IFRS 17 – What it means for Australian insurers

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The International Accounting Standards Board (IASB) released its new accounting standard, IFRS 17 *Insurance Contracts*, on 18 May 2017. IFRS 17 is a significant change for insurers in all jurisdictions, following a 20 year process of development and consultation.

The Australian Accounting Standards Board is expected to adopt the international standard shortly. When this occurs, the standard will be mandatory for reporting periods beginning on or after 1 January 2021 for all entities that issue insurance contracts in Australia. For Australian insurers, this is the most significant accounting change since Margin on Services was introduced in 1995 for life insurance, and risk margins and risk free discount rates were introduced as part of general insurance reforms in 2001.

The greatest impact will be felt by life insurers, with lower deferral of acquisition expenses, the introduction of risk adjustments for reporting purposes, and a likely change in 'boundary' for certain contracts, including Australia's major open product: yearly renewable term. However, all insurers are expected to be impacted, with changes to profit recognition and extensive new disclosure requirements.

A common accounting standard will enable comparisons between insurance companies across many countries (the USA most notably excluded) and across types of insurance (life insurance, general insurance and health insurance).

Focusing on providing the Australian perspective to IFRS 17, in this paper we have outlined:

- the principles contained in the new standard (page 3)[1];
- the differences with the current Australian standards (page 5) and the impacts those differences will have; and
- the key strategic issues for insurers and stakeholders to consider (page 10).

1 A complete summary of IFRS 17 will be published by KPMG Global in our publication "First Impressions", with an expected release date of July 2017.

IFRS 17 - The key principles

The key principles stated in IFRS 17 are that:

- Contracts that are insurance (and those that are not) are clearly identified.
- Components in the contract (including options and guarantees) are separated and valued.
- Contracts are grouped for valuation.
- Current assumptions should be applied to risk-adjusted cash flows to value contracts, and unearned profit remains in the liability until it is recognised.
- Profit is recognised as insurance coverage is provided and the entity is released from risk.
- Insurance revenue, insurance expenses and financing income and expenses are presented separately.
- A higher level of disclosure will better enable users to understand and compare insurance companies.

These principles can be recognised within the General Model – sometimes referred to as the Building Block Approach (BBA).

General Model

Fulfilment cash flows

Future Cash Flows
'Expected cash flows from premiums, claims and expenses'.

Discounting
'An adjustment that converts cash flows into current amounts'.

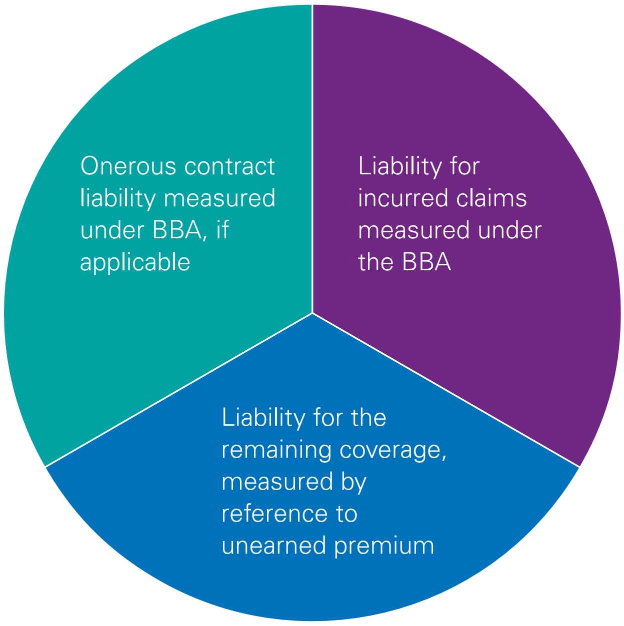
Risk Adjustment
'To adjust for the uncertainty about the amount and timing of future cash flows'.

Contractual Service Margin (CSM)
'To release profit over the contract coverage period. Profit cannot be released at inception, but onerous contracts must have losses recognised immediately'.

There are two other variations of the General Model.

