Profit Levers Under IFRS 17

By Hui Shan and Darryl Wagner

With the IFRS 17 effective date coming closer, most insurance companies have started or nearly completed their financial impact assessment to understand the transitional impact and how profit will emerge under the new global insurance accounting standard. While we all know it is a slippery slope to begin with a desired outcome in mind when making accounting decisions in the financial reporting world, it is necessary for management to understand the levers that drive profits and what to anticipate. That way, management can make informed and reasonable decisions regarding acceptable interpretation and justifiable practices. After all, as humans, we rarely make a choice in our life without consciously or subconsciously evaluating the potential consequence, even though that choice may be the only option given the circumstance.

In this article, we discuss three main profit drivers: contractual service margin, risk adjustment and financial risk. The discussion is focused on the insurance service result on the IFRS 17 statement of comprehensive income.

CONTRACTUAL SERVICE MARGIN

Given the prominence of the allocation or release of the contractual service margin (CSM) in anticipated IFRS 17 profit patterns under the general measurement model, the CSM naturally tops the list of profit levers.

For inforce business, the established CSM amount upon transition sets the tone for the emergence of future profits. The determination of the opening balance sheet varies by the transition approach. Under the full and modified retrospective approaches, the CSM is established for the inforce block as if IFRS 17 had been applied since the inception (with simplifications under the modified approach). Under the fair value approach, the CSM is established as the differential between the fair value and the fulfilment cash flows as of the transition date. To the extent that the fair value (measured as a liability) is higher, especially for business with rich guarantees where market participants would likely demand a level of compensation higher than that under a current value framework, the CSM may eat into equity upon transition. In this case, the erosion of equity translates into increased release of profits into future profit and loss (P&L) as the CSM is released over time.

For new business, the CSM is set up at inception to eliminate profit. If positive, it represents the deferred profit liability that can be released over time into P&L. The CSM is released to reflect services provided during each period and is unlocked or adjusted for changes in fulfilment cash flows that relate to future services.

By design, the IFRS 17 profit pattern is mostly driven by the movement of the CSM, which in turn is driven by multiple methodology decisions and technical calculations. These decisions and calculations include (but are not limited to):

- Transition approach that determines the opening CSM.
- Unit of account, since the granularity of the contract grouping will surely impact the calculations around the CSM.
- The choice of coverage units, which determines how the CSM is released over time.
- The sequence of the CSM calculation; the subsequent measurement of the CSM involves a number of components, including interest accretion, changes in fulfilment cash flows that relate to future services, release of the CSM to reflect services provided, the effect of contract additions, modification and derecognition, and the effect of currency exchange differences. How to handle the sequence of these elements in the modeling will affect the CSM balances.

As noted, for any reporting period, the CSM is adjusted for changes in fulfilment cash flows that relate to future services, such as updates of future nonfinancial assumptions. This adjustment, to the extent the CSM can absorb the impact, offsets the P&L impact due to changes in fulfilment cash flows, thus creating a neutral impact on P&L during the current reporting period. The unlocking adjustment to the CSM will then be subsequently released into future periods as services are provided.

RISK ADJUSTMENT

Under the general measurement model, the risk adjustment (RA) is remeasured at each reporting period, and the movement is recognized in P&L for the portion of the change that relates to the coverage period expired in the reporting period. The other changes in the RA will be reflected in the unlocking adjustment of the CSM, which as described above would be a neutral impact to P&L. In addition, the portion of the RA changes that relate to incurred claims is also reported in P&L.

At the inception of insurance contracts, the determinations of the RA and the CSM are connected in order to arrive at a no-profit situation. If a company targets a high confidence level for the RA, that would lead to a smaller CSM and vice versa. That time zero geography has an impact on the future profit emergence, because the RA and the CSM are not released into income in a consistent fashion. In light of this connection, evaluating the RA and the CSM together in analyzing the emergence of future profits would be logical and would provide valuable insights. It was noted that the CSM is the most prominent part of IFRS17 profit patterns. However, it may not hold true in certain situations. For example, for certain general and health insurance contracts that have claims beyond the coverage period, the CSM will have run off by the end of the coverage period, but the RA will continue to be measured. In this case, the RA will become the sole lever that drives P&L emergence beyond the coverage period.

IFRS 17 sets out five qualitative principles (paragraph B91) to guide RA methodology choices but does not prescribe any techniques to quantify the RA, including how to aggregate the RA for reporting entity-level disclosure or allocate the effect of diversification to a group of contracts. The methodology decisions around the RA will certainly impact the resultant release of the RA into P&L. As analyzed in the September 2018 issue of *The Financial Reporter*[1], the choice of the RA technique, whether a cost of capital approach or a value-at-risk approach, could result in very different profit patterns. In addition, risk mitigation approaches such as reinsurance and product de-risking that affect liability cash flows will also impact the RA.

FINANCIAL RISK

Some insurance contracts expose the insurer to financial risks in addition to significant insurance risks. Financial risks that arise from insurance contacts may include, but are not limited to, credit risk, liquidity risk, foreign exchange risk and market risk. Under the general measurement model, the effect of changes in financial risk, such as the change in discount rates, is recognized as insurance finance income or expenses, either in P&L or other comprehensive income. It does not affect the insurance service result, which is what this article is focused on. However, for direct participation contracts subject to the variable fee approach (VFA), changes in the variable fee due to financial risks, which consist of the value of future charges less the cost of guarantees, impact the CSM. Such adjustment to the CSM is then subsequently released into insurance service result as services are provided. In addition, to the extent the company has a risk mitigation program that meets the conditions in paragraph B116 of IFRS 17, the entity may choose not to adjust the CSM for the changes in the variable fee.

CONCLUSION

The above is not an exhaustive list of levers that drive the profit signatures. Furthermore, magnitude of different profit levers will vary for different kinds of business. An impact assessment that considers possible levers is necessary for management to understand what to anticipate under the new accounting paradigm. The key benefit of performing a financial impact assessment is that it helps to identify and frame potential challenges and issues that need to be addressed in implementation. Sensitivity analyses around those levers—such as the choice of coverage units, target confidence level for the RA, the RA techniques (quantification, allocation and aggregation), and the risk mitigation program for VFA contracts, as well as experience variations and assumption unlocks—are useful to reveal how profits arise and emerge over time. Now that insurance companies are likely going to have one additional year for IFRS 17 implementation[2], it is in their best interest to understand the full scope of potential impacts under multiple scenarios before moving full steam ahead on the implementation journey. ■

The views reflected in this article are the views of the authors and do not necessarily reflect the views of Deloitte.

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ENDNOTES

1 Wagner, Darryl, Hui Shan, and Ryan Kiefer. 2018. IFRS 17 Risk Adjustment – Insights from a Practical Example. *The Financial Reporter*. September.

2 The IASB Board voted on Nov. 14, 2018, to propose a one-year deferral of the effective date of IFRS 17 to 2022.