

Introduction

The paper is intended to be a presentation of the new accounting standard IFRS 17 for insurance companies, approved by the IASB board in May 2017. Given the complexity of both the sector and the variety of existing insurance products, the possibility of creating a single standard that succeeds in truthfully representing the economic reality of the various businesses, becomes extremely difficult.

However, IFRS 4, which allowed the adoption of national accounting standards for the preparation of insurance balance sheets as a temporary solution, lacked comparability between the countries and constituted an obstacle for financial statements' readers and more in general for shareholders.

The entry into force of the standard, scheduled for January 1, 2021, has been rescheduled for a one-year delay (1 January 2022), in view of the request from the European organizations with the support of insurance companies of a delay of at least 2 years.

The industry was hoping for a two-year delay, but, in any case, the one-year extension was well received.

Among other things, the postponement of the international principle IFRS 17 also brings with it the extension of another accounting principle, tied in a double line to the first one. The IFRS 9 regards assets unlike IFRS 17, which instead intervenes on the liabilities of insurance companies. A principle, the IFRS 9, already started for the banks and that has led the institutions to accelerate the cleaning of their balance sheets, increasing the coverage on impaired loans. For insurances, IFRS 9 probably has a less disruptive flow but, in any case, the postponement represents a good update.

In the light of the articulation of the principle, in fact, many companies turned out to be far behind in the implementation project, especially the smaller companies, which rely on the adoption of the principle by large companies, also due to the recent implementation of the Directive of Solvency II, which has slowed down the process.

Thanks to the information provided by some of the major Italian and foreign insurance companies, including Reale Mutua, Assicurazioni Generali, Allianz and Helvetia

Insurance, the third chapter of the report presents an accurate analysis of the status of the current implementation processes initiated by these companies.

Given recent events, the IASB Board accepted the latest request for delay on 14th November 2018, deferring the adoption of the principle to the 1st of January 2022. Thus, many of the companies in the insurance sector are still collecting the necessary information and gathering the essential tools to initiate the actual process. Undeniably, the principle will lead to large profits for external suppliers and partner companies, responsible for providing new information software and management programs for the entities that will have to adopt the new IFRS 17.

What they have in common is the lack of conviction for the added value represented by the principle that, despite the enormous investments it will require, it lacks to show the actual future benefits.

The paper is structured in 3 chapters: in the first, a brief presentation of the issues of IFRS 4, the previous principle concerning the insurance sector, that allowed the adoption of national accounting standards that lead to a lack of homogeneity among the companies and the new IFRS 17 including the calculation methods of expected cash flows and insurance liabilities.

On the other hand, the second chapter deals with a brief, more accurate presentation of the steps that led to the implementation of the standard, the reactions of the European Commission and the request of two further years for the implementation of the principle. Furthermore, a brief analysis on the issues faced by the big four: Ernst&Young, KPMG, PwC and Deloitte in anticipation of the future adoption of the issued regulation.

Finally, the third chapter contains an in-depth study of the steps taken by four of the major Italian and European insurance entities: Reale Mutua, Assicurazioni Generali, Allianz and Helvetia Insurance in order to comply with the new IFRS 17.

CHAPTER ONE

THE EVOLUTIONARY DEVELOPMENT OF THE IASB PROJECT IN THE INSURANCE FRAMEWORK

1.1 Introduction to IFRS 4

1.1.1 The first Phase of the Insurance Contracts project

The “Insurance Contracts” project, firstly launched by the International Accounting Standard Boards (IASB) in 1997 has as its objective the definition of a single-based principle for the computation and evaluation of all types of insurance contracts, including reinsurance contracts. The latter is defined as “insurance for insurers”; many insurance companies, in fact, don’t possess the necessary means to compensate policyholders for disasters linked to large scale events (natural disasters, chain

damage). Once the accident occurs, the reinsurer will help the entity to pay the damages, so as to meet all its contractual obligations and thus reduce the risk of failure. The IASB is the entity responsible for issuing international accounting standards; founded in London in 1973, it is the result of an agreement between the major professional associations operating in Australia, United States, Canada, Mexico, Japan, France, Germany and the United Kingdom. As a private entity, it does not have any right of enforcement upon the parties and, consequently, it cannot force them to use its own principles, which must be implemented solely based on their free acceptance.