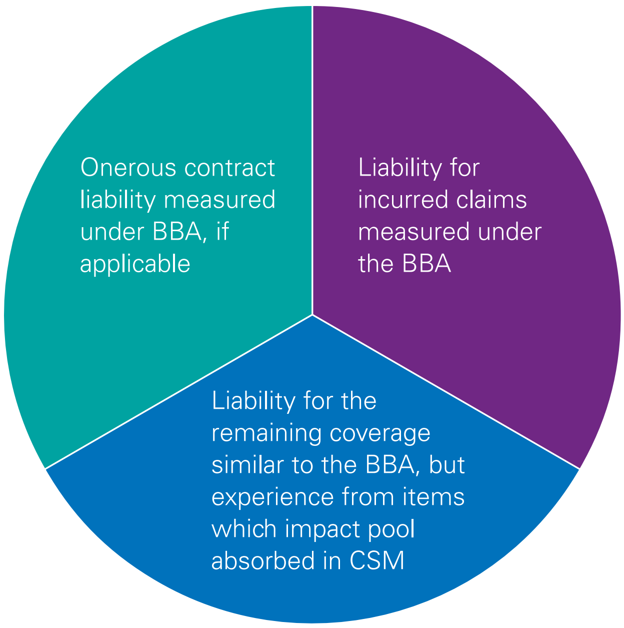
Simplified Approach – Premium Allocation Approach (PAA)

- This approach may be used when it is a reasonable approximation to the General Model, or when the contract's coverage period is 1 year or less.
- The liability consists of three components: unearned premium, incurred claims liability and onerous contract liability (if any). No explicit Contractual Service Margin (CSM) is calculated.
- It is similar to that currently used for general insurance contracts.



Variable Fee Approach (VFA)

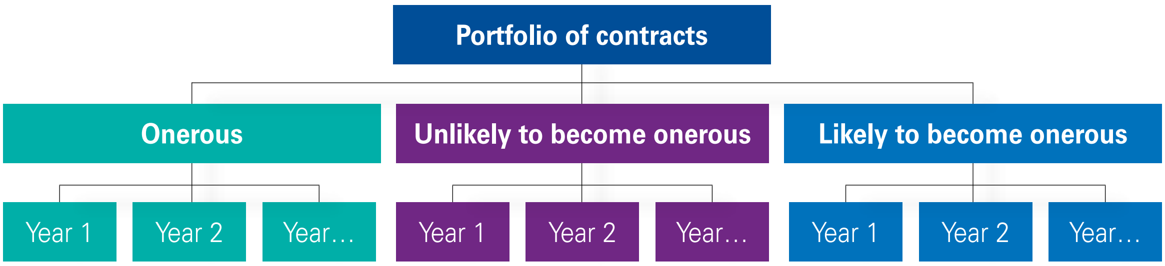
- This approach must be used for "direct participating" contracts – contracts where policyholders share in the returns from a clearly defined pool of underlying items.
- In the Australian context, this means participating traditional contracts, discretionary investment account contracts and investment linked contracts.
- The assessment of whether this approach should be used is made at inception and can't be changed.
- The liability is based on the obligation to pay the policyholder the returns on the underlying items, less a 'variable fee'. The fee is variable because it depends on the returns on the underlying items.



Key differences between IFRS 17 and current Australian standards

Topic	Key changes in accounting standard requirements	Impact of the changes
Insurance Contracts scope	The classification of contracts as insurance is broadly similar to the current standards. The key exception is "unbundling" for some life insurance contracts (e.g. investment linked (IL) with a risk rider, which may no longer be able to be unbundled).	General insurance[2] – none expected. Life insurance – unbundling rule changes may mean some contract components now need to be measured under IFRS 17. For many companies, this may not be a desirable outcome and product changes may be made to prevent the need to re-bundle investment linked contracts with their risk riders.
Aggregation for the purposes of CSM determination	The definition of portfolio – "contracts subject to similar risks and managed together" – is similar to current grouping for both life and general insurance. However, portfolios will be further sub-divided by: • whether a contract is onerous, at no significant risk of becoming onerous or otherwise profitable at inception; • years since inception. Such grouping is done at inception, and not subsequently changed. The onerous contract test is: • performed on the gross contract before the impact of reinsurance; • includes a risk adjustment; and • may ignore any policy characteristic where the regulator does not the permit the insurer to differentiate prices (e.g. age for CTP or health insurance).	A lower level of aggregation / smaller portfolios is required under IFRS 17 and is expected to increase the proportion of the business in loss recognition for both general and life insurance. It will reduce the ability for cross-subsidisation of loss-making products with profitable products. The identification of onerous contracts at inception may create challenges for companies who price and monitor the portfolio as a whole (e.g. using a single loss ratio) rather than performing individual contract projections. If the PAA is used, it can be assumed that no contracts in a portfolio are onerous, unless facts and circumstances indicate otherwise.

