IFRS 17: Profit profiles under IFRS 4 and IFRS 17

[This article is one in a series of articles published on behalf of the IFRS 17 CSM Working Party. Members are Antoon Pelsser, Asim Ghosh, Clarence Er, Huina Zhang, James Thorpe, Joanna Stansfield, Kruti Malde, Natalia Mirin (Deputy Chair), Richard Dyble, Rob Walton, Timothy Berry, Weihe Qin and Wijdan Yousuf (Chair).]

Introduction

This article looks to provide a general understanding of how profit profiles may differ between IFRS 17 and the current reporting standard IFRS 4.

IFRS 4 and IFRS 17

IFRS 4 applies to insurance contracts and was issued in 2004 as an Interim Standard. In the UK under IFRS 4, profits are expected to be released via inbuilt prudential margins in the assumptions used to calculate reserves when the contract is initially setup. In the first year the difference between premium and mathematical reserves at initiation would be recognised in the Profit and Loss Account. In subsequent years, profits would arise from differences between the expected amount of benefit, expenses assumed at the time the reserves were setup against the actual costs and benefits incurred by the entity. In the financial statements this would be implicitly included in the change in mathematical reserves over a period of time. However under IFRS 4 there is no consistent approach followed across the globe thereby leading to lack of comparability within the insurance sector.

For IFRS 17, the Contractual Service Margin (CSM) is setup on day 1 which is the expected profit that the contract would earn during its lifetime. After initial recognition the CSM is runoff over the lifetime of contracts in a systematic way which best reflects the remaining transfer of services provided under the contract (in line with actual experience emerging over time). As part of actual experience emerging over time the overarching principle is that any change in experience that is related to past insurance coverage would be recognised in the profit and loss and changes that relate to future insurance coverage will be acknowledged by changes to the CSM.

Profitability statement comparisons under IFRS 17 and IFRS 4

In the current reporting regime there is a line item in the Profit and Loss Account for change in Liability (which represents the change in reserves). This line item included releases pertaining to both best estimate assumptions (release of BEL) as well as prudential margins.

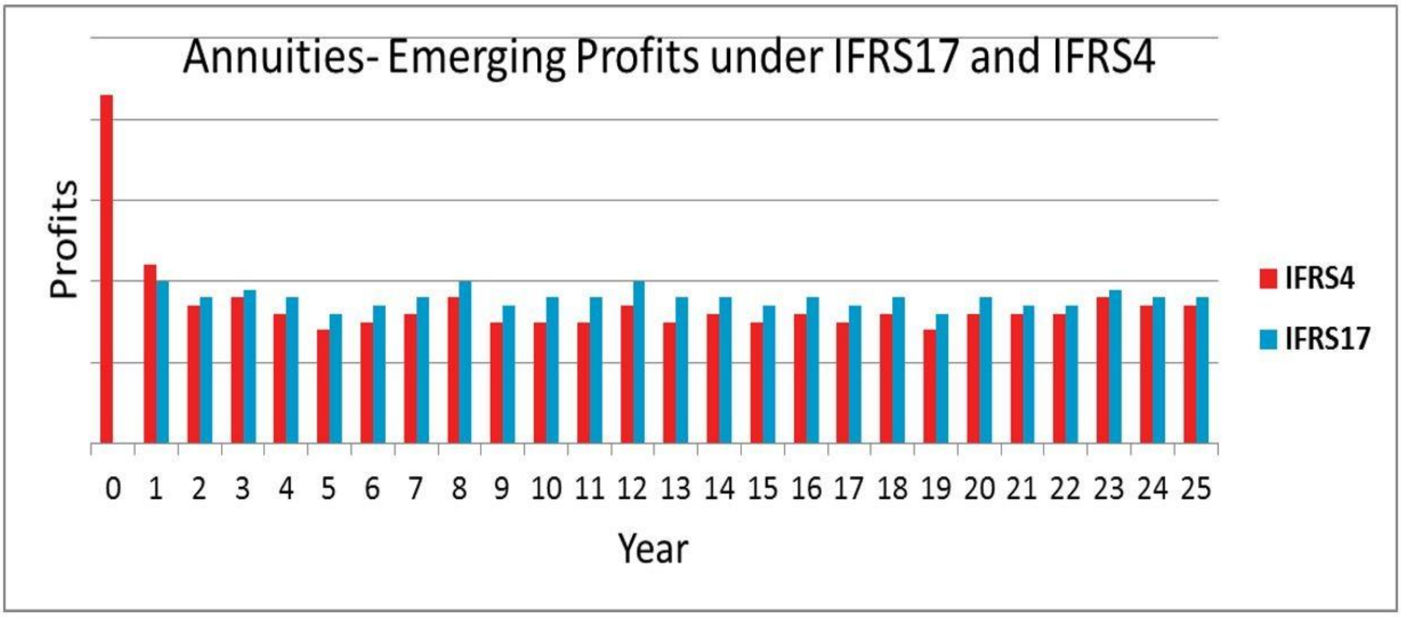
Under IFRS 17 this would be captured under the heading "Insurance Revenue". However there is a clear distinction between "Release in Best Estimate Assumptions" and "Release of Margins". The former is captured as "Release of Expected Outgo" and the latter as "Change in CSM".