After careful considerations and due to the complexity encountered in the implementation of a globally consistent standard, in 2002 the *Board* chose to divide the initial project into two distinct phases¹.

The IFRS 4 *Insurance Contracts Phase I* is the International Financial Reporting Standard issued by the IASB in March 2004 and implemented on the first of January 2005. It currently applies, with a few minor exceptions, to all insurance contracts (including any own-issued financial instrument with a *Discretionary Participation Feature*, DP² - IFRS 4 establishes that the insurer can separate the two components. The discretionary one has to be classified as a separate liability or as a component of equity) defined as “agreements under which one party (the insurer) accepts significant insurance risk from another party (policyholder) by agreeing to compensate him if a specified uncertain future event adversely affects him.”³ A significant insurance risk has been classified as an insured event that could cause an insurer to pay significant additional benefits and the threshold is set at a 10 percent or greater present value loss, expressed as a percentage of the ceded premium for the contract.

On the other hand, a contract that exposes the issuer to a non-significant financial risk is classified as an asset or liability and measured at *fair value*⁴ according to the criteria established by IAS 39⁵.

¹ S. Gutterman, *The coming revolution in insurance accounting*, in “North American Actuarial Journal”, January 2002

² Contractual right to receive, as a supplement to guaranteed benefits, additional advantages whose amount or timing is at the discretion of the issuer and are based on the performance of a specified pool of contracts and the profit or loss of the issuing company.

³ <http://www.ifrs.org>, IFRS 4

⁴ Rational and unbiased estimate of the potential market price of a good, service or asset.

