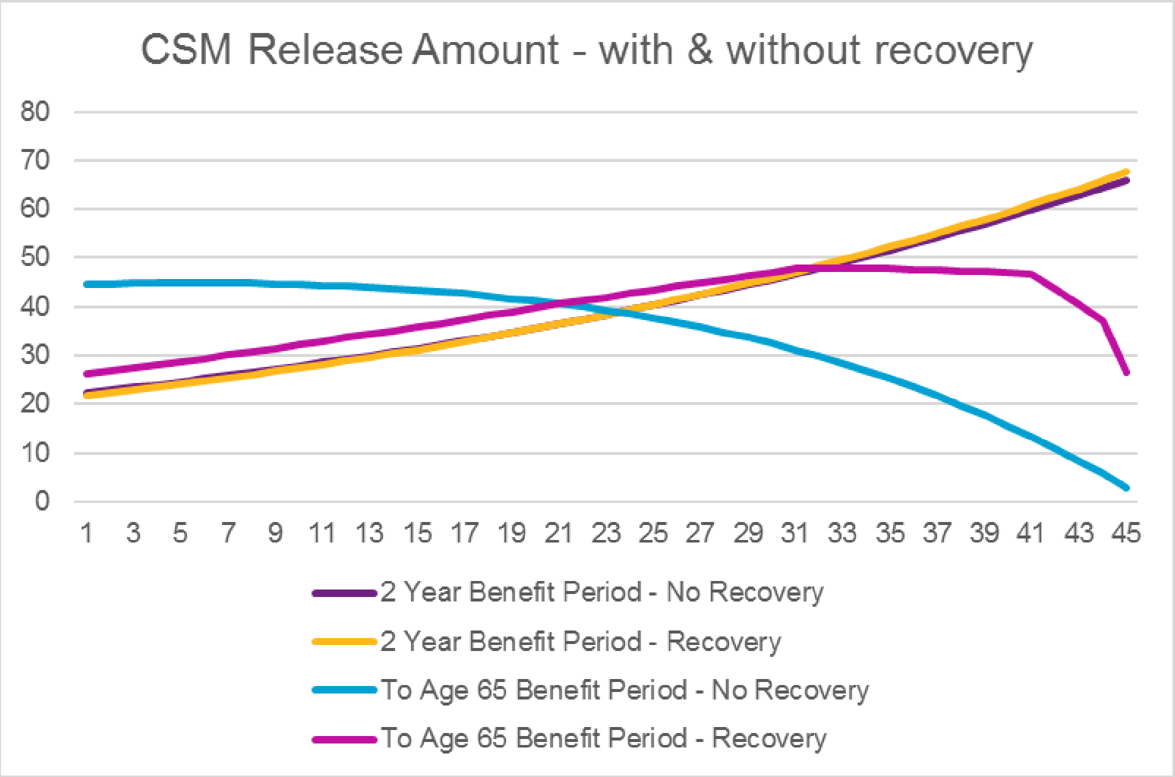
- Contractual Service Margin
  - Insurance coverage = maximum valid claim, i.e.:
    - sum (or pv) of monthly benefits potentially payable upon immediate claim to the end of the benefit period;
    - seems very unlikely that you can allow for recoveries in this
  - Where the benefit period is to age 65 this up fronts profit release
  - Probably not an issue if your IP book is in loss recognition

- Risk Adjustment:
  - Likely to be a major source of profit for income protection
  - Most of it will sit on your incurred claims, with lower amount on active lives
  - This means risk adjustment will:
    - absorb profit in early years as open claims build up; and
    - release profit in later years as claims run off and lapses mean fewer new claims

