Howden Tiger

HOWDEN

IFRS-17 – key implications for reinsurers and clients

February 2024

Strategic Advisory, International

Support, insights and analysis offered by Howden Tiger, tailored to specific client needs

Stakeholder

- ✓ Board / investor
- ✓ Client
- ✓ Market
- ✓ Rating implications (in conjunction with RAA)

Regulatory

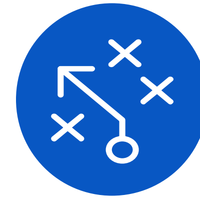
- ✓ Solvency II (EIOPA)
- ✓ IFRS-17 (IASB)
- ✓ Regional (e.g. BMA, CIRC, OSFI, APRA, FINMA, PRA, etc)

Asset-side

- ✓ Counter-party
- ✓ Reinsurer selection
- ✓ Asset-liability matching
- ✓ Yield enhancement
- ✓ Investment return analysis

Underwriting

- ✓ Market landscape
- ✓ Peer comparisons (e.g., geography, segment)
- ✓ Cost of capital
- ✓ Reinsurance programme efficacy
  - ➢ Traditional
  - ➢ Securitised



Strategic

- ✓ Corporate structure (e.g. platform, domicile selection)
- ✓ Capital comparison (debt, equity, hybrids, reinsurance) Captive strategy
- ✓ Start-up planning
- ✓ Enterprise risk management
- ✓ Sustainability advisory
- ✓ Execution (e.g. organic, inorganic)

HOWDEN

Agenda

01. Introduction to IFRS 17

02. The general measurement model

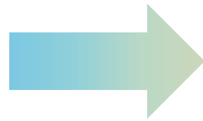
03. The GMM: ‘building blocks’ approach

04. The Premium Allocation Approach

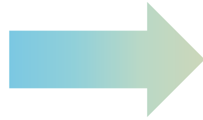
05. Reinsurance specific themes

06. Q&A

“What even is IFRS17…?”

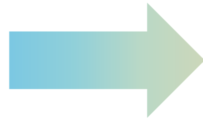


IFRS17 was introduced on 1st January 2023, as the new insurance industry accounting standard.



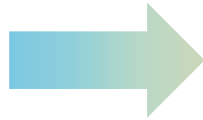
Its purpose was to bring carrier financial reporting under an internationally unified framework, replacing the diverse applications pursued under the previous IFRS 4 regime.

A key issue faced by IFRS 4, which IFRS 17 was intended to tackle, was a lack of a reserve discounting framework.

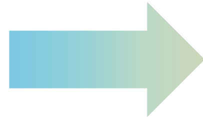


This drove a significant dispersion of reserving methodologies, including a prudency buffer under IFRS4.

“What even is IFRS17…?”



Combines current measurement of future cash flows with the recognition of profit over the period services are provided under then contract



Presents insurance service results separately from insurance finance income or expenses

