

Update on IFRS 17

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NZSA IFRS 17 working group*

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Agenda



- NZSA January 2021 survey
- Deep dives into:
 - What is the accounting contract?
 - How does this affect the portfolio construction?
 - Acquisition costs: allocating to future renewals and the impact on profit
 - Acquisition cost asset recoverability testing

Disclaimer: *This presentation is of a general nature only. It has been based on current state of interpretation, guidance and discussion, which is subject to ongoing debate. Each entity must consider the terms and conditions of its own insurance contracts and management of its own business when interpreting NZ IFRS 17. The views presented here are personal views of the presenters and may not represent the views of their employers.*

IFRS 17 Technical interpretation – January survey



Are we starting to see more alignment in areas of judgement and interpretation?

Good Alignment

- YRT contract boundary = 1 year
- Reinsurance contract boundary long (Life & GI)
- Use of DAC for Life Insurers, but driver not yet decided
- Risk adjustment confidence interval 75% where decided
- GMM coverage units Sum Insured for Lump Sum Life & Commuted claim for Income type covers
- PAA risk release on passage of time
- Minimal profitability groups (onerous + 1-2 profitable)
- General insurance contracts & portfolios (Product Line)

Partial Alignment

- Most using PAA where one year boundary, some also using for 3-4 year terms, most not for longer terms
- Most are intending to apply full retrospective for 1 or 3-5 years
- Contract usually splits benefits as much as possible

Lack of alignment

- Claims termination risk included or only incidence risk
- Contract level profitability testing for some, ability to classify profitability for others
- Life Insurance Portfolio groupings

Accounting contract vs Legal Contract



What is the IFRS 17 accounting contract?

TRG discussions at the February 2018 and May 2018 meetings highlighted that separating or combining legal contracts to an accounting contract involves significant judgement. It is not an accounting policy choice.

The starting point is the legal contract. The TRG identified the following factors to consider in separating or combining benefits:

- Interdependency of risk;
- Whether benefits lapse independently of each other; and
- the ability to price and sell the benefit separately.

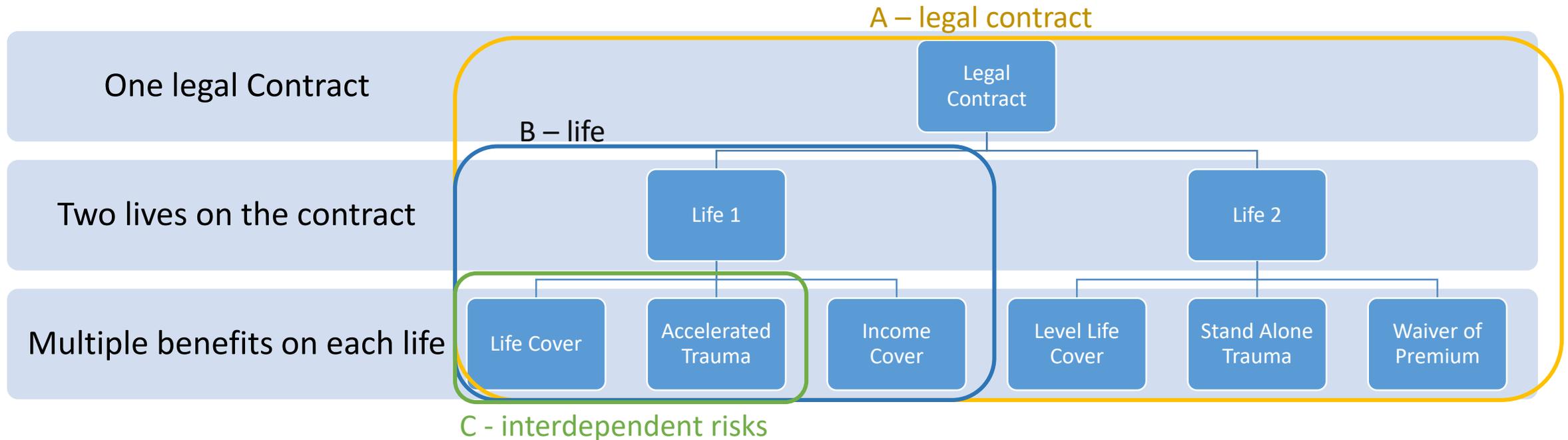
In most organisations, actuaries are best placed to apply this judgement on separation or combination of benefits.

