IFRS 17: Insurance Contracts

Key issues for general insurers

October 2017

The International Accounting Standards Board released the long awaited update for insurance contracts in May this year. IFRS 17 will replace IFRS 4 from 2021, although early adoption is permitted. The NZ External Reporting Board released the standard for for-profit entities in August. An equivalent standard for public benefit entities is yet to be released.

The key issues we see for general insurers are:

- Multi-year policies
- Onerous contracts
- Risk margins

This newsletter starts by looking at the high level differences in approach between IFRS 4 and IFRS 17. We then go on to discuss the key issues noted above, although we acknowledge that there are many more issues that insurers will need to traverse over the next few years.

Similar newsletters looking at issues for life and health insurers are also available.

A change in nomenclature

In its simplest form, what we currently know under IFRS 4 as the *unearned premium liability* and the *outstanding claims liability* will be relabelled as the *liability for remaining coverage* and *liability for incurred claims* respectively. However, there are some subtle differences, particularly around the risk margins as discussed later.

Building Block vs. Premium Allocation

IFRS 17 is framed around what is referred to as the Building Block Approach. The BBA is very much in the style of the Margin on Services type approach which is used by life insurers.

However, IFRS 17 allows for a simplification in certain circumstances – the Premium Allocation Approach. The PAA applies to unexpired risks and works much more like the approach general insurers currently take under IFRS 4.

The criteria for using the PAA are:

- The coverage period is one year or less, or
- The PAA is expected to produce a materially similar result to the BBA.

Multi-year contracts

Some general insurance contracts might run for longer than a year such as:

- Contract works
- Builders warranty
- Mechanical breakdown
- Lenders mortgage insurance
- Extended warranty
- Some types of loan repayment insurance

Multi-year contracts don't meet the first criterion for using the PAA. So if a general insurer wants to avoid using the more complicated BBA (for what may be a small portion of their portfolio) then it will need to demonstrate that the PAA produces a materially similar result – a process which may amount to going through the BBA motions anyway just to prove that it's no different.

Onerous contracts

Whether using the BBA or PAA, IFRS 17 requires reporting of insurance contracts to be divided at a minimum into:

- Contracts that are onerous from the start
- Contracts which have a significant possibility of becoming onerous
- Everything else

The nature of insurance is that there is almost always the possibility that the insurer makes a loss on a contract. However, the definition of an onerous contract is that the *expected* outflows exceed the *expected* inflows.

Under IFRS 4 an insurer must test the adequacy of its unearned premium reserve. Where outflows exceed the pro-rata holding of premium income, an additional reserve must be held.

Whilst IFRS 4 requires the test to be applied to *broadly similar risks managed as a single portfolio*, most general insurers apply the test at the NZ entity level. Individual segments within a portfolio might be under-reserved, but this is accepted so long as the portfolio as a whole is adequate.

Under IFRS 17 onerous contracts must be reported separately and losses recognised immediately. This may mean, for example, that policy packages which include an element of loss leading products need to be declared and recognised upfront. If there are known cross subsidies within a portfolio then these may need to be deconstructed and reserved for separately.

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Risk margins – unexpired risk

Another difference between the liability adequacy test under IFRS 4 and the consideration of whether a contract is onerous under IFRS 17 is the removal of the risk margin.

Currently under IFRS 4 the liability adequacy test compares:

- The unearned premium liability, less Deferred Acquisition Costs, against;
- The sum of:
    - Expected future claims (central estimate)
    - Expected future expenses including reinsurance
    - A risk margin

Simplistically, the test asks the question: is the risk margin larger than the profit margin in the premium? If the answer is yes, then the insurer will need to write off some Deferred Acquisition Costs. Or, more likely, an insurer will err on the conservative when establishing DAC in the first place.

Under IFRS 17 an insurer applying the PAA need only consider whether 'facts and circumstances' indicate that a group of contracts is onerous; there is no mention of including a risk margin in that consideration. So it would appear the test is now effectively applied to the central estimate. This may alleviate some of the strain of having to separately reserve for onerous contracts.

Risk margins – incurred claims

Once a claim has been incurred, the new *liability for incurred claims* is effectively the same as the *outstanding claims liability*, with a subtle difference in the risk margin.

IFRS 4 discusses risk margins in terms of a probability of adequacy e.g. the outstanding claims liability might be set so that there is a 75% probability that the liability will be adequate to meet to the cost of claims and expenses (although no specific percentage is specified in IFRS 4).

IFRS 17, on the other hand, discusses a *risk adjustment for non-financial risk* which is included within the liability for incurred claims. The idea with this risk adjustment is that the insurer would be indifferent between:

- Paying the future cost of claims and expenses as they arise, and
- Locking in a fixed value for future costs as the central estimate plus risk adjustment.

The concept is similar to the risk margin which might be required in an arm's length transaction between willing parties, except that it is based entirely on the insurer's own risk appetite rather than whether or not there might exist a market for this hypothetical transfer.

IFRS 17 does go on to note that the confidence level used to determine the risk adjustment must be disclosed. In other words, tell us what probability of adequacy the margin equates to so that a reader can make informed comparisons.

Perhaps it's a subtle distinction, but the focus on an insurer's own risk appetite, rather than just picking a particular probability of adequacy, should hopefully get insurers asking questions like:

- Is our reserving basis consistent with our overall philosophy to risk taking?
- How does it fit within our capital management plan?
- Does holding more capital elsewhere mean that we're comfortable holding a lower margin on our liability for incurred claims?
- What does this mean for the likelihood of achieving our target return on capital?

Further reading

The full standard is available here.

In this brief newsletter we've picked out three key issues for general insurers – but there's a lot more to the standard than that. If you wish to discuss what any of this might mean for your business then please contact any of the authors below.

ABOUT MELVILLE JESSUP WEAVER

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