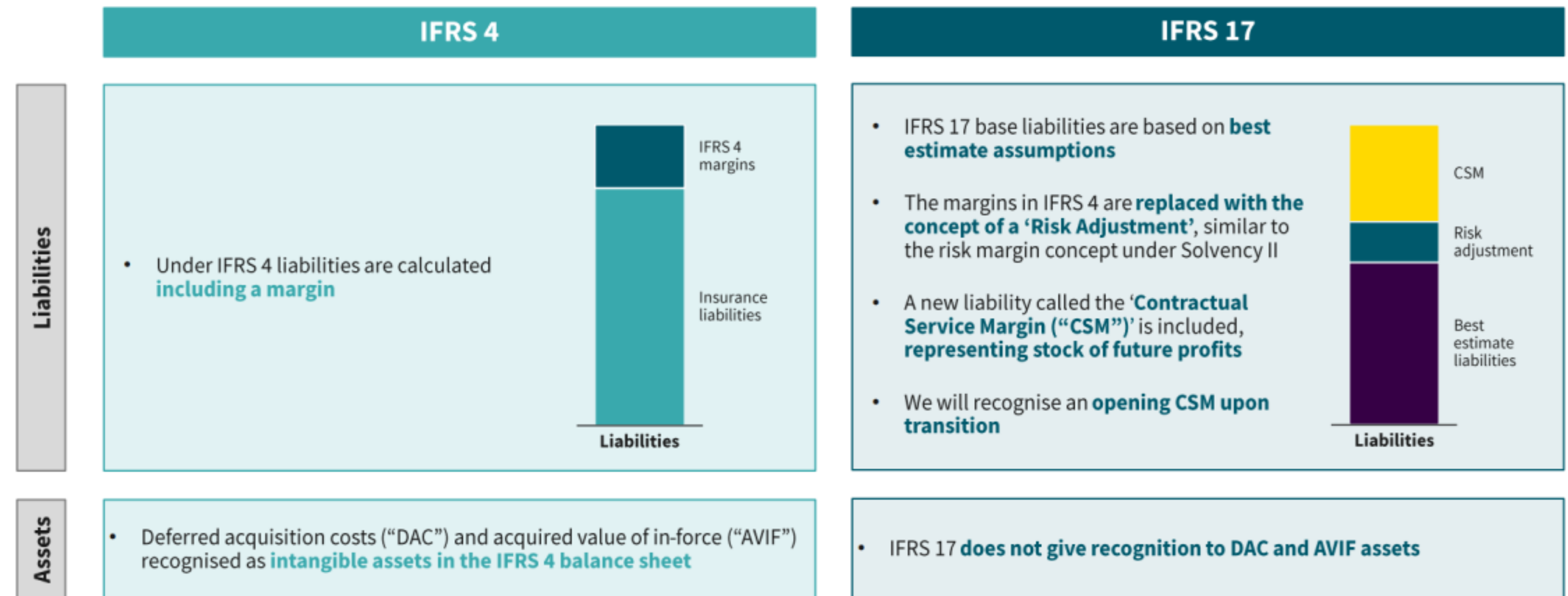
Requires an entity to make an accounting policy choice whether to recognise all insurance finance income or expense for the reporting period in P&L on a portfolio basis, or to recognise some of that income or expense in OCI

01.Introduction to IFRS17

Transition from IFRS 4 to IFRS 17

Insurance liabilities under IFRS 17 are on a 'best estimate' basis, discounted using a similar methodology to that under Solvency II, namely at 'risk free' plus a spread to account for an assumed illiquidity premium on backing assets.

Prudency margins under IFRS 4 are replaced with a 'risk adjustment' to allow for non-hedge-able risks, again similar to the concept of the risk margin under Solvency II.

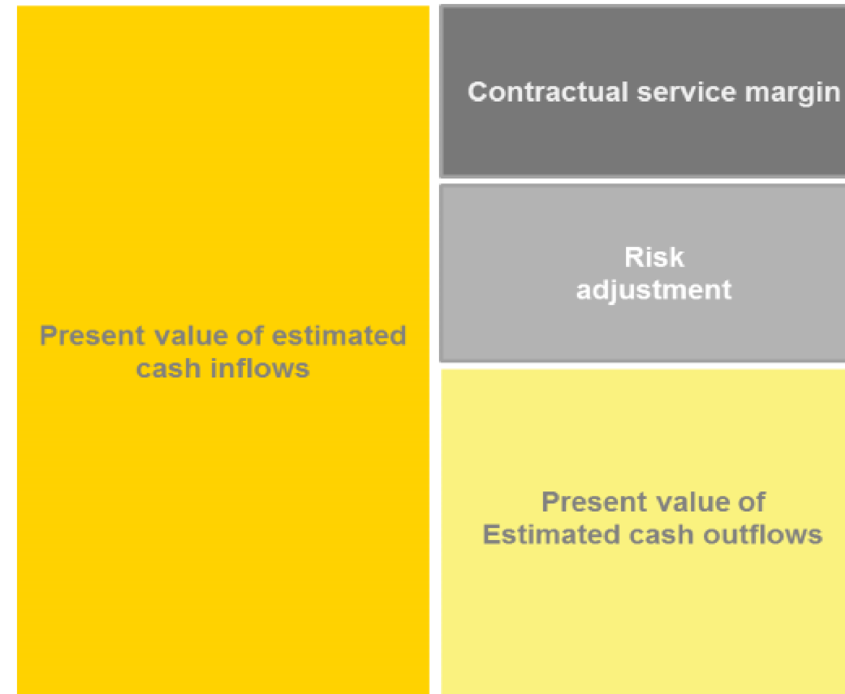


IFRS 17 aims to bring assets and liabilities closer to a 'market consistent' basis, making it more closely aligned to Solvency II than IFRS 4

02. The general measurement model

The default approach to measuring groups of insurance contracts under IFRS 17 is the ‘general measurement model’ (‘GMM’)

- The basic revenue recognition principle under IFRS 17 is that no profit is recognised on initial recognition of a group of insurance contracts,
- A loss must be recognised if the group of contracts is onerous
- Subsequently, profit and revenue are recognised as services are performed under the contract.



