IFRS 17 Insurance Contracts
Breakfast Briefing Series ‘Deep Dive’ event
11 July 2017
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<td>Eimear McCarthy</td>
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**IFRS 17 Insurance Contracts**
Introduction
Introduction

Insurance IFRS

Counting cost or maximising benefit?

Insurance companies have been waiting over a decade for a single global accounting standard that fits their unique and complex industry. Deloitte understands the insurance industry and its need to gain improved economics of scale and minimise duplication through mandated regulatory change.
Recognition, modification and de-recognition
Recognition
An entity shall recognise a group of insurance contracts it issues from the earliest of:

• Beginning of the coverage period;
• The date when the first payment from a policyholder becomes due; or
• When the group becomes onerous.

Modification
If the terms of an insurance contract are modified, an entity shall derecognise the original contract and recognise the modified contract as a new contract if there is a substantive modification, based on meeting any of the specified criteria.

De-recognition
An entity shall de-recognise an insurance contract when it is extinguished or substantially modified.
Recognition, Modification and De-Recognition

Conditions for recognising a modified contract as a new contract

There is substantive modification if inclusion of any of the modified terms below at contract inception would have produced one of the following effects:

- The modified contract is excluded from the scope of IFRS 17;
- An entity separates different components from the host insurance contract;
- The modified contract is allocated different cash flows;
- The modified contract is included in a different group of contracts;
- The original contract met the definition of a direct participation contract, but the modified contract no longer meets that definition, or vice versa;
- The entity applied the PAA to the original contract, but the modified contract no longer meets the eligibility criteria for PAA; or
- After modification, the conclusion about unbundling of components of an insurance contract would have changed.

Unless any of the above conditions are met, an entity shall derecognise an insurance contract only when the contract is extinguished (i.e. obligation expired or discharged or cancelled).
Recognition, Modification and De-Recognition

**Conditions for recognising modified contract as a new contract (contd.)**

If a contract modification meets **none** of the conditions, the entity shall:

- Recognise an obligation to provide any additional benefits that result from the contract modifications as a new contract;
- De-recognise the part of a contract relating to benefits eliminated by the contract modification; and
- Treat changes in cash flows that are not accompanied by a change in the level of benefits as changes in estimates of fulfilment cash flows.
Recognition, Modification and De-Recognition

Gains and losses on modification

• Any gains or losses that arise on modification are recognised as an adjustment to the cash outflows arising from the contract.

• When an entity derecognises an insurance contract, it shall recognise a gain or loss in P&L.

\[
\text{Gain/loss} = \frac{\text{Premium would have charged a contract with equivalent terms}}{-\text{carrying amount of the derecognised contract}}
\]
Unbundling of non-insurance components
Unbundling Under IFRS 17

• An insurer may need to separate/unbundle non-insurance components from an insurance contract.

• IFRS 17 has three different regimes to unbundle each of these three components.
Unbundling Under IFRS 17

Telling the difference

How do we know whether a contract issued by an insurance company is under the scope of IFRS 17, or whether it is under the scope of IFRS 9 or IFRS 15?
Unit of account / Level of Aggregation
Aggregation of contracts

- A **portfolio** is a group of contracts subject to **similar risks and managed together** as a single pool.
- The portfolio is then required to be disaggregated into **groups** of insurance contracts that at inception are:
  
  A. Onerous
  
  B. Profitable with no significant risk of becoming onerous; and
  
  C. Other profitable contracts
- There is decreasing ranking of the risk-adjusted profitability of the groups (B, C, A). B is the highest ranking risk-adjusted profitable group and A is the lowest (A is actually expected to be loss making).
- Further disaggregation of the specified groups is permitted.
- Only contracts issued **within the same twelve-month period** are permitted to be grouped. Groups for shorter periods are permitted. This period does not need to coincide with the annual reporting period of an entity.
- An entity shall establish the groups at initial recognition, and **shall not reassess** the composition of the groups subsequently.
Unit of account

Aggregation of contracts

Groups of Portfolio A

<table>
<thead>
<tr>
<th>Issue year 1</th>
<th>Issue year 2</th>
<th>Issue year N</th>
</tr>
</thead>
<tbody>
<tr>
<td>Onerous</td>
<td>Onerous</td>
<td>Onerous</td>
</tr>
<tr>
<td>No significant possibility of becoming onerous</td>
<td>No significant possibility of becoming onerous</td>
<td>No significant possibility of becoming onerous</td>
</tr>
<tr>
<td>Other</td>
<td>Other</td>
<td>Other</td>
</tr>
</tbody>
</table>

