IFRS 17 CSM Working Party Transition: fair value approach

1. Introduction

The determination of the fair value CSM or loss component is proving to be one of the most elusive areas of IFRS 17. Formulaically, the calculation is a deceptively simple difference between two items (see section 2) but it remains far from obvious how companies should (or will) actually approach this calculation.

This article introduces the fair value approach, possible methods of measuring the fair value of liabilities and briefly touches on difficulties and judgement required.

Questions and comments about items discussed in this article can be left in the comments section.

2. Basic calculation required to determine the fair value CSM or loss component

2.1. Under the fair value approach, the CSM or loss component at the transition date is calculated as the difference between the fair value of the liabilities for a group of contracts, applying IFRS 13, and the fulfilment cash flows for that group, applying IFRS 17, at that date.

2.2. If the fair value of the liabilities is greater than the fulfilment cash flows, the difference is recognized as a CSM on the balance sheet. On the other hand, if the fair value of the liabilities is less than the fulfilment cash flows, the difference is recorded as a loss component of the liability for remaining coverage.

2.3. Once the opening CSM or loss component balance at the transition date has been determined, all subsequent calculations for these balances must revert to the usual requirements of IFRS 17.

2.4. Note that whilst it is possible, it will not be commonly expected for loss components to arise when using the fair value approach as most calculations required to arrive at the fair value liabilities will result in a higher fair value liability than the fulfilment cash flows (e.g. the inclusion of the cost of holding capital that a market participant would require for accepting these obligations - see section 3.4).

3. How to calculate the fair value of a liability

3.1. The fair value of a liability needs to be calculated from the perspective of a market participant operating in the same principal (or most advantageous) market. It is the hypothetical exit price at which the liability will be transferred in an orderly transaction between market participants at the measurement date.

3.2. Once a fair value of the liability has been arrived at through any one of the methods described in this section, companies can follow the steps in section 2 to derive the resultant CSM or loss component.

3.3. <u>Use observable market prices</u>

One theoretically possible method is to set the fair value of the liabilities in accordance with observable market prices for such contracts. Companies will need to consider whether the data is representative of the business being valued (e.g. type of business, date of valuation etc.) and the adjustments that might be needed. For this reason, the conclusion is that it is unlikely for there to be readily usable prices to identify the fair value of a liability simply by looking towards the market and work will be required to consider the information available before it is used.

3.4. Adjust the fulfilment cash flows

Companies could make several adjustments to their fulfilment cash flows to arrive at a fair value of liabilities. Allowances could be made, for example, for the risk of the company's own non-performance for groups of contracts (note this is mandatory under IFRS 13) or different underlying demographic or attributable expense basis (for e.g. because a market-participant may have different economies of scale or because it has different underwriting, claims management and policy retention practices). Adjustments may also include an allowance for the return a market participant may require for accepting the liability and the risks that come with it.

3.5. Use a cost of capital or IRR approach

Under this method, companies could estimate the cost of capital or IRR a market participant will require to take on the obligations for the group of contracts being valued. One possibility could be to calibrate the company's own solvency or economic capital requirements to that of an average market participant's capital requirements and then apply a weighted average cost of capital needed by the shareholder of that participant.

3.6. Leverage existing EV or SII calculations

Existing EV or SII calculations could be used as one way of approaching the methods in 3.4 and 3.5 instead of approaching the calculations from a blank slate.

4. Summary

4.1. The main challenge with the fair value approach is in judgement and calibration. There are different methods that firms could adopt in calculating the fair value CSM. Examples of these include adjusting the fulfilment cash flows, using some form of cost of capital or IRR approach or even using existing embedded value or Solvency II metrics. Ultimately the challenge is that any method chosen will involve the application of judgement and companies will need to be able to justify these.

4.2. Areas where judgements and calibrations might be required include determining the level of the risk adjustment used, the profit loading included or the discount rate or the IRR assumed. This requires companies to find sufficient credible data (either externally or internally) and qualitative arguments to support the fair value of liabilities that they calculate.

On behalf of the IFoA IFRS 17 CSM Working Party

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