The distinguishing new feature introduced under IFRS 17 is the contractual service margin (‘CSM’)

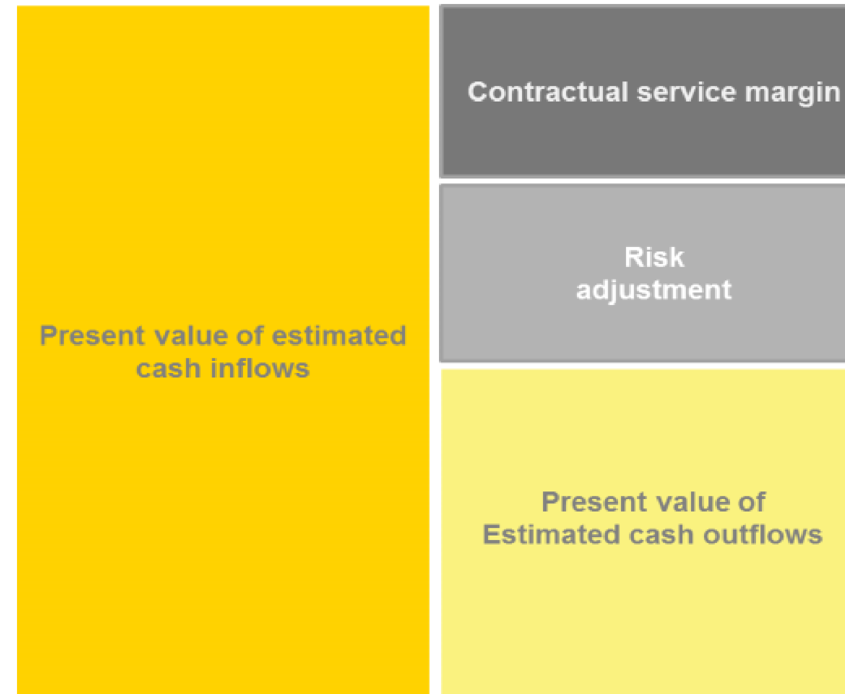
02. The general measurement model

After initial recognition of a group of insurance contracts, the carrying amount of the group at each reporting date is the sum of:

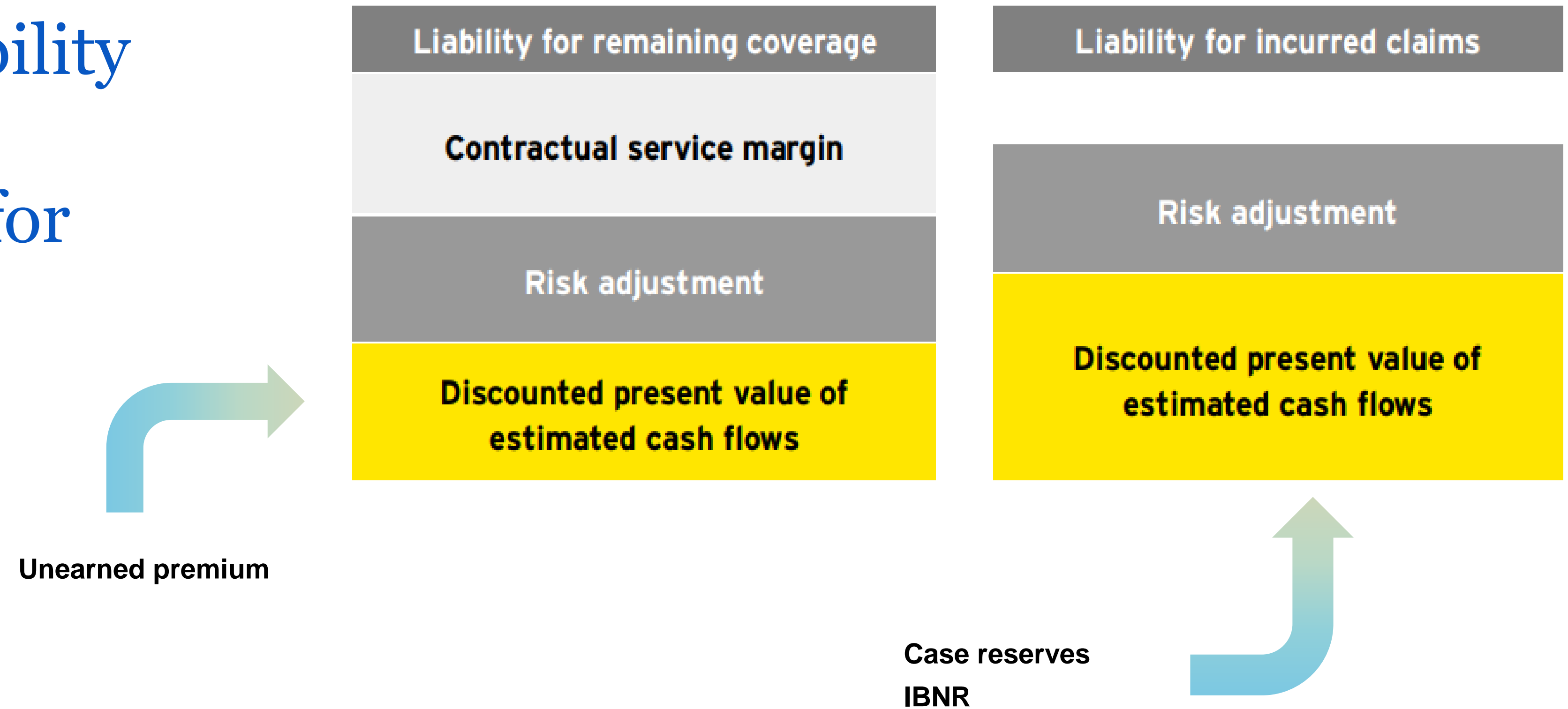
- The liability for remaining coverage, comprising:

1. The fulfilment cash flows related to future service allocated to the group at that date
2. The contractual service margin of the group at that date

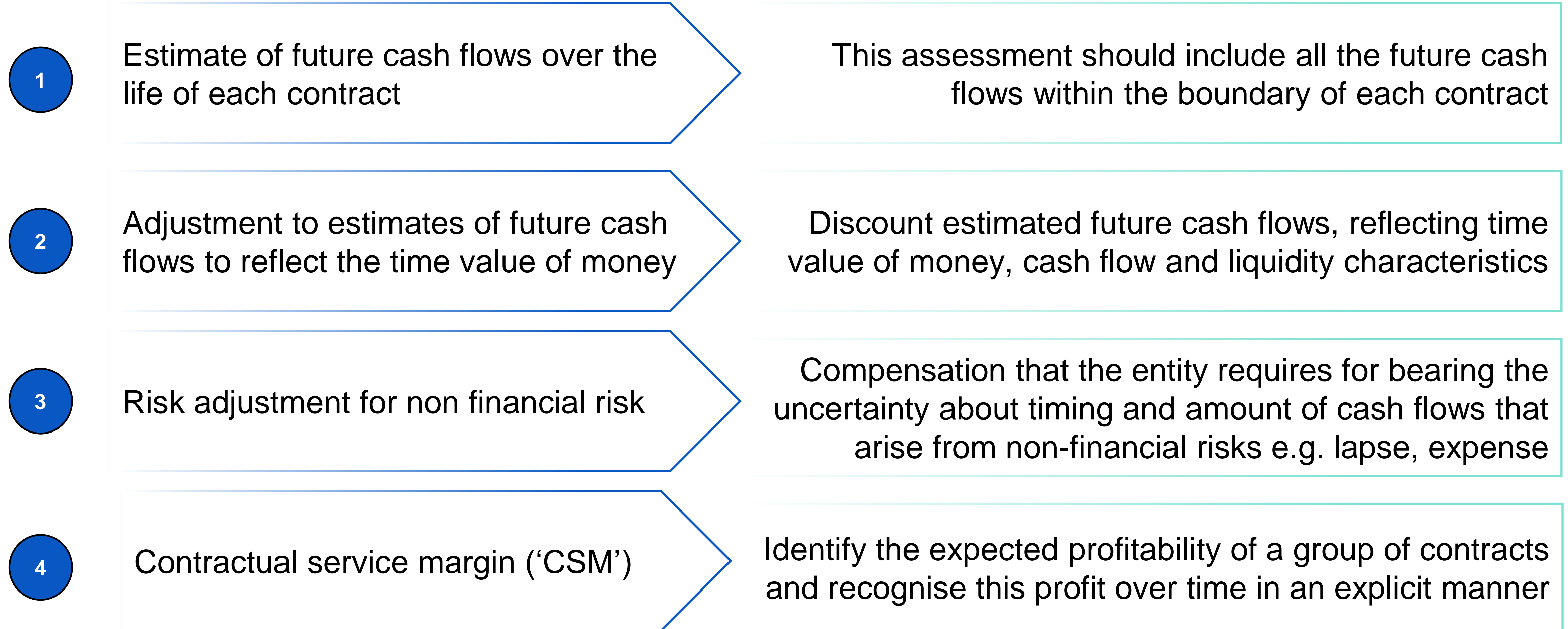
- The liability for incurred claims comprising the fulfilment cash flows related to past service allocated to the group at that date



