

IFRS 17: Fair Value Approach to Transition

Considerations when determining the Fair Value of insurance liabilities

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Introduction

The new insurance contracts accounting standard, IFRS 17 (**'the Standard'**), has an expected implementation date of 1 January 2022 and the countdown is on for companies to be ready for implementation. This is a relatively short deadline when considering the significant changes required to companies' financial reporting results, systems, and processes.

In their first set of accounts under the new regime, impacted firms need to show a re-stated balance sheet on an IFRS 17 basis as at the expected Transition Date of 1 January 2021¹. The calculation of the Contractual Service Margin (**'CSM'**) at the Transition Date is proving to be one of the most complicated parts to implement.

The choice of transition approach will impact the size of the CSM at transition. An approach that leads to a higher CSM at transition will mean lower retained earnings and higher, and potentially less volatile, future profits. (Re)insurers may prefer a higher or lower CSM at transition depending on their relative preference for earlier dividends versus higher future profits.

This financial impact will need to be explained to, and understood by, all stakeholders so that the optimal approach to transition can be made.

This paper focuses on the Fair Value Approach (**'FVA'**) to Transition. It is assumed for the purposes of this paper that the reader has a basic knowledge of IFRS 17. For an introduction to IFRS 17 please see our IFRS 17 website:

<http://www.milliman.com/IFRS/>

Transition Requirements

The Standard requires the Transition Date balance sheet to be calculated retrospectively using a full retrospective approach (**'FRA'**) unless this is impracticable.

The FRA requires companies to calculate their balance sheet as if IFRS 17 had always applied. This requires the calculation of the Best Estimate, Risk Adjustment and CSM for all in-force business as at the initial recognition date and rolling these amounts forward to the transition date. For long-term business this is a huge undertaking.

However, where an insurer can demonstrate that full retrospective application is impracticable, it may instead choose between applying either the Modified Retrospective Approach (**'MRA'**) or a Fair Value Approach (**'FVA'**) to transition.

The MRA attempts to achieve the closest outcome to the FRA that is possible using reasonable and supportable information. A range of specific modifications are allowed under the MRA, however their use is restricted to situations where the company can demonstrate the impracticability of the FRA. In practice, insurers have found that historic data limitations can limit their ability to use the MRA. Given these challenges, many companies are therefore looking to use the Fair Value Approach.

The FVA is a fundamentally different approach to the FRA or MRA as the calculation of the CSM is performed on an entirely prospective basis. This provides an alternative for insurers where it is impracticable to obtain the necessary data to perform a retrospective approach.

Fair Value Approach

Under the FVA, the CSM at the transition date is determined as the difference between the Fair Value of the insurance business (which is computed in accordance with IFRS 13) and the IFRS 17 Fulfilment Cash Flows (**'FCF'**) as at the Transition Date. The FCF are the sum of (i) the present value of the best estimate cash flows plus (**'BE'**) (ii) the Risk Adjustment (**'RA'**).



Fair Value is defined in IFRS 13 as “the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date”. The Fair Value is based on an exit price principle, rather than the fulfilment perspective of IFRS 17, which leads to additional considerations that are discussed in the following section.

¹ or the equivalent for firms that have alternative reporting dates

Fair Value Measurement

Given the lack of a liquid, observable market for insurance liabilities, IFRS 13 allows the use of present value techniques to determine the Fair Value. When determining the Fair Value of liabilities using a present value technique, the following items are included:

- Future cash flows that the buyer would expect to incur in fulfilling the obligation
- Time value of money
- Compensation for the risk that the actual cash flows might differ from the estimated ones (a risk premium)
- Non-performance risk, including the entity's own credit risk

Existing established insurance liability valuation approaches, such as Market Consistent Embedded Value ('MCEV'), or the Solvency II value of liabilities could be a starting point for the Fair Value, or even the IFRS 17 FCF themselves.

However, these measures can differ from the Fair Value requirements of IFRS 13 and therefore some adjustments will likely be required across a number of areas discussed below. These adjustments may require judgement and will impact on how easy it is to explain the resulting Fair Value. Some existing valuation approaches require fewer and/or more intuitive adjustments than others. The choice of the existing valuation approach to use as the starting point is therefore an important one.

