IFRS 17: Determining the risk adjustment at the group of contracts level

[This article is one in a series of articles (which can be found here and here) 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).]

1. Overview

This article considers whether determining the risk adjustment for non-financial risk (RA) at the group of contracts level may create any potential issues through its influence on the CSM.

2. Background

The RA is an adjustment to the estimate of the present value of future cash flows to reflect the compensation that the entity requires for bearing uncertainty about the amount and timing of cash-flows that arise from non-financial risk.

The RA also reflects the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk.

The CSM, at both initial recognition and subsequent recognition, depends on the RA. The latter is because at the end of a reporting period the CSM is adjusted for changes in fulfilment cash-flows relating to future service, which includes changes in the RA.

3. Challenges

IFRS 17 requires a level of aggregation of insurance contracts derived from first identifying portfolios of similar risks and then dividing these into groups including by yearly cohort.

This suggests that the RA should be determined for each group of contracts.

The IFRS 17 Transition Resource Group (TRG) indicated in their May 2018 meeting that the RA should be determined at the entity level. This suggests that at lower levels, such as the group of contracts level, the RAs should be additive to sum to the entity level RA.

Insurers familiar with Solvency II will be used to determining the Solvency II Risk Margin, which has similarities to the RA, at the entity level. However, determining the RA at the group of contracts level is likely to be challenging as it requires allocating the entity diversification benefit between each of the groups.

There are various possible methods to allocate the entity diversification benefit between the groups which insurers may wish to consider. The choice of method may be influenced by balancing the reasonableness and accuracy of the outcome with the practicality of the method.

Further consideration could be given to the impact on the CSM. When an insurer writes new business then they may seek to allocate the new diversification benefit entirely to the new business, which could be referred to as the marginal approach. Alternatively, the insurer may seek to allocate the new diversification benefit across both the new and existing business, which could be referred to as the proportional approach.

The diversification benefit will reduce the RA and increase the CSM whichever approach is used, marginal or proportional. An advantage of the marginal approach is that investors and analysts may pay more attention to the RA and CSM on new business. Furthermore, this also benefits from a more stable RA on existing business. However, the marginal approach could result in similar blocks of business receiving different levels of diversification benefit which may not be theoretically reasonable and may be more complicated when determining how the diversification benefit changes as the business runs-off.

4. Conclusion

The approach to determining the RA at the group of contracts level is likely to be a complicated matter for insurers.

Furthermore, the CSM on existing groups of contracts may be impacted by writing new business into unrelated groups due to the impact from the diversification benefit from the new business on the RA of each existing group. It could be suggested that potentially this is not a desired outcome of the CSM as instead insurers may typically expect to fully benefit from the diversification benefit gained from writing new business.

The working party is interested to learn which approaches to determining the RA at the group of contracts level are being adopted by insurers and whether any such approach is creating any issues from its influence on the CSM.

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