Components of liability for remaining coverage/ liability for incurred claims:



03. The general measurement model: building blocks approach



03. The general measurement model: building blocks approach

1

Estimate of future cash flows over the life of each contract

This assessment should include all the future cash flows within the boundary of each contract

How is a contract boundary defined?

The outer limit of the existing contract is the point at which the entity is no longer required to provide coverage and the policyholder has no right of renewal. Beyond that outer limit, neither party is bound.

The entity is no longer bound by the existing contract at the point at which the contract confers on the entity the practical ability to reassess the risk presented by a policyholder and, as a result, the right to set a price that fully reflects that risk.

The first element of the building blocks in the general model is an estimate of the future cash flows over the life of each contract.

03. The general measurement model: building blocks approach

1

Estimate of future cash flows over the life of each contract

This assessment should include all the future cash flows within the boundary of each contract

Two types of variable can affect estimates of cash flow

- Market variables, eg those that can be observed in, or derived directly from markets (eg prices of publicly traded securities, interest rates)
- Non-market variables, e.g. frequency and severity of insurance claims and mortality

03. The general measurement model: building blocks approach

2

Adjustment to estimates of future cash flows to reflect the time value of money

Discount estimated future cash flows, reflecting time value of money, cash flow and liquidity characteristics

Discount rates must:

- Reflect the time value of money, characteristics of cash flows and liquidity characteristics of the insurance contract
- Be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts
- Exclude the effect of factors that influence such market prices, but do not affect future cash flows of the insurance contracts

The second element is an adjustment to estimates of future CF to account for TVM and financial risks associated

03. The general measurement model: building blocks approach

2

Adjustment to estimates of future cash flows to reflect the time value of money

Discount estimated future cash flows, reflecting time value of money, cash flow and liquidity characteristics

Insurance liability measurement component	Discount rate for liability
Fulfilment cash flows	Current rate at reporting date
Contractual service margin interest accretion for contracts without direct participation features (including insurance and reinsurance contracts issued and reinsurance contracts held)	Rate at date of initial recognition of group

Methods for determining discount rates:

1. **Bottom up approach**

Determine discount rate by adjusting a liquid risk free yield curve to reflect differences between liquidity characteristics of financial instruments and insurance contracts

2. **Top-Down approach**

Determine based on a yield curve that reflects current market rates of return implicit in a FV measurement of a reference portfolio of assets. Adjust to eliminate factors not relevant to insurance contracts, but not for liquidity.

03. The general measurement model: building blocks approach

3

Risk adjustment for non financial risk

Compensation that the entity requires for bearing the uncertainty about timing and amount of cash flows that arise from non-financial risks e.g. insurance, lapse, expense