The diagram below indicates how portfolios are to be sub-divided.



2 Note that comments relating to general insurance also include health insurance.

Topic	Key changes in accounting standard requirements	Impact of the changes
Contract boundary and valuation approach **("Maximum Projection Period")**	General insurance: LMI, Builders Warranty, Consumer Credit and some Reinsurance contracts may now be long term and require full cash flow projection (using the BBA). Life insurance: Stepped premium contracts, where premium rates are not guaranteed, will change from long term to short-term and can now be valued using the PAA (although there has been no change in the final standard to clarify this point). Group insurance will need to demonstrate that the outcome under the PAA is materially the same as the BBA in order to use the PAA approach.	Changes in contract boundary and valuation approach may significantly change the pattern of profit, increase complexity or require methodology changes. For example: • Life insurance YRT: Acquisition costs can no longer be effectively deferred beyond 1 year for most contracts. This will substantially reduce profit in the first year, but increase it in subsequent years. Smaller, fast growing insurers may find that reported profits are initially lower under IFRS 17. The consequential change in the policy liability may have tax benefits. • Reinsurance: It would seem that reinsurance held is short term. 3 months of new business cash flows may be within the contract boundary where the reinsurer is required to give 90 days' notice before terminating the contract to new business. • Long term general insurance contracts: These contracts may now require full cash flow projection (BBA), and if so, will result in a different profit release pattern.
Discount rates	The discount rate should: • reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts; • be consistent with observable current market prices; and • exclude factors that influence market prices but do not impact future cash flows, such as credit risk. This is similar to what is currently required of Australian insurers. However, under IFRS 17, either a top down or a bottom up approach may be used to determine the discount rate that meets these requirements. Both a yield curve approach and a single weighted average discount rate continue to be acceptable. Changes to discount rates may be recognised in profit and loss or may instead be recorded through Other Comprehensive Income (OCI).	Many companies currently choose to use a risk free discount rate to align the discount rate used between financial reporting and regulatory reporting. This approach may no longer be viable under IFRS 17. For some products it may be possible to use a slightly higher discount rate than is used at present, because of the addition of a liquidity margin, or the use of a top-down approach. Australian companies may opt to recognise changes in discount rates through OCI to align with global parents. Typically companies which opt to use OCI would make a similar choice regarding asset valuation changes under IFRS 9.

Topic	Key changes in accounting standard requirements	Impact of the changes
Valuation of incurred claim reserves	General insurance: Broadly unchanged. Life Insurance: Changes in assumptions will impact P&L – currently, some companies opt to smooth assumption changes on incurred claim reserves through the profit margin.	Profit may be more volatile for some life insurance products, and treatment will be more complex if OCI is used.
Expenses	Only costs that relate directly to the fulfilment of the contract are included for acquisition costs, administration / maintenance costs and claims handling costs. The direct costs can include an allocation of fixed and variable overheads. The direct costs must exclude costs resulting from abnormal amounts of wasted labour/resources (e.g. where the product/company is sub-scale), and some product development and training costs. If the contract term is 12 months or less then the acquisition costs need not be deferred.	The acquisition costs that can be effectively deferred and maintenance costs that need to be projected are lower than current levels. Life Insurance: Most retail risk business will now have a 1 year contract boundary. For insurers where this is their main product, the impact of the reduction in directly attributable costs is less material, as any effective deferral is only for a very short period. General Insurance: Greater analysis of maintenance expenses will be needed for long-term contracts where the BBA is used. There will likely be variability in interpretation regarding what overheads can be allocated to direct costs. A redesign of the expense allocation process is likely to be needed.
Risk adjustment	A risk adjustment must be held for non-financial risk, which reflects the compensation that the entity requires for the uncertainties related to future cash flows, and is clearly linked to a company's own risk appetite. The risk adjustment may be determined using a number of methods, but the confidence level associated with the risk adjustment and the calculation technique must be disclosed. Currently, APRA requires that general insurers hold a minimum risk adjustment calculated at a 75 percent confidence level for prudential purposes. The risk adjustment as it is unwound will emerge as profit.	The risk adjustment is a new concept in accounting for life insurance and health insurance companies. It will require models to be updated, and will increase the likelihood of the business being onerous. General insurers are expected to maintain their existing risk margin.
Contractual Service Margin (CSM) **(applies to policies valued using the BBA or VFA)**	Conceptually, the CSM is similar to the current profit margin in life insurance, and serves the same purpose in spreading the profit over the contract period. The CSM is a dollar amount (a single amount for each group), which needs to be tracked over time and gradually run off.	The inclusion of a specific CSM, and the mechanics of its calculation, will require work to implement and maintain for life insurance and will impose an additional requirement for long term general insurance contracts (e.g. LMI).