What is the “commercial effect”? What is just administrative convenience?

Life - Should we separate the legal contract?



A typical Life Insurance legal contract might cover multiple lives and multiple benefits. Should benefits be split for accounting purposes?



Fact Pattern:

- Life Cover, Stand Alone Trauma and Income Cover can each be sold as separate benefits
- Accelerated Trauma must attach to a Life Cover
- Waiver of Premium waives the premium for both lives if Life 2 claims

TRG Factors:

- Interdependency of risk;
- Interdependency of lapse; and
- Ability to price and sell the benefit separately

General – should we combine the legal contract?

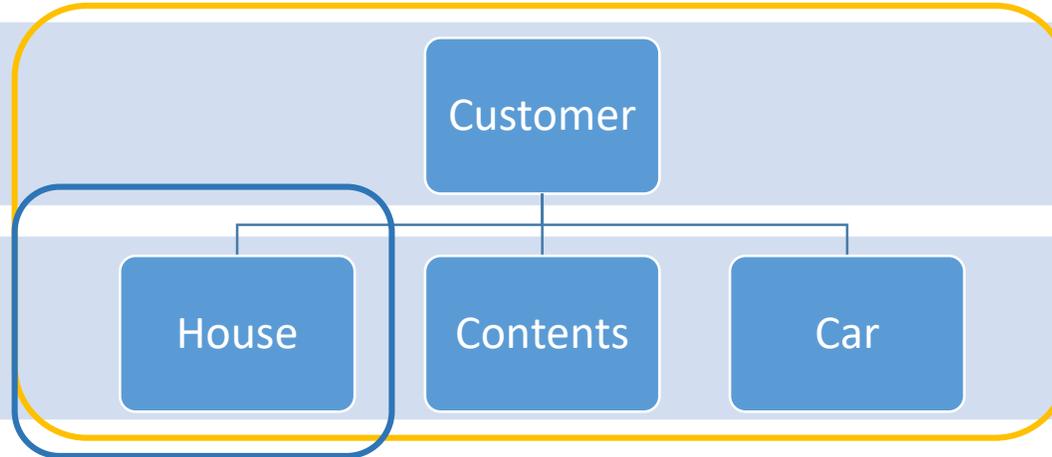


Typical General Insurance legal contracts are separate policies for each cover that a customer holds. Should these be combined?

E – combine to customer level

One customer

Three policies



F – each legal contract separate

Fact Pattern:

- Each policy is a separate legal contract
- The customer gets a multi-policy discount and the size of the discount increases with the number of policies

Factors:

- Different economic effect if combined
- Interdependency of risk;
- Interdependency of lapse; and
- the ability to price and sell the benefit separately

How homogeneous should Portfolios be?



Once you've decided on your accounting contracts, how would you group them into portfolios?

Are the following similar risks & managed together? (Y/N)

1. Participating (Conventional) and Non-Participating?
2. Group Risk (Employee cover) vs Retail Business?
3. Lump Sum and Income Cover?
4. YRT and Level Premium Death Cover?
5. Home and Contents?
6. Motor and Personal Marine (eg Boats)?
7. General insurance policies issued in different countries?

Time to vote!



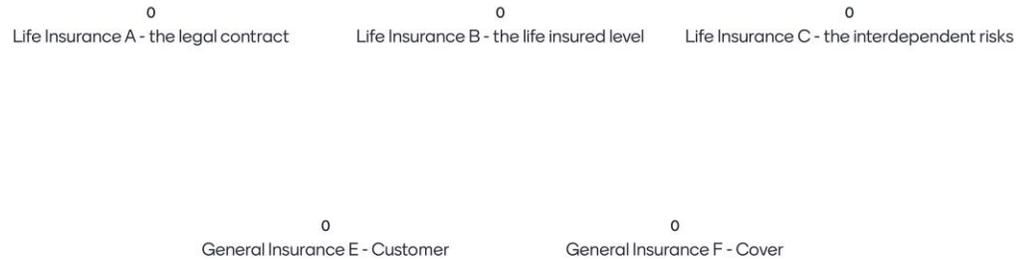
Go to www.menti.com and use the voting code 4785 5747

