Calculating the value at initial recognition

1. Overview

This article looks at how the CSM is calculated at initial recognition and considers some of the things an entity will need to take into account in applying this calculation. In particular, we focus on the challenges around determining the date at which contracts should be initially recognised.

2. Background and basic calculation

The CSM is a liability on an entity's balance sheet. It represents the unearned profit from an insurance contract, which an entity will recognise as it provides insurance contract services[1] in the future.

On recognising a new group of insurance contracts[2] we therefore need to calculate its CSM at initial recognition. The IFRS 17 requirements for the basic calculation for doing this are fairly clear, with limited judgement required.

The CSM at initial recognition is, effectively, a balancing item to ensure a net zero impact on the balance sheet at inception[3].

The CSM at initial recognition can be represented by the following formula:

CSM = PV(best estimate future cash inflows) – PV(best estimate future cash outflows) – Risk Adjustment – any deferred acquisition costs allocated to the group + cash inflows at date of recognition – cash outflows at date of recognition.

It should be noted that:

- The first 3 items of the formula above are referred to as the Fulfilment Cash flows (FCFs)
- The cash flows at the date of initial recognition will include acquisition costs and initial premiums.
- The present value calculation is carried out at the appropriate IFRS 17 discount rate.

3. Challenges

Whilst the interpretation is clear in determining the format of the calculation itself, there is judgement required in the practical application of this formula. In this article we discuss the challenge of determining the date at which new contracts should be recognised.

[1] The Exposure Draft clarifies that insurance contract services includes both insurance services and investment services.

[2] Grouping of insurance contracts is an interesting topic in its own right and will be the subject of a future article.

[3] The exception to this is where a negative CSM would be required to achieve this, i.e. the contract is loss making; the CSM cannot be negative for directly insured business In this case a loss component is established (instead of a CSM) and the loss is recognised through P&L immediately. This scenario is not discussed further in this article.

IFRS 17 states that a group of insurance contracts[4] should be recognised from the earliest of 3 dates:

a) The beginning of the coverage period of the group of contracts;
b) The date when the first payment from a policyholder in the group becomes due; and
c) For a group of onerous contracts, when the group becomes onerous.

Setting aside the latter date (i.e. assuming we are dealing with a profitable group) this leaves two dates to consider. The interpretation of the second date is relatively clear, particularly given the clarification in the standard that, where there is no contractual due date, the first payment is deemed to be due when it is received. However, the first date could be interpreted in a couple of ways. A standard actuarial way of interpreting this could be as the date the entity becomes "on risk" for providing services under a contract. However, in IFRS 17 the "coverage period" is a defined term, which refers to "the period during which the entity provides insurance contract services[5]". Therefore in assessing this date consideration needs to be given to the IFRS 17 coverage period.

The other challenge to be aware of is that this definition, whilst similar, is subtly different from Solvency II (SII), which requires contracts to be recognised at the earliest of the date coverage begins and the date the entity becomes a party to the contract. Whilst in most scenarios you may expect the concluding recognition date to be the same under IFRS 17 and SII, there may be scenarios where small differences may arise. This is likely to give rise to operational challenges.

An example: a bulk annuity contract is signed on 1 January, the premium is due on 1 February and the "coverage" starts on 1 February (in this example we assume the IFRS 17 coverage period start date and the SII coverage start date are the same). Under this example, the IFRS 17 recognition date would be 1 February but the SII recognition date would be 1 January.

If such differences arise entities may want to explore options to avoid such recognition date discrepancies in their different bases. For example, they may explore the materiality of any date differences or whether processes can be put in place to avoid date discrepancies arising for future new business.

Once you have determined the recognition date for your groups of contracts, you will need to work through the practical considerations. For example, determining the point at which you assume the contract is recognised in your actuarial cash flow models – this will potentially impact a number of things, including the date at which you determine the locked in discount rate, the appropriate non-economic assumptions to use for recognising the CSM at initial recognition and how much (if any) CSM release will be recognised in P&L for the month in which a new contract is written. The standard is silent on this point, however, in line with current industry practises under SII and IFRS, it is assumed that some approximations are acceptable, although these will need discussion with your auditors. There appear to be 4 choices for date of recognition in your models:

1. The actual recognition date
2. The start of the period
3. The end of the period
4. An "average" point in the month, e.g. the midpoint of the month for all contracts written in that month.

[4] This definition applies to underlying insurance contracts; for reinsurance the requirements differ.
[5] Source: Appendix A Defined Terms in the June 2019 IFRS 17 Exposure Draft.

In deciding between these options, an entity should consider a number of factors, for example:

- Operational considerations – what approach is currently used in your actuarial liability models? If they currently assume recognition of new business at, say, the start of the month then there may be some significant model development required to change to, say, an end of month approach.
- Commercial considerations – the sensitivity of the results to, for example, interest rate changes, and the materiality of the new business volumes should be considered. For example, for a high materiality product line with high interest rate sensitivity you may choose to use a more "accurate" approach to try and tie the locked in discount rate as closely as possible to that used in pricing.
- Complexity of calculation – more complex approaches, e.g. the actual date or average date may introduce more complexity to your calculation, requiring more effort to validate and explain to users. In contrast, an end of month approach will result in no interest accretion or CSM release in the month of new business being written, which may simplify the validation process.

4. Conclusion

Whilst the basic calculation of the CSM at initial recognition is well defined in the IFRS 17 standard, there are a number of judgements that an entity will need to make in determining the detail behind this calculation. For example, an entity will have a number of decisions to make in determining the appropriate point to recognise new business. In making these judgements an entity should consider the balance between operational impacts, commercial implications and the complexity introduced to the calculations and therefore the results.