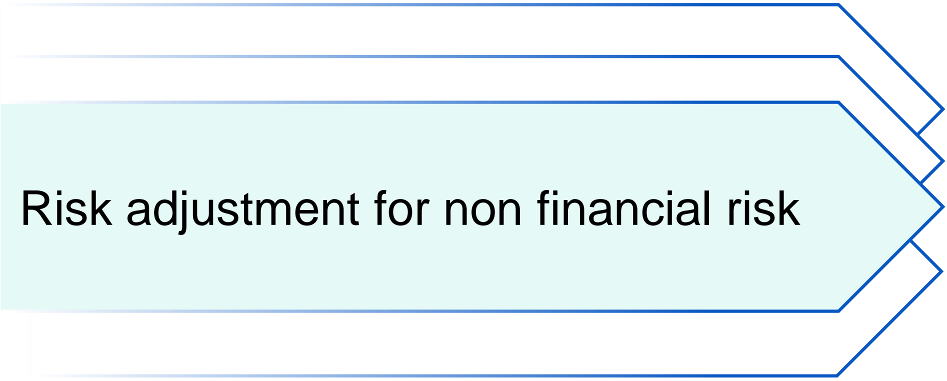
Non-financial risk is risk arising from insurance contracts other than financial risk, which is included in the estimates of future cash flows or the discount rate used to adjust the cash flows.

Measures the compensation to make an entity indifferent between:

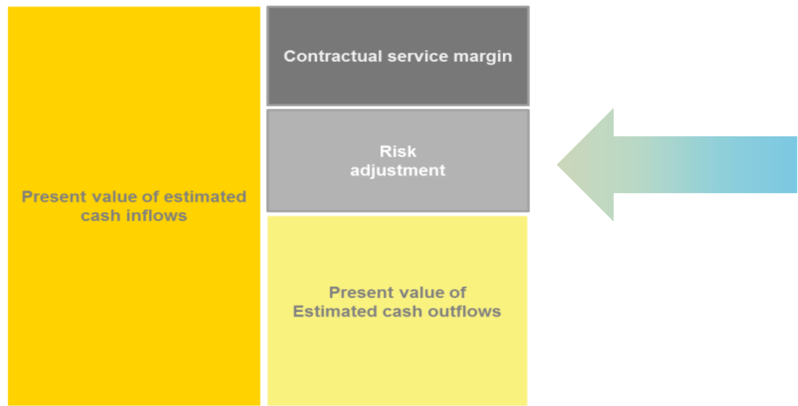
- Fulfilling a liability that has a range of possible outcomes arising from non-financial risk
- Fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contracts

The third element of measuring fulfilment cash flows in the general model is a risk adjustment for non-financial risk.

03. The general measurement model: building blocks approach



Compensation that the entity requires for bearing the uncertainty about timing and amount of cash flows that arise from non-financial risks e.g. insurance, lapse, expense



Risk adjustment characteristics

- Risks with low frequency and high severity will result in higher risk adjustments than for non-financial risks, than risks with high frequency and low severity
- For similar risks, contracts with a longer duration will result in higher risk adjustments for non-financial risks than those with shorter duration
- Risks with a wider probability distribution will result in higher risk adjustments than risks with a narrower distribution

03. The general measurement model: building blocks approach

4

Contractual service margin ('CSM')

Identify the expected profitability of a group of contracts and recognise this profit over time in an explicit manner

The distinguishing new feature introduced under IFRS 17 is the contractual service margin ('CSM')

- Represents the **stock of future profits** under insurance contracts, released over coverage period
- Makes insurance industry **more aligned** to other sectors
- Particularly relevant for life insurers, where release of CSM now 80-90% of operating profits

CSM = future profits embedded in insurance cash flows

03. The general measurement model: building blocks approach

4

Contractual service margin ('CSM')

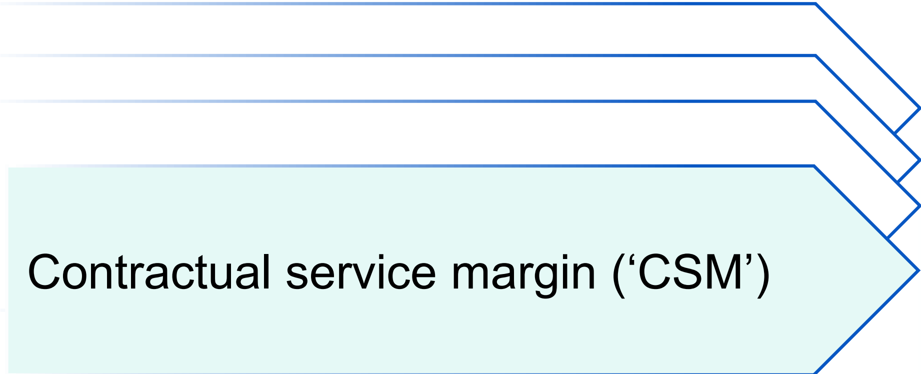
Identify the expected profitability of a group of contracts and recognise this profit over time in an explicit manner

The contractual service margin is a new concept introduced in IFRS 17 to identify the expected profitability of a group of contracts and recognise this profitability over time in an explicit manner, based on the pattern of services provided under the contract.