IFRS 4	IFRS17
<u>Change in Liability - shown as a single line in Profit and Loss but which includes:</u> ✓ Release from expected outgo (release of BEL) ✓ Release from margins embedded in assumptions	<u>Insurance Revenue - which would have separate lines for:</u> ✓ Release from expected outgo (release of BEL) ✓ Release of margins through CSM

Overall Profitability - Comparison

Overall profitability (present value of future profits) is likely to be very similar under the current and proposed IFRS 17 approach. However, the timing would differ under the two approaches. The profits released under IFRS 4 have a general trend of being higher at inception and in the first policy year, but lower in subsequent years when compared to IFRS 17. This is due to the fact that at initiation the difference in premiums and reserves would be instantly recognised as a profit. Under IFRS 17 the expectation is that it would produce a more stable profit signature as we are only realising profits as and when we move ahead in time and the service for the Insurance contract is provided. The difference in timing for profit releases will primarily depend on how the release of margins compared against the CSM runoff method used under IFRS 17.

In the illustration below we look at the likely profit emergence for a Fixed Annuity over a 25 year horizon. At time 0 the profits under IFRS 17 is 0 (due to setting up a CSM for expected future profits). However under IFRS 4 at inception, the entire difference between premium paid and reserves setup is recognised as profits. Whilst the total profits emerging is the same under IFRS 4 and 17 the expectation is that profits reported under IFRS 17 will be less volatile as compared to the current reporting regime.



Whilst we would expect the overall profitability to be very similar under both approaches there are two key areas where we see divergences emerge.

Treatment of onerous / loss making contracts

There is a distinction in the profit profile for onerous contracts under the two approaches. Under IFRS 17 loss making contracts are identified separately and the losses are recognised immediately in the Profit and Loss Account. There is also a requirement under IFRS 17 to monitor the profitability of contracts in the future and whenever onerous contracts are identified, recognise these losses immediately in the Profit and Loss account. However, under IFRS 4 the approach has been varied given the different approaches followed across the globe. It has been seen that for some jurisdictions (including the UK), negative reserves are allowed for within specific cohorts of business. Thus, offsets would occur (with positive reserves) thereby leading to a profit reported (change in reserves) that would include the impact of negative reserves. The hypothetical example below would highlight the impact negative reserves might have on profits for the year.

Change in liability = Reserves t+1- Reserves t

Say Reserves t+1 ->£20000 (including a negative offset say, £1500)

Reserves t ->£17200 (including a negative reserve offset say, £1200)

Impact on profits from reserve movements in the year (Reserves at t+1 less Reserves at t) =£20000-£17200=£2800

However if we were to ignore negative reserves in the opening and closing reserve balances the impacts on profits for the year would be

(£20000+£1500) less (£17200 +£1200) =£3100

Under IFRS 4 there was also a requirement to do a Liability Adequacy Test which involved comparing the current estimate of the net contractual cash flows with the carrying amount of the Insurance Liabilities. If the former was larger this would be recognised in the Statement of Comprehensive Income. Again, the way this test is performed varied differently between companies and this requirement is no longer relevant under IFRS 17.

Impact of change in assumptions on future profitability

One of the key impacts on future profitability would be the impact of a change in assumptions (financial and non-financial). Under IFRS 4 everything is implicitly included under change in reserves. Under IFRS 17 there is an option to show financial impacts either in the Profit and Loss Account or Other Comprehensive Income. The rationale behind this would be to limit the effect of volatility on Profit and Loss Accounts. IFRS 17 presents Life Companies with an opportunity to align the accounting treatment for a specific portfolio of insurance contracts with the accounting treatment of the assets that back the relevant liabilities. For example, if an insurer mainly holds financial assets measured at fair value and recognises in profit or loss changes in fair value, the insurer is likely to also present all changes in relevant insurance contract liabilities from financial assumptions in profit or loss. The approach followed by life companies would also depend on the approach (calculation of CSM) and level of complexity associated with various product lines. This is one area which will be explored in further detail in the future sessional paper on the same theme.

In the upcoming sessional paper we will look in further detail to explore profit profile comparisons (IFRS 17 vs IFRS 4) for key product lines - annuities, unit-linked products, protection and with-profits business.

[END]