[IFRS 17 contracts and portfolios - Mentimeter](#)

Multiple Choice

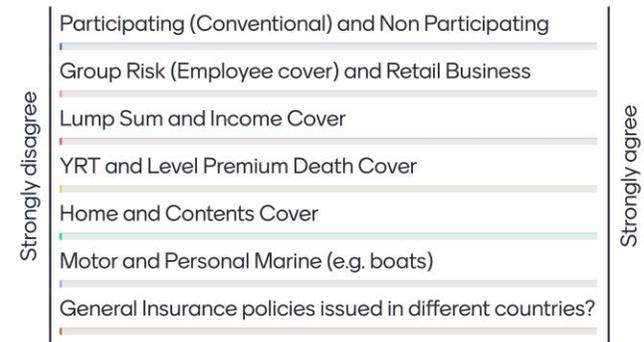
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Portfolios - are these similar risks managed together?

Mentimeter



What are the implications of contract/portfolio?



Financial impacts? Practical implementation issues?

Coverage units under the General Measurement Model:

Can you add your coverage units for your different products that are in the same Portfolio/Group of contracts?

Onerous contracts:

How much cross subsidisation is there between benefits? Are you able to classify your contracts by profitability group or will you have to test them?

Premium Allocation Approach (PAA or Simplified model):

Which contracts are you intending to use PAA for? Are they in a different portfolio from the contracts you intend to use GMM for?

Modelling considerations:

How different will the data requirements be for your models if you have a higher level grouping?

Solvency impacts:

Will your Portfolio/Group decisions have unintended consequences for regulatory capital?

Insurance acquisition cash flows



Under NZ IFRS 17.28A, an entity is required to allocate insurance acquisition cash flows to groups of insurance contracts using a systematic and rational method, unless using para 59(a). This will allocate acquisition cash flows to future renewals of the existing contracts, thereby creating a DAC asset.

Key questions:

1. If insurers are deferring acquisition costs, how will they allocate acquisition costs to future renewals using a “systematic and rational method”? (*NZ IFRS 17.28A, B35A-B35B*)
2. Is there any interest accretion on the insurance acquisition cashflow asset?
3. How will these items affect the profit signature of a life insurance contract and what are the impacts if discount rates change?
4. What does the recoverability testing of the acquisition cost assets look like?

SURVEY!!

Insurance acquisition cash flows: YRT Life



Fact pattern:

- Yearly renewable term life policy
- One year contract boundary
- Renews for up to 50 years
- Initial annual premium of \$1,000
- Sum insured of \$500,000
- Initial claims ratio of 50%
- Insurance acquisition costs of \$2,000
- Premium and claims escalate at 12% p.a.
- Renewal expenses \$50 per policy per year, inflating at 2% p.a.
- Lapse rate of 10% p.a.
- Tax rate of 28%
- Discount rate of 3% p.a.
- Risk adjustment 10% of PV claims

Consider three options below for an allocation method. Expected premiums over 50 and 10 years and expected sum insured. All methods allow for lapses.

Renewal Year	Premiums (50 yr)	Premiums (10 yr)	Sum insured
1	1,000	1,000	500,000
2	1,018	1,018	454,500
3	1,036	1,036	413,141
4	1,055	1,055	375,545

Total	80,177	10,854	5,447,934

Insurance acquisition cash flows: YRT Life



The method selected has a significant impact on how much of the insurance acquisition cash flows are allocated, particularly in the early years.

Renewal Year	Allocation of acquisition costs		
	Premiums (50 yr)	Premiums (10 yr)	Sum insured
1	25	184	184
2	25	188	167
3	26	191	152
4	26	194	138