CASH FLOWS IN SCOPE

The cash flows included in the Fair Value calculation should reflect what a buyer would expect to incur in fulfilling the liabilities. This can lead to adjustments to other valuation approaches in the following areas:

Expense cash flows

Under a Fair Value approach, expenses may be based on an average market level of expenses rather than the entity's own expenses. This can be of particular importance to new companies or those with closed books of business, where a company's own expenses may be significantly higher than an average market level.

Furthermore, although an overhead allowance is included in the fair value, existing liability valuation approaches may contain more non-attributable expenses than required.

Contract boundaries

Both IFRS 17 and Solvency II take contract boundaries into account and do not include the value of future renewals beyond this point. Under Fair Value there is scope to take a more economic approach to contract boundaries compared to the somewhat artificial and restrictive requirements of Solvency II and IFRS 17. Contract boundaries could potentially be extended to cover all future regular premiums on existing contracts, which can have a material impact on the Fair Value and therefore the CSM that is recognised. In certain circumstances, extending the contract boundaries could

result in the fair value being less than the fulfilment value of the liabilities, which may affect the decision on transition approaches.

DISCOUNT RATES

Under Solvency II, discount rates are prescribed by EIOPA and can include features such as the Ultimate Forward Rate ('UFR'), and illiquidity adjustments such as the Matching Adjustment ('MA'), or Volatility Adjustments ('VA'). Under MCEV the discount rate is based on a risk-free rate plus an illiquidity premium, where applicable (Solvency II discount rates can also be used).

The discount rate used under IFRS 13 should reflect the assumptions that market participants would use when valuing the insurance liabilities and be consistent with the characteristics of the liabilities, such as duration and currency. Some adjustment to Solvency II or MCEV discount rates may therefore be required.

Where the cash flows being discounted are risk-adjusted, a risk free rate should be used to discount the cash flows. Where the cash flows are not risk-adjusted the discount rate should include an allowance for risk that market participants would require.

ALLOWANCE FOR RISK

Where the discount rate used in the Fair Value calculation is on a risk-free basis a separate allowance for risk is generally required. Both Solvency II and MCEV regimes include an allowance for risk though the Risk Margin and Cost of Residual Non-Hedgeable Risks respectively. Similar approaches could therefore be used to allow for risk under the Fair Value methodology. Whichever approach is used it will need to reflect the allowance for risk required by market participants, and therefore should reflect the market view of risk rather than the entity's own risk appetite.

It is important to note that this is not the case when using the IFRS 17 risk adjustment as this reflects the entity's own perception of risks. Differences in the allowance for risk between Fair Value and IFRS 17 or Solvency II can arise due to:

- Level of diversification assumed
- Difference in cost of capital
- Use of internal model or standard formula for determining capital

These differences can lead to a significant change in CSM or loss component at transition.

NON-PERFORMANCE RISK

IFRS 13 requires that the Fair Value reflects the effect of non-performance risk, which includes the risk that the obligation will not be fulfilled by the seller of the liability (own credit risk). Neither Solvency II nor MCEV have a similar principle and therefore may need to be adjusted for non-performance risk.

CONCLUSION

The approach to transition is an important one because of the potentially significant impact on companies' balance sheets and future profits. Where a full retrospective approach is impractical, the Fair Value Approach can provide a practical alternative. However it is important for companies to assess and understand the impact to ensure an optimal approach.

How Milliman can help

The calculation of the Fair Value of insurance liabilities requires significant actuarial expertise and judgement. Milliman has a depth of experience and expertise in IFRS 17, Solvency II and Embedded Value reporting, and is therefore ideally placed to advise on and review Fair Value calculations for IFRS 17.

Our other services in relation to IFRS 17 implementation include:

- Assumption and methodology development and implementation
- Independent review
- Gap analysis and impact assessment
- Modelling and Review of Best Estimate, Risk Adjustment and CSM calculations
- Transition calculations
- Training on IFRS 17 concepts
- Implementation of IFRS 17 systems

If you have any questions or comments on this paper or any other aspect of IFRS 17, please contact any of the consultants below or your usual Milliman consultant.



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