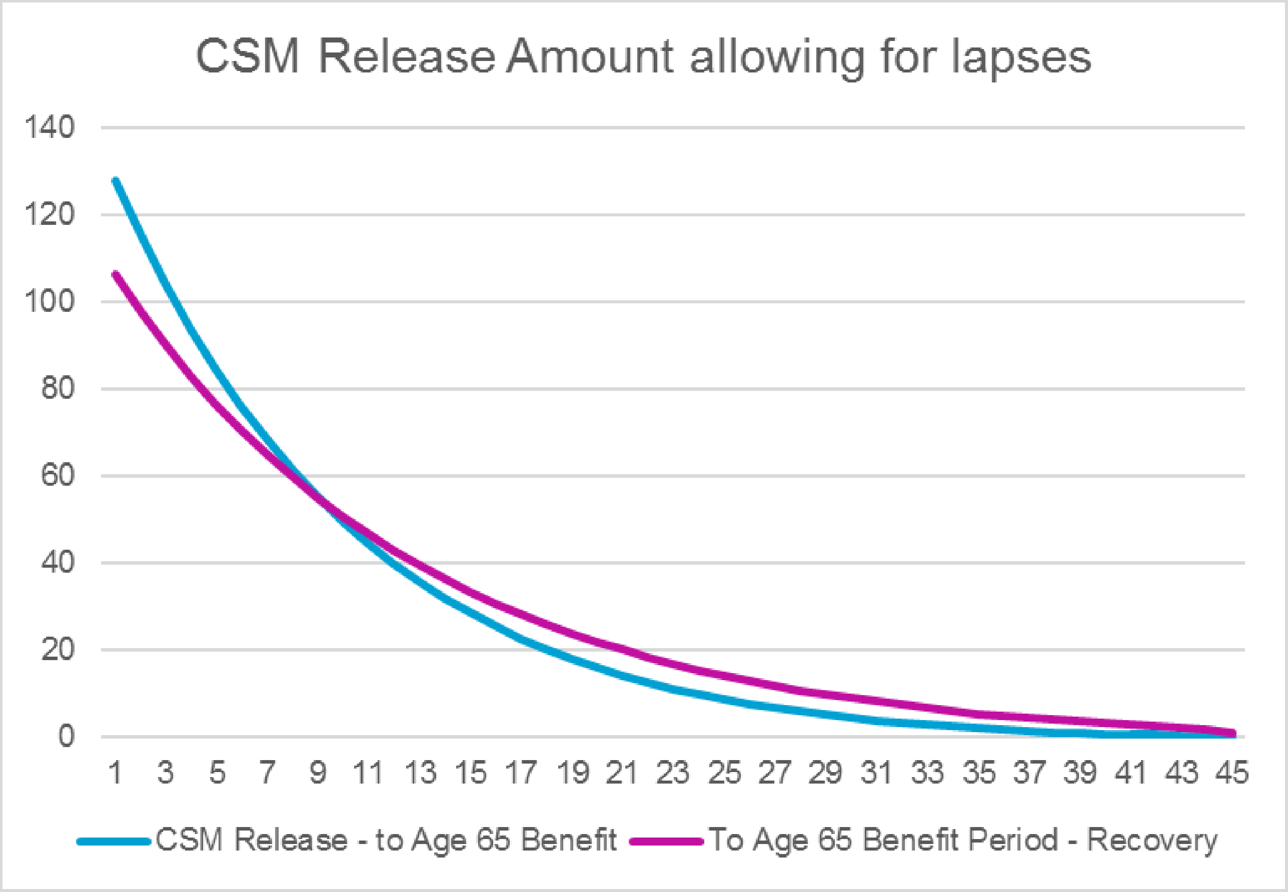
Profit Release – IP Coverage



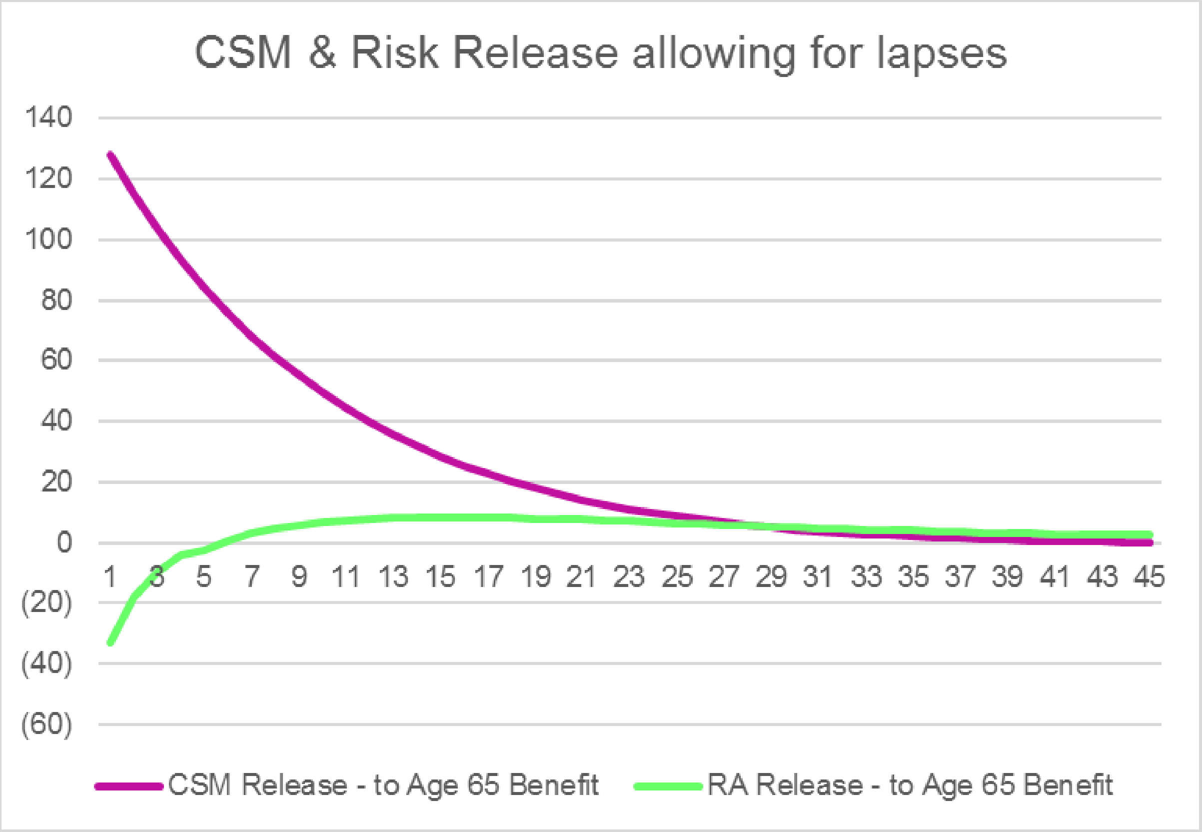
Profit Release – IP CSM



Profit Release – IP CSM with Lapses



Profit Release – IP With Lapses -CSM & Risk Adjustment



THREE AREAS OF "UNCERTAINTY"

3 areas of “uncertainty”

- Premium received
- Reinsurance
- Unbundling

Premium received

- Under PAA, the liability for remaining coverage (UEP) is to include only premium received by groups of insurance contract and precludes the recognition of premium receivables. Ref 55 (a) (i) and 55 (b) (i)
- The core requirement specifies experience adjustment to CSM for premium received for future service (not premium due).

- This is a significant change to current practice.
- There is global support for change in standard.

Reinsurance

- Reinsurance must be accounted for as an asset and considered <u>independently</u> from the gross liability.
- This means <u>significant accounting mismatch</u> can occur :
  - The underlying contract can be short term but the reinsurance contract can be long term,
  - The impact of assumption change can be significantly different : lapses, discount rates
- A reinsurance contract can not be onerous. AASB 17.68
- There is no offset for onerous contract at inception, even if it is 100% ceded.

➔ Profit emergence can be unusual and/or unintended, in some cases not intuitive considering the economics of the contracts.

Unbundling

- Under AASB 17, separation of investment and insurance contracts are only permitted and required if either component is able to lapse without the other also lapsing. AASB 17.11 and AASB 17 B31,32

- In 2005, Australian insurers unbundled insurance riders from investment component.

- Potentially have to rebundle investment component with insurance riders and value the combined contract as insurance contracts.

QUESTIONS