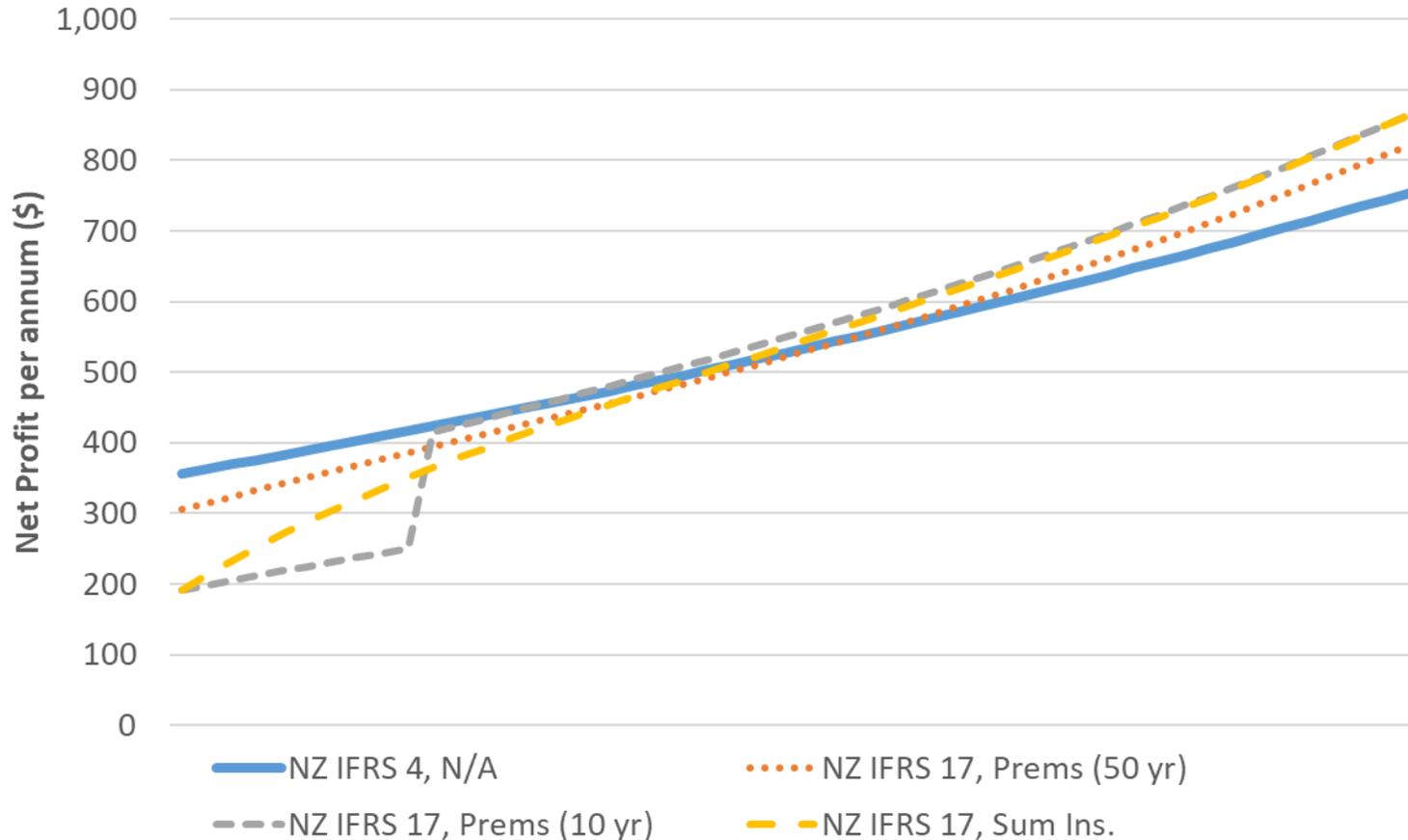
Total	2,000	2,000	2,000

Out of the \$2,000 acquisition costs, \$184 is allocated to the first year's renewal
 i.e. $\$184 = \$1,000 / \$10,854 \times \$2,000$

This means the "DAC" asset at the end of year 1 is $\$2,000 - \$184 = \$1,816$

It is assumed that no accretion of interest is added to the DAC asset each period, per NZ IFRS 17.B125