Portfolio A

Similar risk, managed together at initial recognition

Mutualisation exemption

Regulatory exemption
Measurement – General Model
Measurement Requirements

The general model a.k.a the building blocks approach ("BBA")

Principles

- Measurement uses current estimate assumptions
- Contracts are grouped by portfolio, year of sale and one of the three possible profitability levels
- Profit measured and reported based on the delivery of the "insurance coverage service"
- Deferred profit absorbs assumption changes for future coverage ("Unlocking")
- Discount rates based on market interest rates (currency, duration, liquidity)
- Expected profit from participating contracts revalued based on assets

Total IFRS Insurance Liability

Block 1: Expected Future Cash Flows (unbiased probability weighted mean)

Block 2: Time Value of Money

Block 3: Risk Adjustment

Block 4: Contractual Service Margin ("CSM")

Fulfilment cash flows

- Measured at inception as the expected contract profit to be earned as services are fulfilled.
- It is adjusted for changes in non-financial variables affecting future coverage cash flows. It accretes interest based on day 1 discount rate (locked-in rate)

An entity-specific assessment of the uncertainty about the amount and timing of future cash flows

An adjustment that converts future cash flows into current amounts

Expected (probability-weighted) cash flows from premiums, claims, benefits, expenses and acquisition costs
Building Block 1: Future Cash Flows

Best estimate cash flow, recognition & boundaries

### Requirement

- Recognition of contracts to be determined based on the earliest point in time of start of coverage period, date first payment is due from policyholder or where evidence contract will be onerous.
- Contract boundaries will need to be clear and explicit on the point at which the insurer is no longer required to provide coverage or can fully reassess and re-price the risk.
- Requirement to produce best estimate cash flows.

### Impact

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<thead>
<tr>
<th>Impact (H/M/L)</th>
<th>Life</th>
<th>Non-Life</th>
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</table>

- Recognition – earlier of the three dates specified (incl. non incepted contracts).
- Boundaries – analysis to be performed taking into account characteristics of contracts.
- Best estimate cash flows – common concept to Solvency II/MCEV but the actual cash flows can differ.
Building Block 1: Future Cash Flows

Directly attributes acquisition cash flows

**Requirement**

- Insurance companies that issue insurance contracts and investment contracts have to treat directly attributable acquisition costs differently (insurance contracts at group level / investment contracts at contract level).

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- Flexible and adequate cost accounting systems in place for initial and subsequent measurement.
Building Block: Future Cash Flows

Cash flows included and excluded in best estimate cash flows

**Cash flow included:**
- Premiums and cash flows that arise within the “contract boundary”
- Claims and benefits paid to policyholders, plus associated costs
- Surrender and participating benefits
- Cash flows resulting from options and guarantees
- Costs of selling, underwriting and initiating that can be directly attributable to a portfolio level
- Transaction-based taxes and levies
- Policy administration and maintenance costs
- Some overhead-type costs such as claims software, etc.

**Cash flow excluded:**
- Investment returns
- Payments to and from reinsurers
- Cash flows that may arise from future insurance contracts
- Acquisition costs not directly attributable to obtaining the portfolio of contracts
- Cash flows arising from abnormal amounts of wasted labor
- General overhead
- Income tax payments and receipts
- Cash flows from unbundled components
Discount Rates

How will discount rates be determined?

### Top-Down Approach

<table>
<thead>
<tr>
<th>Yield curve based upon actual or reference asset portfolio</th>
<th>Unexpected loss adj.</th>
<th>Expected loss adj.</th>
<th>DISCOUNT RATE IFRS 17</th>
</tr>
</thead>
</table>

Remove factors that are not relevant to the insurance contracts (such as market risk premiums for assets included in the reference portfolio) and adjust for differences between timing of cash flows between the assets and the cash flows of insurance contracts.

### Bottom-Up Approach

- **Liquidity adj.**
- **Risk-free rate**

A “risk-free rate” plus a liquidity adjustment based on the characteristics of liability cash flows.

Dependent on:
1. Duration
2. Liquidity
3. Currency
Building Block 2: Discounting

Discount Rates

**Requirement**

- Insurers are required to discount future cash flows to a present value basis.
- Yield curve may be determined using “top down” or “bottom up”.
- Need to adjust discount rate for
  - duration mismatch; and
  - expected credit losses on reference asset/portfolio of assets.
- If cash flows depend (wholly or partly) on the returns of underlying items, the discount rate to measure those cash flows shall reflect the extent of that dependence.