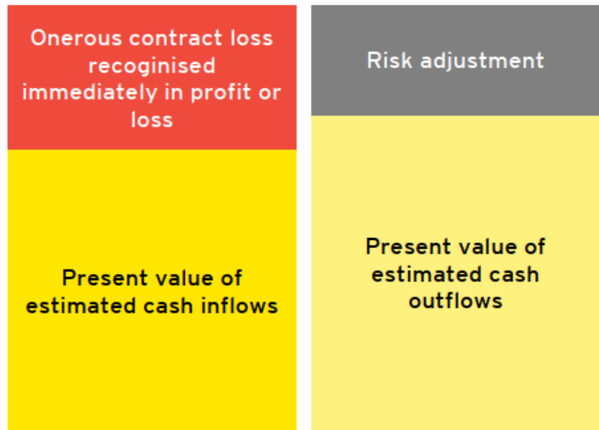
I.E No day 1 profit!

Although losses (onerous contracts) must be recognised immediately

03. The general measurement model: building blocks approach



Identify the expected profitability of a group of contracts and recognise this profit over time in an explicit manner



Onerous Contracts:

- A loss must be recognised on initial recognition of a group of insurance contracts if that group is onerous
- An entity should group such contracts in a portfolio separately from contracts that are not onerous

03. The general measurement model: building blocks approach

4

Contractual service margin ('CSM')

Identify the expected profitability of a group of contracts and recognise this profit over time in an explicit manner

Recognition of P&L in each period:

- Identify coverage units in group.
- Allocating CSM at the end of the period (before recognising any amounts in P&L to reflects the insurance contract services provided in the period) equally to each coverage unit provided in the current period/ expected to be provided in future periods
- Recognising in P&L the amount allocated to coverage units provided in the period.

04. The Premium Allocation Approach (PAA)

General overview:

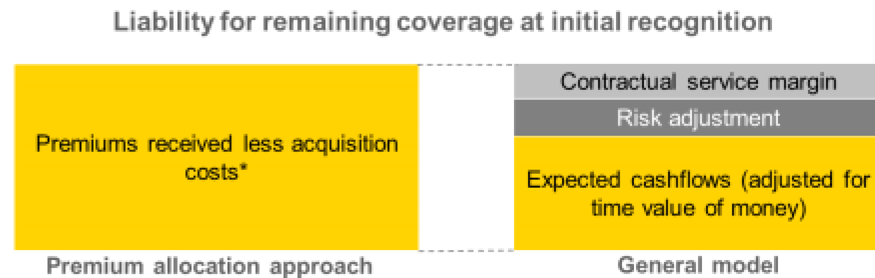
The PAA is a **simplified form of measuring an eligible group of insurance contracts** issued or reinsurance contracts held. Permitted if:

The entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that **would not differ materially** from measurement under the GMM

The coverage period of each contract in the group is **one year or less.**

04. The Premium Allocation Approach (PAA)

General overview:

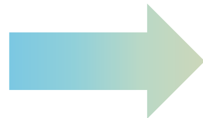


- Similar to unearned premium reserve under IFRS4.
- Only a total amount which is the liability for remaining coverage is recognised
- Subsequently, the liability for remaining coverage is recognised over the coverage period on the basis of the passage of time.

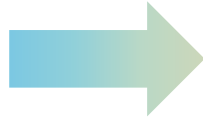
Key differences:

- The liability for remaining coverage is measured using premiums received minus any insurance acquisition costs
- No DAC. Acquisition cash flows are subsumed within the liability for remaining coverage, unless acquisition cash flows elected to be expensed.
- Short tail liabilities would generally not have been discounted under IFRS4

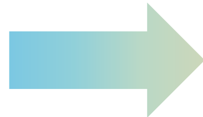
General overview:



The requirement for recognition and measurement of reinsurance contracts issued are **the same as for insurance contracts**

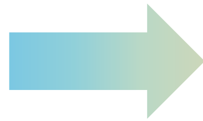


The issuer should make an **estimate of the fulfilment cash flows** including estimates of expected future cash flows