Profit signature: YRT Life



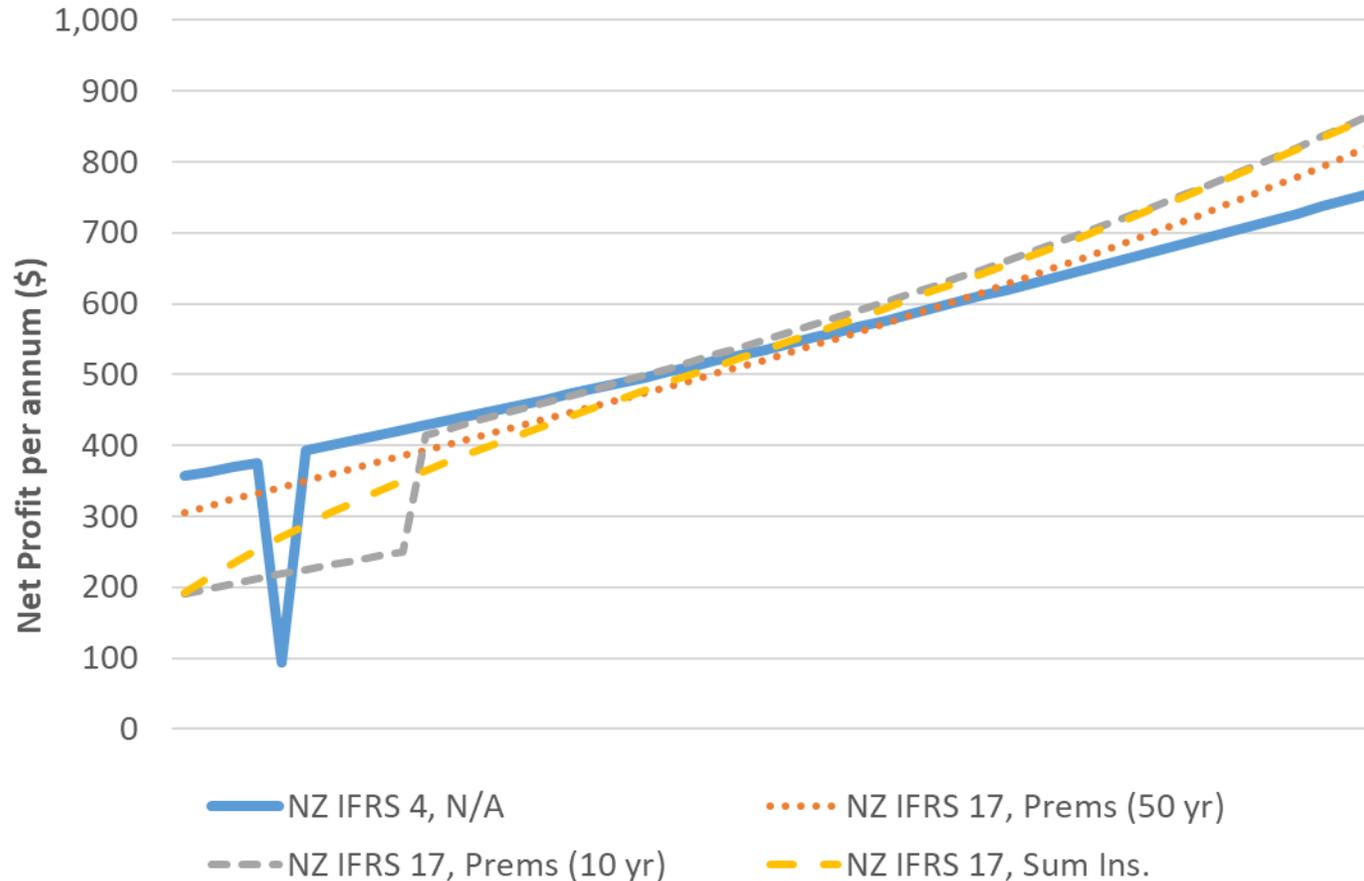
Observations:

- Lower profits under NZ IFRS 17 in the early years compared to NZ IFRS 4
 - *Part of the reason is no interest accretion on DAC*
- Decision on systematic and rational method can result in much lower early year profits due to writing off DAC faster
 - *Disconnect between AC allocation and coverage units?*

Profit signature: YRT Life



Same fact pattern, but discount rates increase to 4% in year 5.