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<td>H</td>
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</tbody>
</table>

- Insurers are familiar with discounting but a methodology for calculating discount rates will need to be developed which could have a significant impact on modelling, systems and data. Insurers should consider whether RBC/EV methodology is appropriate for IFRS reporting or whether a new methodology is needed.
- Complexity of discount rates for cash flows depending on the returns of underlying items.
Building Block 3: Adjustment

Risk adjustment

Requirement
• Additional disclosure of equivalent confidence interval requirement for an adjustment for the effect of uncertainty (risk adjustment) about the amount and timing of future cash flows.
• An insurer can use one of the following techniques for estimating risk adjustments: confidence level, conditional tail expectation, cost of capital or other techniques.
• Determination of separate risk adjustment for claims liabilities (life and non-life) is required.

Impact

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• New concept for IFRS but Solvency II or equivalent risk margin approaches could potentially be leveraged.
Building Block 4: Contractual Service Margin

Contractual Service Margin ("CSM")

**Requirement**

- Eliminates gains at inception of a contract.
- The release of the CSM is over the coverage period based on coverage units.
- Measured at “group” level (units of account).
- Requirement to “unlock” CSM for changes in non-market assumptions at each reporting date.
- Negative CSM (onerous losses) needs to be tracked for potential reversal to P&L.

**Impact**

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<th>Non-Life</th>
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- Brand new concept for IFRS – impacting the timing of profit recognition.
- Unlocking will require integration between finance and actuarial systems and introduces additional data requirements.
- Limited impact for non-life when PAA is adopted for the pre-claims liability where the full CSM will be implicitly reported.
Illustrative Example

Measuring and insurance contract using the general model

**Facts:**
- A group of similar insurance contracts.
- Single premium, paid at inception of the contract (i.e. at $t=0$).
- Contract covers risk of insured event over the next 5 years.
- No claims expected for first 4 years. At the end of the fifth year, a claim of €500 is expected to be settled.
- Assume risk adjustment to be zero; discount rate of 3%.
- The entity would measure the fulfilment cash flows and CSM at inception ($T^0$) as follows:

<table>
<thead>
<tr>
<th>Time</th>
<th>Components of the insurance contract liability</th>
<th>Nominal amount</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$T^0$</td>
<td>Expected inflows</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>$T^5$</td>
<td>Expected outflows</td>
<td>(500)</td>
<td>(431)</td>
</tr>
<tr>
<td></td>
<td>i) Net expected cash flows</td>
<td></td>
<td>69</td>
</tr>
<tr>
<td></td>
<td>ii) Risk Adjustment</td>
<td></td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>iii) Fulfilment cash flows at inception (i+ii)</td>
<td></td>
<td>69</td>
</tr>
</tbody>
</table>
|      | iv) Contractual Service Margin \[
|      | \[\max(0, - (Fulfilment Cashflows))\]\] | | (69) |
|      | v) Total IFRS 17 Insurance contract liability (iv + v) | | 0 |
## Subsequent measurement under BBA

### Impact of assumption changes and experience variance

<table>
<thead>
<tr>
<th></th>
<th>CSM</th>
<th>OCI</th>
<th>P&amp;L</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lapse/Surrender</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Mortality</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Morbidity</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Other claims incidence and recovery rates for active lives</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Acquisition expenses with direct link</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Maintenance expense</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Expense inflation</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Investment expenses</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Discount rate</td>
<td></td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Risk adjustment</td>
<td></td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Expected credit losses on RI assets</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Claims recovery rates for claim cases</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>IBNR assumptions</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Other assumptions in respect of past coverage</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
</tbody>
</table>
Scenario 1: Perfect estimation

**FACTS**

- Single premium, €900.
- Coverage period of **three years**.
- Expected claims outflow of €200 at the end of each year – all claims paid when incurred. i.e. **€600 of claims expected over the next 3 years**.
- Each contract carries the same amount of **benefits** therefore **amortisation of CSM is approximately straight-line**.
- For simplicity, the example assumes that:
  - The time value of money, lapses and the risk adjustment are immaterial; and
  - The actual cash outflows is exactly the same as expected on initial inception.