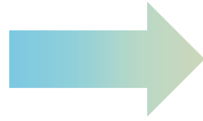


At initial recognition (and at each reporting date), this will include estimates of future cash flows arising from underlying insurance contacts expected to be issued by the reinsuring entity, that are **within the contract boundary** of the reinsurance contract

Reinsurance contracts held:

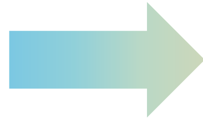


IFRS 17 requires a reinsurance contract held to be accounted for separately from the underlying insurance contract to which it relates (because reinsurance doesn't de facto allow insurer to reduce payments to policyholders)



Modified version of the GMM is applied by cedents for reinsurance contracts held, reflecting:

- Groups of reinsurance contracts held are usually assets rather than liabilities.



- Entities holding reinsurance contracts generally pay a margin to a reinsurer as an implicit part of the premium rather than making profits from reinsurance contracts.

Reinsurance contracts held: Modifications to GMM

General model for insurance contracts issued	Modifications of general model for reinsurance contracts held
Recognition	
A group of insurance contracts issued shall be recognised from the earlier of: ▸ The beginning of the coverage period of the group of contracts Or ▸ The date when the first payment from a policyholder in the group becomes due Or ▸ For a group of onerous contracts, when the group becomes onerous	A group of reinsurance contracts held shall be recognised from the earlier of: ▸ The beginning of the coverage period of the group of reinsurance contracts held Or ▸ Any gain on initial recognition which covers losses of onerous underlying insurance contracts A simplification exists for proportionate reinsurance

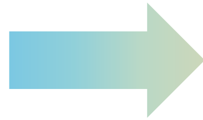
Reinsurance contracts held: Modifications to GMM

Day 1 profits initially recognised as CSM, and amortised as per GMM, except where:

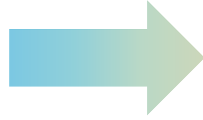
- Any portion of a day 1 difference (i.e the net cost of purchasing reinsurance cover) that **relates to events before initial recognition of the reinsurance contract held.**
- Any day 1 gain on initial recognition of the reinsurance contract held, which is expected to recover the losses at initial recognition of onerous underlying insurance contracts.

NB: A reinsurance contract held cannot be onerous. As such, the requirements for onerous contracts in the GMM do not apply.

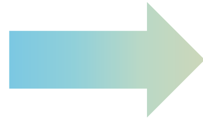
Issued adverse loss development covers:



For reinsurance contracts which cover events that have already occurred, but for which the financial effect is uncertain, IFRS 17 states that the insured event is the **determination of the ultimate costs** of the claim.



Where events have already occurred, but the financial effect of which is uncertain, the claims are incurred when the financial effect is certain. NB: this is not when an entity has a reliable estimate if there is still uncertainty involved.



Results in entities accounting differently for similar contracts, depending on whether entity acquired contracts or they originally issued.

Issued adverse loss development covers issue:

The net cost of purchasing reinsurance relating to events that have already occurred must be **recognised immediately in the cedant's financial statements**,

The gain for the reinsurer is **spread in the usual way over the coverage period** (which would be the claim settlement period in this case).

This may **reduce or remove** the value of ADC.

IFRS 17 legacy transactions: feedback from captive forum

"“This is having an impact (on pricing), We don’t yet have a clear direction on what IFRS 17 is doing in terms of ***rationale for transaction****”.*

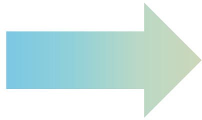
“The main challenge is the ***lack of recognition of a day 1 profit,*** *this is something the market has been well aware of”*

“There is heightened interest in 3rd party capital for ***fee business****, rather than having to take balance sheet day 1 gains”.*

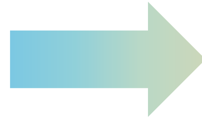
“There is ***varying application of the risk adjustment*** *on the IFRS 17 balance sheet”*

“One impact is the legacy market is more interested in ***shorter tail books****, because the revenue recognition is that much quicker”*

Accounting for ceding commissions and reinstatement premia:



The economic effects of amounts charged between a reinsurer and cedent that are not contingent on claims is equivalent to charging a different premium. Therefore recognised as part of insurance revenue.



Where different amounts charged are contingent on claims is equivalent to reimbursing a different amount of claims than expected. Therefore recognised as part of expenses.

Howden Tiger

HOWDEN