Observations:

- Large loss under NZ IFRS 4 in year 5 from interest rate increasing from 3% to 4% p.a. due to revaluation of the insurance contract asset
- There is little interest rate sensitivity under NZ IFRS 17 due to a short term contract boundary and DAC asset that is no longer interest sensitive
 - *Less of an impact from discount rate changes in P&L (or OCI)*

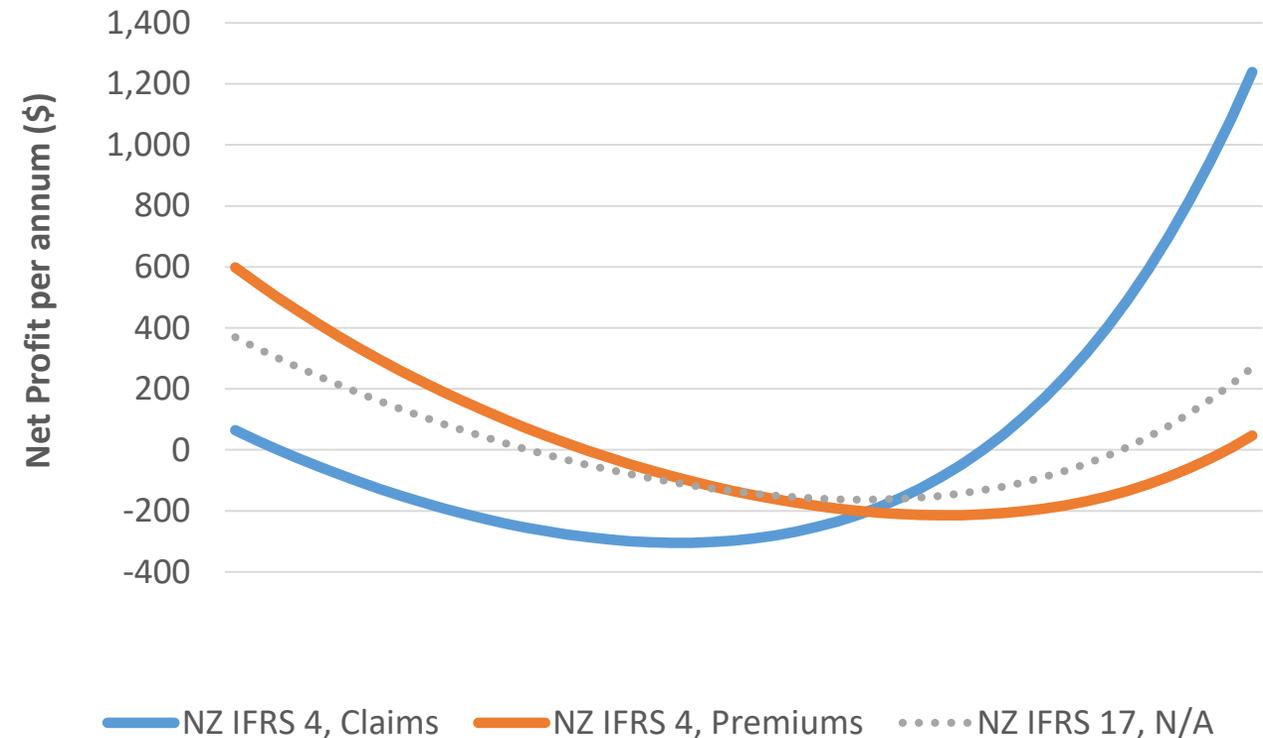
Profit signature: Level Life



Fact pattern:

- Level premium, 50 year, life policy
- Initial annual premium of \$2,000
- Sum insured of \$500,000
- Initial claims ratio of 5%
- Insurance acquisition costs of \$2,000
- Claims escalate at 12% p.a.
- Renewal expenses \$50 per policy per year, inflating at 2% p.a.
- Lapse rate of 5% p.a.
- Tax rate of 28%
- Discount rate of 3% p.a.
- Risk adjustment 10% of PV claims