**QUESTIONS**

1. What are the expected cash flows and CSM on initial inception, year 1, year 2 and year 3?
2. What is the insurance contract liability at the end of each period?
3. What is the profit/loss for each period?
### Scenario 1: Working schedules

<table>
<thead>
<tr>
<th>Expected Cash Flows</th>
<th>Initial recog.</th>
<th>Yr 1</th>
<th>Yr 2</th>
<th>Yr 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected cash outflows</td>
<td>600</td>
<td>400</td>
<td>200</td>
<td>0</td>
</tr>
<tr>
<td>Expected cash inflows</td>
<td>(900)</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Fulfilment cash flows</td>
<td>(300)</td>
<td>400</td>
<td>200</td>
<td>0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Reconciliation of CSM</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>300</td>
<td>300</td>
<td>200</td>
</tr>
<tr>
<td>Recognised in P&amp;L</td>
<td>0</td>
<td>(100)</td>
<td>(100)</td>
</tr>
<tr>
<td>Change in the estimate of future cash outflows adjusted to margin</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Closing balance</td>
<td>300</td>
<td>200</td>
<td>100</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Insurance contract liability</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0</td>
<td>600</td>
<td>300</td>
</tr>
</tbody>
</table>

#### Statement of Profit or Loss and Other Comprehensive Income

<table>
<thead>
<tr>
<th>Total</th>
<th>Yr 1</th>
<th>Yr 2</th>
<th>Yr 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Release of CSM</td>
<td>300</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Estimated claims</td>
<td>600</td>
<td>200</td>
<td>200</td>
</tr>
</tbody>
</table>
**Insurance revenue** | 900 | 300 | 300 | 300 |
| Actual incurred claims | (600) | (200) | (200) | (200) |
| Amount immediately recognised in P&L | 0 | 0 | 0 | 0 |
| Profit / (loss) | 300 | 100 | 100 | 100 |

#### Profits over the contract term

- Year 1: 150
- Year 2: 300
- Year 3: 300
Scenario 2: Overestimation of expected cash outflows

FACTS
Same facts and assumptions as Scenario 1
However,
• The actual cash outflows or claim paid for the year 2 is only €150, which is €50 less than expected.
• As a result, at the end of year 2, the entity revises its estimated cash outflows to €150 for the year 3.

QUESTIONS
1. What are the expected cash flows and CSM in year 2 and year 3?
2. What is the insurance contract liability in year 2 and year 3?
3. What is the profit/loss for year 2 and year 3?
### Scenario 2: Working schedules

<table>
<thead>
<tr>
<th>Expected cash flows</th>
<th>Initial recog.</th>
<th>Yr 1</th>
<th>Yr 2</th>
<th>Yr 3</th>
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<tr>
<td>Expected cash outflows</td>
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<td>0</td>
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<tr>
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<td>(900)</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Fulfilment cash flows</td>
<td>(300)</td>
<td>400</td>
<td>150</td>
<td>0</td>
</tr>
</tbody>
</table>

### Reconciliation of CSM

| Opening balance | 300 | 300 | 200 | 150 |
| Recognised in P&L | 0 | (100) | (100) | (150) |
| Decrease in the estimate of future cash outflows added to margin | 0 | 0 | 50 | 0 |
| Closing balance | 300 | 200 | 150 | 0 |

### Insurance contract liability

| Insurance contract liability | 0 | 600 | 300 | 0 |

### Statement of Profit or Loss and Other Comprehensive Income

<table>
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<th>Total</th>
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<tr>
<td>Actual incurred claims</td>
<td>(500)</td>
<td>(200)</td>
<td>(150)</td>
</tr>
<tr>
<td>Amount immediately recognised in P&amp;L</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Profit / (loss)</strong></td>
<td>400</td>
<td>100</td>
<td>150</td>
</tr>
</tbody>
</table>

### Profits over the contract term

- **Year 1**: 0
- **Year 2**: 100
- **Year 3**: 150

(IFRS 17 Insurance Contracts)
Measurement – Variable Fee Approach
Deep dive 2: Variable fee approach

- Modification to the general approach for valuing insurance contracts with payments that vary with return on underlying items, e.g.
  - Unit-linked (with insurance risk)
  - With-profits

- Treats returns on the assets underlying these contracts as part of the fee that the entity charges the policyholder for the services provided

- CSM at inception is the same as general model. CSM subsequently differs from general model:
  - CSM adjusted for financial assumption changes
  - Includes changes to the value of risk mitigation for guarantees, unless these are ‘formalised’
  - CSM has interest accretion at current rates

- The CSM under VFA cannot be calculated prospectively

- Benefit of VFA is that it eliminates artificial volatility in the Profit & Loss
Comparison of VFA to BBA

Impact of changes in assumptions

No change in assumptions

Change in financial assumptions

Change in underlying items

IFRS 17 Insurance Contracts
Comparison of VFA to BBA
Discount rates used to determine CSM adjustments

**Interest accretion**

At inception, the CSM is determined as a discounted amount.