Topic	Key changes in accounting standard requirements	Impact of the changes
Adjustments to the CSM	**Non-participating contracts** The discount rates are locked in under the BBA for the purpose of unlocking the CSM. The CSM will be impacted or unlocked by: • Changes to assumptions (including the risk adjustment). • Changes to future cash flows resulting from actual experience differing from expected. These changes will be matched with a corresponding offset to the CSM at the locked-in discount rate. The difference between the locked in discount rate and the current discount rate will immediately impact P&L (or OCI). Once the CSM is reduced to nil, any subsequent changes will impact the P&L rather than the CSM. **Participating contracts** The discount rates are current under the VFA for the purpose of unlocking the CSM. Hence, unlocking will not result in any difference immediately impacting P&L (or OCI).	The calculations required to adjust the CSM are more complicated than currently and will require changes to processes. Future profitability will be impacted by events in the current period, even though the cash flows associated with the continuing contracts are unchanged.
Run-off of CSM	Allocation of the CSM over current and future periods is performed on the basis of coverage units, reflecting the expected duration and size of the contracts in the portfolio. The CSM which is to emerge in the current period is determined after all other adjustments (changes to assumptions and future cash flows) have been made to the carrying amount of the CSM and coverage units.	The run-off pattern of the CSM differs from the current pattern of profit emergence for all long-term insurance contracts. • The release of "expected" profit is now calculated after rather than before changes to assumptions and experience – because of the changed order of calculation it is possible for the current year profit to reflect some of the impact of the change in future assumptions and volume changes. • Common profit carriers such as claims may not be an appropriate proxy for coverage units. Participating products: A link between bonus payments and profit for participating life insurance contracts no longer exists, and the pattern of profit emergence for investment linked business is changed – a potential incentive to accelerate migration of investment linked contracts to off-balance sheet structures (such as stand-alone superannuation funds).

Topic	Key changes in accounting standard requirements	Impact of the changes
Reinsurance	The valuation of reinsurance contracts has a range of features, which differ from the gross contract: • The characteristics of the reinsurance contract may differ from the gross contract resulting in a different contract boundary. • The reinsurance contract may have a positive or negative CSM at inception and if the gross contract has a loss at inception, then profit on the reinsurance contract is not capitalised to offset the loss. • The reinsurance contract may have a positive or negative CSM after inception and if the portfolio becomes more or less onerous after inception, the impact on the reinsurance contract will be capitalised in the same proportion to the gross contract.	The changed treatment of reinsurance adds complexity to the process. It also increases both the likelihood of contracts being onerous at inception and the magnitude of the loss resulting from onerous contracts at inception. Reinsurance may be less effective at reducing risk under IFRS 17.
Asset valuation	The current Australian requirement to measure all assets supporting policy liabilities at fair value through profit and loss may not be included in the Australian IFRS 17 (to create consistency with international requirements). This would give insurance companies the option of valuing assets using alternative approaches – the difference between fair value and book value may be recognised through OCI.	The ability of Australian insurers to use OCI for changes in asset values (and discount rates) would enable insurers to report on a basis more consistent with that potentially adopted by global peers. However the use of OCI may arguably make the accounts more opaque compared to current processes and may create significant differences between regulatory and financial reporting.
Disclosures	The disclosures required will be more extensive, requiring increased granularity, more analysis of movements and a different presentation of financial performance (including insurance revenue, loss recognition and experience profits, in place of premiums and changes in liabilities). However, disclosures will now be aligned to overseas insurers.	The extra disclosures required will involve greater complexity, and possibly extra model calculation and output.