⁵ Recognition and measurement of financial instruments

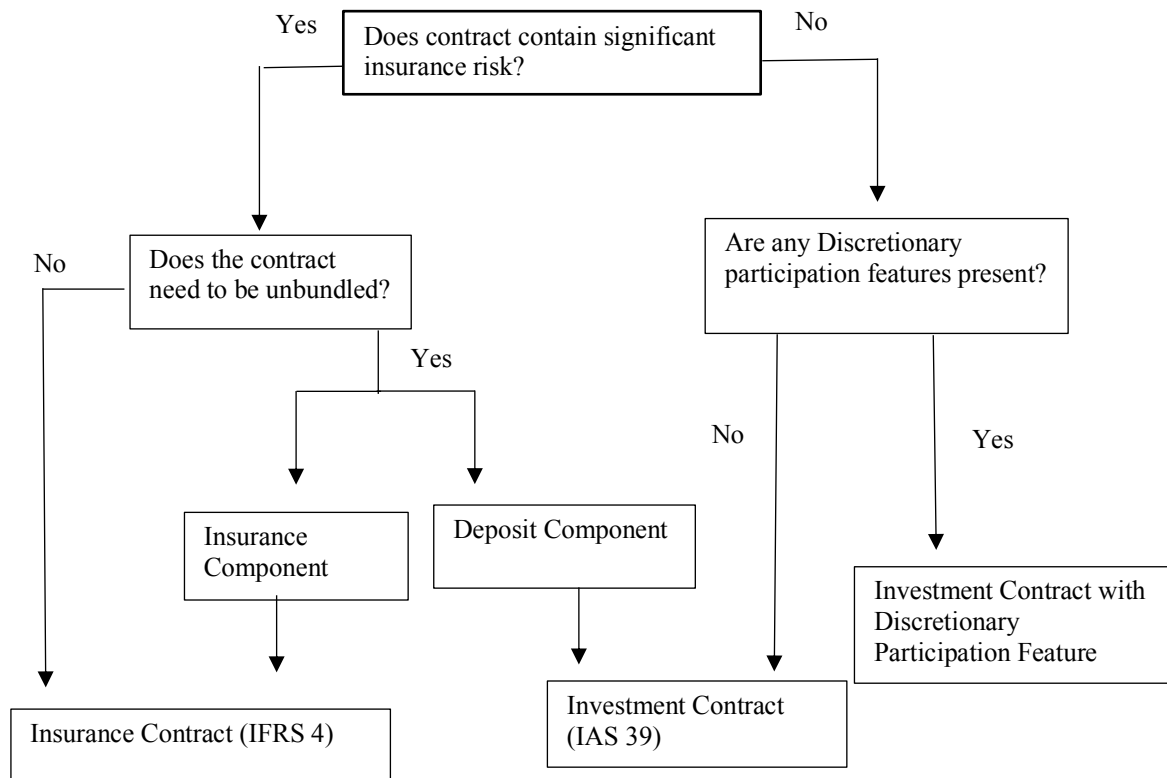


Figure 1.1: IFRS 4 Measurement

IFRS 4 requires an insurer to unbundle the contract from the deposit component (saving process leading to an individual claim of the policyholder; since the policyholder must generally pay premiums in advance, virtually all insurance contracts have an implicit or explicit deposit component) only when this treatment is needed to ensure the recognition of the rights and obligations arising from it and when those rights and obligations can be measured separately. If only the second condition is present, IFRS 4 permits unbundling but does not require it.

The IFRS 4 is an interim standard and it was originally designed as a temporary measure to allow entities to continue to implement existing local accounting policies provided that they comply with the relative requirements.

The “*Liability Adequacy Test*” (LAT) is one of them; it needs to be performed every year at the end of the current reporting period using an estimation of the risk adjusted present value of future cash flows related to future claims. In the event that this estimate exceeds the unearned premium liability (computed net of intangible assets and deferred

acquisitions costs), the deficiency should be recognized in the balance sheet as an increase in provisions and as an expense in the income statement.

In the context of an accounting model like the one shown so far as the result of a combination of a variety of different accounting cultures and logics, a clear mismatch arises between insurance liabilities that continue to be valued with local principles and those that are evaluated according to the requirements of IAS 39.

This problem was only partially mitigated by the *shadow accounting* procedure, a set of records maintained at a local or department level under which any hidden reserve (or loss) affects the evaluation of insurance liabilities in the same way as a realized gain. The main object of the shadow accounting practice is to ensure that variations occurred in insurance assets or liabilities are not incorrectly allocated to shareholders. This methodology permits to partially resolve the mismatch between the valuation of accounting assets and liabilities: value changes in the assets would normally be recognized in a revaluation reserve as part of equity or directly as a P&L (Profit and Losses). By applying shadow accounting, unrealized gains and losses are allocated to the insurance liabilities. In this way, any possible value adjustments will not lead to an undue movement in equity or P&L.

The accounting effect is to allocate the unrealized gains/losses to the deferred insurance liabilities and, for those pertaining to insurance companies, to equity.

It should be noted that this approach mimics the full fair value one where a change in assets is matched with a similar shift in the liabilities; the economic outturn is a result of all the adjustments incurred during the exercise of the operating activity.

The standard also provides disclosure requirements to identify and explain amounts in the financial statements as well as to help users understand the amount, timing and uncertainty of cash flows; in particular it contains rules for the explanation of values that have a major material impact on estimates in balance sheet and income statement such as discount rates or legislative changes.

Some of the major improvements introduced by the first Phase of the standard can be summarized in the following points:

- the characterization and classification of insurance contracts based on the disclosure of the criteria for the identification of significant insurance risk;
- distinction between insurance and financial contracts: a contract that only provides for financial risks is a financial contract (regulated by IAS 39), while

a policy that provides for both financial and insurance risks is an insurance contract;

- the separation of options and derivatives incorporated in the main insurance contract: embedded derivatives should be separated and measured at fair value, but in Phase I they can continue to be valued with principles as long as they are of an insurance nature;
- the implementation of a *mark to market* accounting system built on the *fair value* standard;
- the introduction of a *Liability Adequacy Test*;
- more transparent disclosure of primary information.

However, IFRS 4:

- prohibits provisions for possible claims under contracts that are not in existence at the end of the reporting period (such as catastrophe and equalization provisions); and
- requires an insurer to keep insurance liabilities in its statement of financial position until they are discharged or cancelled, or expire, and to present insurance liabilities without offsetting them against related reinsurance assets.

1.1.2 The second Phase of the Insurance Contract project

In May 2007, the IASB published the first output leading to the implementation of *Phase II*, which faces the technical-operational issues more strictly related to the implementation methods of the predetermined accounting rules. The *Discussion Paper "Preliminary Views on Insurance Contracts"* deals with numerous issues concerning the different alternatives surrounding the accounting evaluation methods for insurance contracts and addresses one of the main controversies related to the application of the IASB project, namely the computation of technical reserves in the insurance sector.