Over time, the effect of that discounting should be reversed.

The unwinding of the discounting recognised at inception is referred to as accretion.

- **General measurement model**
  - The interest is accreted using the rate locked in at inception of the contract.

- **Variable fee approach**
  - Although the CSM is not a cash flow in itself, and the IASB has concluded that it cannot be remeasured, the interest is implicitly accreted in the change of the variable fee thus using the current interest rate.
Measurement – Premium Allocation Approach
The Premium Allocation Approach (PAA) is a simplified approach to measuring the liability for remaining coverage only.

The key simplification is to exempt the insurer from calculating and explicitly accounting for the CSM, the main component of the liability for remaining coverage.

It does not apply to the liability for incurred claims for which the general measurement model/BBA always apply.

Contracts with investment components are also eligible to use the PAA, but revenue needs to be reported the same way as in the general model (i.e. disaggregate the investment components for presentation purposes).

The primary impact of the PAA is that it allows non-life insurers to continue to use their process and systems for calculating unearned premiums amounts.
Premium Allocation Approach (PAA)

Criteria

When to use the Premium Allocation Approach:

1. If it would be a reasonable approximation to BBA and the coverage period at initial recognition is more than one year

OR

2. If the coverage period at initial recognition is one year or less

- Applies to liability for remaining coverage only

- Applicable for yearly-renewable term life and short-term health rider products

1 is not met if at the inception of the group an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the liability for remaining coverage during the period before a claim is incurred.
### Premium Allocation Approach (PAA) Specifics

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Description</th>
<th>Impact</th>
</tr>
</thead>
</table>
| **Onerous contracts** | • An insurer will need to hold an additional liability for onerous contracts where PAA is used over the coverage period and for signed but not yet incepted contracts that are onerous.  
  • An insurance contract is onerous if the expected PV of the future cash outflows from the insurance contract plus Risk Adjustment > expected PV of future cash inflows and the carrying amount of the liability for the remaining coverage period, if any. | • Evolution of existing approach to assessing unexpired risk reserves.  
  • New measurement of onerous contracts based on BBA.  
  • Applies for groups measured using PAA and for signed but not yet incepted contracts that are onerous. |
| **Interest Accretion** | • Accrete interest unless the term from coverage to incurred loss event is less than 1 year.                                                                                                                    | • Accretion of interest during the coverage period using the initial recognition discount rate.   |
# Premium Allocation Approach (PAA) Measurement

## PAA Insurance Liability

| Liability at initial Recognition | + Premium received at initial recognition  
|                                  | - Insurance acquisition cash flows  
|                                  | + Any onerous contract liability recognised |

| Liability at each subsequent reporting period | + Previous Liability  
|                                              | + Premiums received in the period  
|                                              | - Insurance acquisition cash flows  
|                                              | + Any onerous contract liability recognised  
|                                              | - Amount recognised as insurance revenue for the coverage provided in that period  
|                                              | + Amount recognised as the amortisation of acquisition cash flows  
|                                              | + Any adjustment to reflect the time value of money (if applicable) |
Premium Allocation Approach (PAA)

Comparison of BBA and PAA

Acronym key

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Risk adjustment is recognised over combined coverage and claims handling period.
Risk Adjustment
What is a risk adjustment liability?

- Risk adjustment for non-financial risk (RA) measures the compensation that the entity requires for it to be indifferent/neutral between fulfilling a liability that:
  1. Has a range of possible outcomes arising from non-financial risk; and
  2. Will generate fixed cash flows with the same expected present value as the insurance contracts.

- Risk adjustment is the compensation that the entity requires for bearing uncertainty about the amount and timing of cash flows that arise from non-financial risk.

- Risk adjustment reflects:
  a) diversification of risks the insurer considers, and
  b) both favourable and unfavourable outcomes reflecting the entity’s degree of risk aversion.

