

IFRS 17 – impact on UK protection business

This article from the IFRS 17: Transversal working party introduces some key issues insurers may face when implementing IFRS 17 for UK protection business. The working party intends to explore some of these issues more deeply over the coming months and would be happy to receive feedback from members on topics of particular interest.

Requirements of the standard

Under IFRS 17 protection business will generally be measured using the General Measurement Model under IFRS 17. For the Contractual Service Margin (“CSM”) this means that the financial assumptions will be fixed at the inception of the contracts i.e. the discount rate is “locked-in” at inception whereas non-financial assumptions will be updated in line with the experience.

IFRS 17 requires companies to present underlying and reinsurance contracts separately (for further details on this see the separate note on reinsurance). This requirement can have particular implications for UK protection business because it is not uncommon for the base contract to be loss making and only when related reinsurance contracts are taken into account will writing protection business be profitable. As the base protection contract and reinsurance contracts must be presented separately the base contract may be onerous and the reinsurance contracts profitable with a CSM recognised. This could result in an overall loss being recognised at issue for the direct insurer before any allowance for reinsurance, despite the net position being profitable. The June 2019 IASB Exposure Draft includes a proposal which may help address this issue, however there are still challenges around the proposed approach, including the definition of proportionate reinsurance.

Under IFRS 17 companies must identify insurance contracts that are subject to similar risks and managed together and group these contracts into portfolios. Once a portfolio has been identified it should then be divided into three groups at initial recognition; the three groups are (a) contracts that are onerous, (b) contracts with no significant possibility of becoming onerous and (c) the remaining contracts. For protection contracts these new requirements around the grouping of policies give rise to the following specific considerations.

Contract boundaries

IFRS 17 applies the concept of a contract boundary. For protection business, the IFRS 17 contract boundary may be different (shorter) from the contract boundary under other reporting and regulatory regimes.

The first challenge is that protection business can be written as a rider to another base contract. IFRS 17 only unbundles riders in limited circumstances based on theoretical rules. In most cases the rider and base contract would be considered together. The contract boundary for both the rider and the base contract is set to the maximum of the two contract boundaries which may create a mismatch.

The second challenge is that some protection business is written on a short term basis but is renewable. Whether a contract boundary exists at the point of renewal is based on an assessment as to how full the repricing is in relation to re-assessing the risks at that point in time. If there are limits on the amount that the premium can be re-priced from one period to the next, this may mean that a contract boundary is not created at the end of the period and a longer boundary exists. However, in many cases a short contract boundary will arise.

This can be a particular problem for group business which can be highly competitive in the UK market. Group business may be priced at a higher level, with specific terms and conditions around any re-pricing.

The treatment of acquisition expenses

Acquisition expenses for protection business can be very significant when short term protection business is priced and sold assuming there will be future renewals. This means that the acquisition expenses can be larger than the (present value of) premiums and the contracts onerous, if all the acquisition expenses are put against the first contract. To allow for this, IFRS 17 allows the acquisition expenses to be spread across the first contract and the expected future renewals. An asset, similar to the Deferred Acquisition Costs under existing insurance accounting rules, for the acquisition expenses allocated to the future business, which has not been written yet is set up and as those renewals do or do not arise, the asset must be adjusted in future periods for that experience as it arises (i.e. should the asset be impaired?). From a systems point of view this will introduce the challenge of reconciling the opening and closing balance of such asset.

Gender neutral pricing

For protection business such as level term insurance, the approach to aggregation could have resulted in all contracts for males being in the onerous group and all contracts for females being in a profitable group. However IFRS 17 states that when contracts within a portfolio fall into different groups because law or regulation constrains the company in setting a different price (gender neutral pricing) the contracts may then be included in the same group. In the case of level term insurance this means that contracts for males and females can be grouped together and whatever the combined position of the group at initial recognition is would be the grouping for all contracts.

Transition

IFRS 17 must be applied retrospectively to business in force. For protection business, as with other types of business, identifying the required data and assumptions can be challenging for business written historically. However, a specific issue arises due to a potential short IFRS 17 contract boundary, protection business considered in-force may need to be separated into multiple groups and indeed future renewals treated as new business. This will require data, systems and modelling changes.

Summary

There are a number of specific challenges for the UK protection market. These issues will have impacts across all areas from data, systems and processes to technical and modelling considerations. There will be impacts on transition for in-force business, as well as on new business. Due to the importance of reinsurance in the protection market, participants may seek to amend their reinsurance provisions.

More generally, profit recognition profiles will change as insurers move from IFRS 4 to IFRS 17. This is likely to have wider business implications, for example pricing. At this point it is too early to predict what these other impacts will be.

Further articles from the IFRS 17 Transversal Working Party will discuss these and other annuity issues further. See <https://www.actuaries.org.uk/practice-areas/life/research-working-parties/ifrs-17-transversal> for details.