The document presents two different accounting models, one based upon the *Asset & Liability Measurement*⁶ and a second one based on the *fair value* in accordance with the choice of the *current exit value*⁷, determined on the basis of the value of the transferred insurance portfolio. The exit value is in fact the price an insurer is willing to pay to transfer the present insurance obligations to another party. Normally, it is the discounted value of the expected cash flows for insurance liabilities. Exit value is not favored since the method does not reflect actual CFs due to the fact that the value of life insurance liabilities is hardly available in the market.

The purpose of the model, both for life and non-life insurance policies, is to estimate the present value of the fulfillment of the company in regard to the obligations originated by the contract. In order to obtain this value, insurance companies use techniques to determine the present value of the incoming (premiums) and outgoing (claims and casualties) cash flows considering the following aspects (*building blocks*):

- more faithful representation of insurer obligations and rights;
- future cash flows determined by objective assessments that take into consideration different scenarios and assign to each of them a likelihood of occurrence;
- a discount rate that aligns the cash flows in accordance with the value of money over time: available at the present time is worth more than the identical sum in

⁶ L. Todd Johnson, *Understanding the Conceptual Framework*, The FASB Report, December 28, 2004

⁷ Sum of two distinct elements: the best estimate and the risk margin

the future due to its potential earning capacity. Provided money can earn interest, any amount of money is worth more the sooner it is received;

- risk adjustments calculated at portfolio level that reflect the uncertainty related to the amount and timing of future cash flows;
- a residual margin that eliminates any possible income from the initial recognition of the liability: prohibition of accounting profit on sale. The deferred profit is reported and accounted for in the residual margin balance.

At the time of initial recognition, the company must therefore value an insurance contract as the sum of two components: the result of the algebraic sum between the expected present value of the risk adjusted outgoing and incoming cash flows (CFs) arising from the fulfillment of the insurance contract and the residual margin which originates when that result is less than zero. Residual margin data will provide powerful insight in an insurer's embedded profitability.

The above listed features should allow financial statement users to be able to acquire a variety of information which relate in particular to:

- the amount, time and uncertainty of the expected cash flows;
- an estimate of expected cash flows evaluated in accordance to standards consistent with the already existent international principles;
- an interpretation of imminent risks through a specific risk adjustment item;
- the ability of the company to generate profit through the period;
- a decreasing in the mismatch created between assets and liabilities due to the adoption of non-homogeneous accounting policies;
- the consistency with market prices, which are understandable and credible benchmarks.

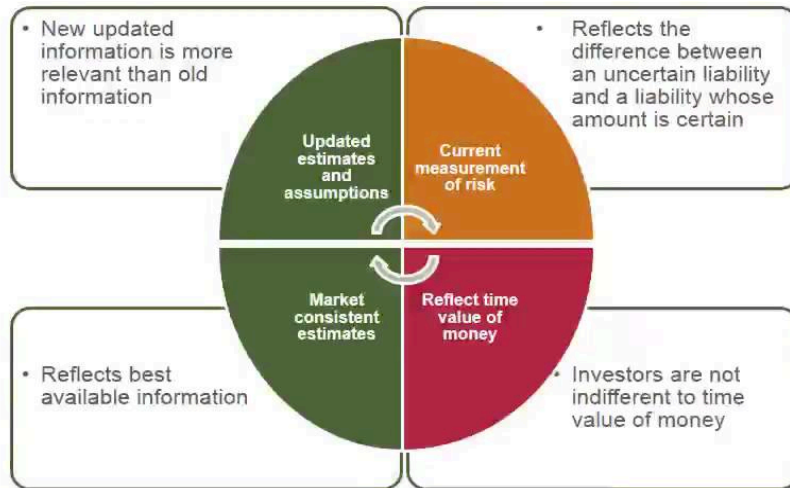


Figure 1.2: Key Features of the model

The valuation of technical reserves does follow the steps highlighted by the picture below:

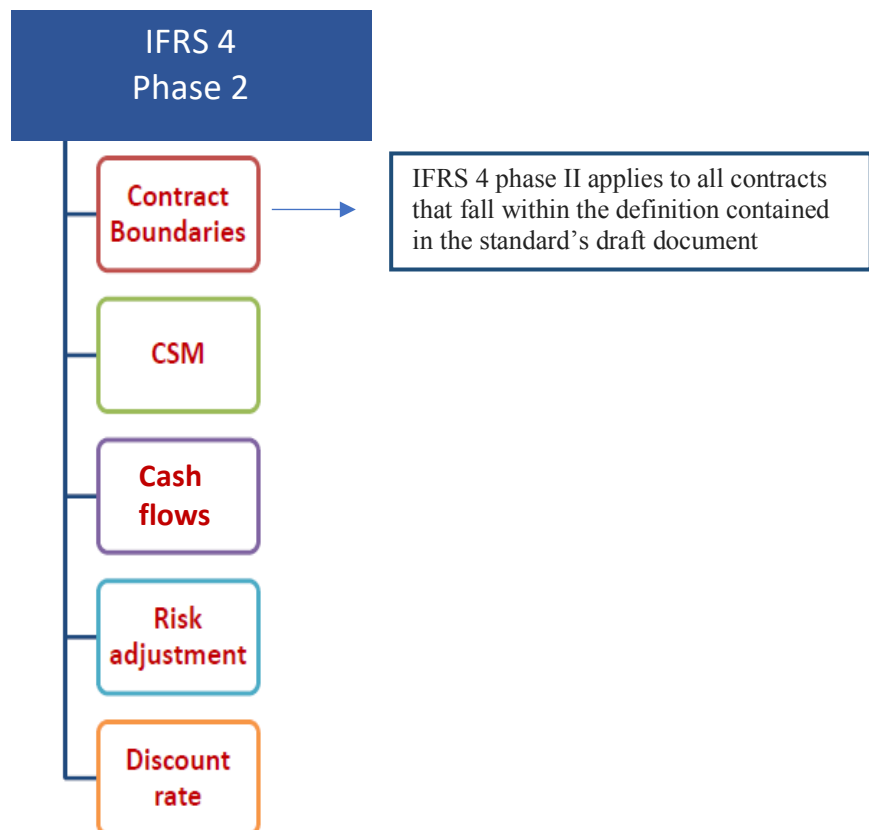


Figure 1.3: Technical reserves computation, IFRS 4 Phase II

The IFRS 4 second phase prohibits the recognition of a profit at the time the contract is concluded. In fact, the Contractual Service Margin (CSM) was introduced as the estimation of the expected profit and is defined as the risk-weighted present value of the sum of the incoming and outgoing cash flows.

The IASB has described cash flows as “an explicit, unbiased and profitability-weighted estimate of future cash flows that will arise as the insurer fulfils the insurance contract”.⁸

Furthermore, it provides for an independent evaluation component (risk adjustment) that measures the effects of uncertainty and the relative timing and expresses the remuneration that would make it indifferent for a company to satisfy a passivity with uncertain cash flows compared to one with certain cash flows.

Short-term market fluctuations, mechanically reflected in the income statement, increase the volatility of operating results and do not connect with the long-term commitment of insurance liabilities that lasts for several years, even decades in the case of life insurance policies.

Therefore, the accounting volatility complicates the interpretation of the operating results that may not significantly reflect the underlying insurance business and lose value with respect to future performance.

This underlines the presence of significant disharmonies and unbalanced accounting asymmetries among the evaluation methods of IFRS 4 also due to the undeniable peculiarities of the operational processes of the companies in question.

⁸ <http://www.ifrs.org>, *Preview of IFRS 17 Insurance Contracts*

1.1.3 Solvency II

“This is an ambitious proposal that will completely overhaul the way we ensure the financial soundness of our insurers. We are setting a world-leading standard that requires insurers to focus on managing all the risks they face and enables them to operate much more efficiently”⁹.

In view of the profound changes in the companies’ performance, as well as in the regulatory and supervisory framework, a new administrative system has been established. The Solvency II directive was published in the official journal of the European Union on December 17, 2009 and entered into force on January 1, 2016.

Solvency II is a European Union directive with the aim of extending Basel II to the insurance system. Basel II is in fact an agreement on the minimum capital requirements concerning the banking sector, on the basis of which banks must set aside capital shares proportionate to the risk assumed, assessed through the rating tool.