- Risk adjustment reflects all non-financial risks associated with the insurance contracts. It shall not reflect financial risks or risks that do not arise from the insurance contracts.

- The risk adjustment is an entity specific measurement.
Risk adjustment

Example

A cash flow with 50% chance of a €110 outflow and a 50% chance of a €90 outflow in the next year, has an expected value of €100 outflow.

Similarly, a cash flow with a 50% chance of a €200 outflow and a 50% chance of a €0 outflow in the next year, has an expected value of €100 outflow also.

However, if an entity would want to cede this cash flow into the market, the price the market is willing to accept would be different for both cash flows, despite having the same expected return.

Due to the increased variability of the 2nd cash flow, the market will tend to require a higher premium than the 1st cash flow, on top of the expected €100 outflow, in order for them to be willing to take on the liability.
Criteria for suitable risk adjustments

Key accounting requirements

Despite no restrictions on the technique that is allowed to use for determining the risk adjustment, the risk adjustment shall have the following characteristics:

- risks with low frequency and high severity will result in higher risk adjustments than risks with high frequency and low severity;
- for similar risks, contracts with a longer duration will result in higher risk adjustments than contracts with a shorter duration;
- risks with a wide probability distribution will result in higher risk adjustments than risks with a narrower distribution;
- the less known about the current estimate and its trend, the higher the risk adjustment; and
- to the extent that emerging experience reduces uncertainty about the amount and timing of cash flows, risk adjustments will decrease and vice versa.

The entity shall also consider whether the technique provides concise and informative disclosure so that users of financial statements can benchmark the entity’s performance against the performance of other entities.
Risk adjustment techniques & approaches
How do we calculate risk adjustment?

IFRS 17 does not specify the technique to determine the risk adjustment.

Three main methods commonly discussed in market today:

A. Cost of capital

B. Quantile (e.g. Value at Risk or Conditional Tail Expectation)

C. Explicit assumption (e.g. factor-based or judgment based on experience studies)

• Disclosure of confidence level required irrespective of the technique used to measure the risk adjustment.

• Risk adjustment is explicit - balances for unexpired coverage liability and for claims liability must be disclosed separately.
Cost of Capital ("CoC") approach

Principle

• CoC approach determines the capital amount which the entity would expect to hold for bearing the risk and the costs for holding such capital:

\[
Risk \text{ Adjustment} = \sum_{t=0}^{n} \frac{Capital_t \times CoC \ Rate}{(1 + discount \ rate_t)^t}
\]

  o Popular approach and intuitive.
  o Reflects estimated cost of holding required capital to meet obligations with high confidence.

• Calculations relatively straightforward, but significant judgement and expertise required to design and implement.

  1) Capital base - What basis? What components? How to project forward?
  2) CoC rate - What is cost of indifference that reflects the risk of the liability?
  3) Discount rate - only straightforward component – consistent with BEL.

• Disclosure of a confidence level still required.
Quantile approach

Principle

Quantile approaches set a margin equal to a selected distribution of probabilities.

Confidence level - Value at Risk ("VaR"):  
- Derives the margin required such that the probability of the actual liability outcome leading to insolvency is below a specified confidence interval.
- Easy to communicate disclosure requirements.
- Less intuitive than Cost of Capital approach, but provides a more stable disclosure.

Conditional Tail Expectation ("CTE") or Tail VaR:  
- Margin calculated as the probability weighted average of all scenarios in the chosen tail of the distribution less the mean estimate.
- Shows expected outcome condition there is a shortfall, a better reflection of extreme losses.
- May be more appropriate for distributions that are not statistically normal.
Explicit assumptions approach

Key features of this approach

This approach is also known as PAD (Provision for Adverse Deviation).

- Margin associated with individual assumptions
  - For example: 10% of mortality, 5% of lapse
- Possibly easiest to reflect
- Potentially difficult to measure as confidence internal
- Consistent with many current valuation methods
- Computationally intensive
Closing remarks
Deloitte Next Steps

Series of upcoming breakfast briefings:

AUGUST 2
Understanding the financial and practical impacts for reserving

SEPTEMBER 5
Understanding the impact across the entire business: from IT to actuarial and finance

- Launch of new series of “on demand webcasts” and eminence papers on topical issues that will follow the insurers’ IFRS 17 journey to implementation
- Publication of an IFRS 17 practical guide
- Deloitte interpretative guidance on IFRS 17 will be released continuously on our online accounting research tool IASPlus.com
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