10 key issues that insurers and stakeholders will need to consider as they implement IFRS 17

Strategic considerations

1 What options should be chosen on transition, given the impacts of such options on the balance sheet?

On transition, the balance sheet is restated as if IFRS has applied from inception, subject to it being practical to do so. If not practical, some approximations can be made, or another method (the Fair Value approach) used. The availability and quality of data is a key factor. An insurer needs to understand the impact of each option to make informed choices about the transition.

2 How might IFRS 17 change the way the business is managed and measured in the future, including measurement of company and executive performance?

Reported profit is a key measure of an insurer's performance for the analyst / investor community, due to impacts on dividend payments.

Does reported profit need to be re-interpreted under IFRS 17, or can it continue to be used for measuring performance?

What considerations will be relevant for measuring executive performance and remuneration? Should changes to KPIs be considered in light of IFRS 17?

3 Early adoption: Subject to an assessment of transitional impacts, is there a cash flow benefit or a competitive advantage to be had over your competitors by early adopting IFRS 17?

If the expected impact on your business is positive relative to your peers, should you consider early adoption to realise benefits earlier?

Are there any "one-off" benefits from early adoption?

4 What information about the business might new disclosures reveal to competitors and external stakeholders?

Equally, what insights into your competitors might be available under IFRS 17?

Operational considerations

5 How extensive should the implementation be?

Should this be a compliance exercise or is there an opportunity to improve processes, deliver efficiency and improved business analysis at the same time?

6 What effect might IFRS 17 have on market and regulatory reporting timeframes?

Will reporting timeframes be extended to accommodate the extra calculations and disclosures, or will efficiencies need to be found to deliver within the current timeframes?

7 What communications are required for analysts and regulators during transition and subsequently?

Not only will the measures change, but how they are communicated and interpreted will also change.

Are insurers prepared for the potentially greater scrutiny and challenge that may eventuate, as investors have the potential to obtain a more detailed understanding of the underlying business and a greater ability to compare businesses on a global scale?

How will regulators respond to the new standard? What lobbying / discussion is required to minimise the disconnect between reporting for general financial, regulatory and taxation purposes?

8 What are the resource and project management requirements to undertake the implementation, what resources does the insurer have, and what are the capabilities of those resources?

Are the resources and skills sufficient, or does the scope, size and timing of the work required mean that more capable resources are needed?

What training is required?

What adjustments to forecast project and capital spend are required?

Considerations beyond the implementation of IFRS 17

9 What changes might be made to the insurer's business to produce a stronger, less volatile, and growing business in a post-IFRS 17 world as profit drivers change?

How do the impacts of IFRS 17 interact with other industry changes, including reforms to distribution arrangements, statutory schemes and regulatory oversight?

What changes to the business might this project facilitate that insurers have not had the time or resources to do in isolation?

Changes can be considered for products, pricing, commissions, reinsurance structures or business model that would simplify the conversion to IFRS 17, and / or deliver a more sustainable profit profile, or make the business more resilient.

As processes need to change to accommodate IFRS 17, can this also be extended to include more data analytic capability, automation, machine-learning, cost savings, efficiency, more advanced modelling capabilities aligned to economic and regulatory capital requirements, and simplification?

10 What actions might competitors take, and how might the insurer respond?

How will the insurer compare with its peers? An industry-wide interpretation on some issues may be appropriate. On others, there is scope for competitive advantage.

Action plan

Insurers will need to:

1. Undertake initial gap analysis (financial statement formats, calculations, processes – expense allocation, chart of accounts – actuarial models, groupings, data, IT infrastructure, experience analyses, etc.) to determine the extent of the work that needs to be done.