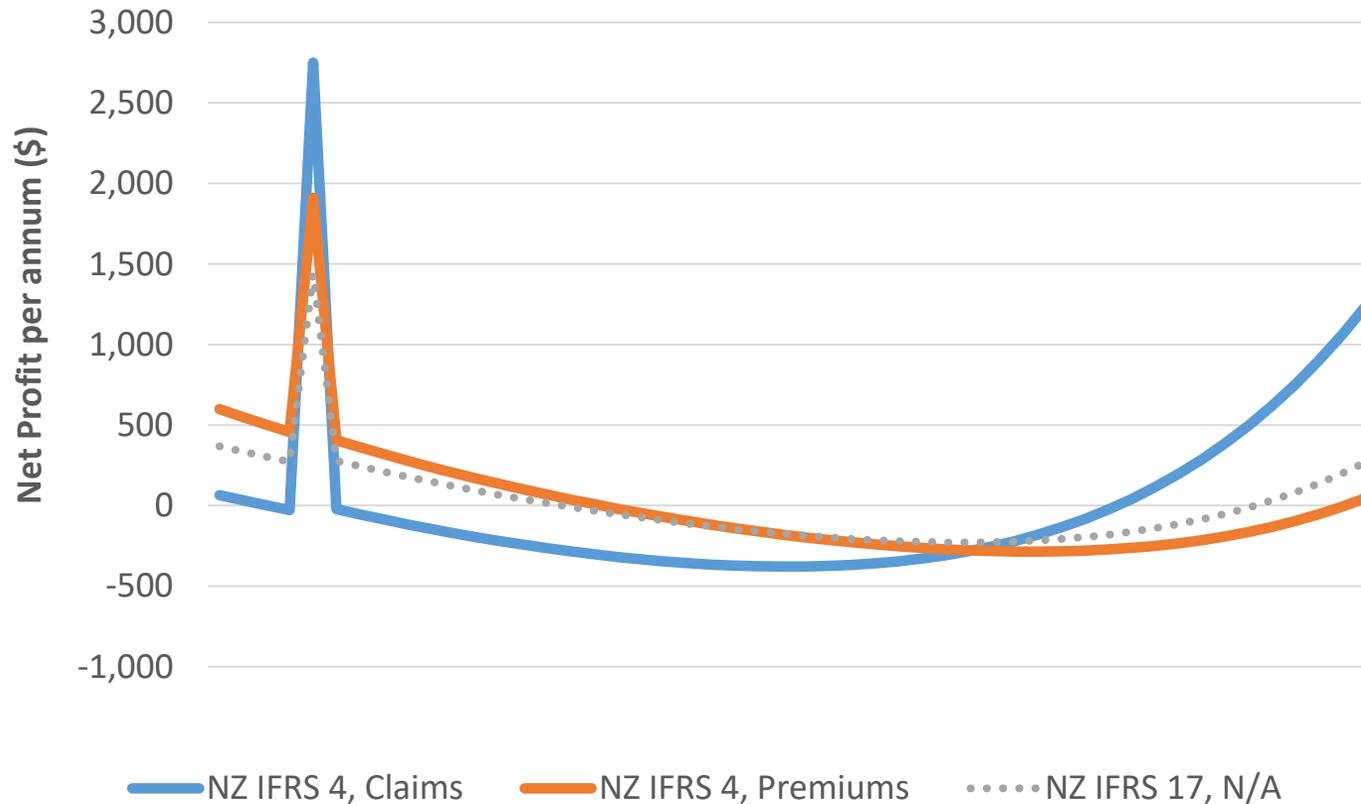
Profit profiles with profit carrier under NZ IFRS 4 as either claims or premiums.



Profit signature: Level Life



Same fact pattern, but discount rates increase to 4% in year 5.



Observations:

- Interest rate sensitivity is less under NZ IFRS 17 in this scenario
 - Due to the impact of locked-in discount rates for the CSM
- Combined with YRT Life:
 - Interest rate impacts could be **less volatile** and in the **other direction** post transition
 - Hedging opportunities?
- What about for GI businesses?

Acquisition cost asset recoverability testing



Assuming one new policy gets underwritten each year and the expected premiums over 10 years method for allocation.

		Year of issue for accounting						Total at 20X3	
		20X1	20X2	20X3	20X4	20X5	20X6		
Year of underwriting	20X1	184	188	191	194	198	202	...	1,628
	20X2		184	188	191	194	198	...	1,816
	20X3			184	188	191	194	...	2,000
	20X4				184	188	191	...	
Total				563					

Observations:

- As per para B35D, recoverability testing of the acquisition assets will be required
- Narrow view is the asset allocated to each and every future *group* of contracts needs to be tested
- Practical approach might be to consider highlighted assets, testing the aggregate asset across rows of renewals and down the first column