2. Undertake a financial impact assessment (balance sheet, performance, capital strength, tax, volatility, trends, etc.) to determine what the impacts are, and how material they might be, so that actions can be appropriately prioritised.

3. Brief the Board and senior management of likely impacts and recommended responses.

4. Lobby the regulators, and produce supporting analysis.

5. Establish an implementation project (a project plan, governance structure, resourcing, etc.), the scope, size and timing of which will depend on answers to the above questions.

6. Be prepared for analysts' queries in the December 2017 reporting season.

Interaction with other standards

Standard	Interaction
IFRS 9 (Financial Instruments) **Effective 1 January 2018**	Assets of insurers (and some liabilities) will be measured under IFRS 9, which provides choices such as fair value through profit and loss (FVTPL), fair value through OCI (FVOCI) or amortised cost. How some assets are measured may change as a result. Also, the application of the new unbundling rules will affect whether some liabilities are measured under IFRS 9 or IFRS 17. Ideally, implementation of IFRS 9 (in respect of insurance business) and IFRS 17 should take place at the same time to minimise volatility between assets and liabilities that would result from implementing at different times. To reduce volatility during the transition phase, IFRS 4 has been amended introducing two optional solutions: • Overlay Approach – the volatility that could arise when IFRS 9 is applied to insurance assets before IFRS 17 is adopted may be recognised in OCI rather than P&L; or • Temporary Exemption – companies whose activities are predominantly connected with insurance (insurance liabilities exceed 80 percent of total liabilities) may defer adoption of IFRS 9 until 2021, allowing the implementation dates of IFRS 9 and IFRS 17 to be aligned. Entities applying AASB 1023 *General Insurance Contracts* and AASB 1038 *Life Insurance Contracts* will continue to measure financial assets backing insurance liabilities at FVTPL until IFRS 17 is applied. IFRS 9 allows entities to elect to measure financial assets at FVTPL if it eliminates measurement inconsistencies. This measurement election would appear to allow insurers to continue to measure financial assets backing insurance liabilities at FVTPL. For entities that do not meet the condition to defer the application of IFRS 9, they are allowed to revisit the designation of assets when IFRS 17 is adopted. Companies are only allowed to early adopt IFRS 17 if IFRS 9 is also adopted on or before that date.
IFRS 15 (Revenue from contracts with customers) **Effective 1 January 2018**	The recognition of profit under IFRS 17 is similar to the recognition of revenue from non-insurance contracts under IFRS 15. Under both there is a concept that revenue is recognised over time, as services are provided. Companies are only allowed to early adopt IFRS 17 if IFRS 15 is also adopted on or before that date.

Reliance on regulators

Regulator	Reliance
AASB	Accounting for Australian insurers is governed by Australian accounting standards issued by the AASB, rather than IFRS. The AASB will issue its own standard, equivalent to IFRS 17.
APRA	At the moment, the regulatory financial statements, on which capital requirements are based, are almost identical to those produced for general financial reporting purposes. Whether that continues to be the case will depend on whether APRA considers the accounts produced under IFRS 17 (or the Australian equivalent) to be appropriate for its own capital purposes. If APRA does decide to make changes to its own standards, particularly those relating to regulatory financial statements, it is possible that the implementation date of such changes will not align with the early adoption of IFRS 17 by insurers – separate regulatory and general purpose accounts will therefore be needed in the interim. Australian legislation may not be consistent with IFRS 17 (e.g. in relation to unbundling or the treatment of participating business). It may be some time before legislative changes are made, and it may not align with the adoption of IFRS 17 by insurers.
ATO	Tax will change where the standards on which tax is based are similarly changed to align with IFRS 17. However, until such changes are made, insurers will be faced with the consequences of any misalignment (e.g. the deferral of acquisition costs, the assessment of what is 'directly attributable', and the measurement of insurance liabilities). However, even when the measurement of liabilities is aligned, it is unlikely that the ATO Government will allow any tax windfall to be immediately received, and so it is likely that any deduction brought forward for acquisition costs will be phased in on a transitional basis.

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