In November 2003, the European Commission established a standing committee with the task of preparing a draft framework law for risk management in the insurance sector. The CEIOPS (Committee of European Insurance and Employment Pensions Supervisors) is a supranational coordination of the authorities of the Member States for the insurance sector and occupational pensions.

In 2005, CEIOPS instructs the IAA (International Actuarial Association), an international association that deals with the standardization of internal and statutory company accounting, to draw up a non-exhaustive list of risks in the insurance sector, not covered by Basel II, which is a regulation designed for banking.

The primary objective and intention is to provide a system of rules that is more suitable than the current one to reflect the actual riskiness for the firms and that is able to deliver them incentives for an appropriate risk management.

It is based on three main areas (*pillars*) of focus:

⁹ Charlie McCreevy, International Market and Services commissioner speaking at the launch of the Solvency II draft Framework Directive

- *Pillar 1* consists on the quantitative prerequisites such as solvency and minimum capital requirements;
- *Pillar 2* sets out conditions for the governance and risk management of insurers, as well as for their effective supervision;
- *Pillar 3* focuses on disclosure and transparency.

Solvency II and the international accounting standard have numerous similarities in particular in the valuation of financial statement figures; both use a measure that reflects the expected value of future cash flows, adjusted by the integration of a risk margin computed in each reference period. This allows businesses to ponder the variations occurred in the previous assumptions and evaluations of the flows.

Clearly, many companies will be required to use unfamiliar techniques that are completely divergent from the current methods, mostly based on static criteria and not directly matched by current market values. It will therefore be necessary to generate stochastic scenarios able to replicate the behavior of the assets on the financial markets and to calibrate these scenarios in accordance with the last market price observed.

Some of the aspects of the discipline will be gradually regulated by the implementing legislation; specifically, the most controversial topic of the first pillar concerning the definition of the risk-free rate, severely reduced in the past decades, which will be used to discount the cash flows and compute the reserves. The subject, of fundamental importance in times of market turbulence, is still open and raises a comparison among different positions within the various institutional communities.

1.2 Introduction to IFRS 17

1.2.1 What is wrong with IFRS 4

The existing standard IFRS 4 allows for a wide range of insurance liabilities modelling methods, authorizing the adopters to account differently for insurance policies they issue even if those contracts are similar. Complying with some minor requirements, such as the Liability Adequacy Test, each country is entitled to develop its own rules enduring the presence of globally divergent valuation methods.

Among the main critical issues brought up by the IFRS 4, some of them are listed below:

- a) lack of comparability between countries and companies where local standards allow for a choice of approach;
- b) shortage of regular updates: insurance liabilities may be calculated based on historical assumptions rather than upon the effects of changes in the economic environment (such as variations in interest rates and risk);
- c) insurance liabilities computations do not take into consideration the different levels of risk, instead they are embedded in the calculations;
- d) discounting is not always required, in particular for contracts with a duration of 1 year or less as well as for non-life third party's insurance¹⁰;
- e) the valuation of insurance liabilities does not have to be cash flows based.

Furthermore, IASB members Professor Barth and Messrs Garnett, Gélard, Leisenring and Smith dissented from the issue of IFRS 4 because of the exemption of some entities from the accounting policies changes of IAS 8¹¹; they believed that the requirements specified in IAS 8 had particular relevance and applicability in the case of lack of specificities, as in IFRS 4.

¹⁰ The beneficiary of the policy is someone other than the two parties involved in the contract

¹¹ *Accounting policies, Changes in Accounting Estimates and Errors*, IAS 8 prescribes criteria for selecting and changing accounting policies

They were also concerned about the inclusion of contracts with a discretionary participation feature as well as for the shadow accounting practice; finally, they assumed that the definition of insurance contracts was too broad and contained unnecessary exceptions.

The chairman of the IASB, Hans Hoogervorst, described the need for IFRS 17: “Insurance is one of the last parts of the economy where we do not have an international standard. There is no high-quality accounting information and, in many cases, there is no way that investors can have a good view of what is going on”¹².

Practically speaking, IFRS 4 does not address how to measure insurance contracts, making it rather problematic for stakeholders and investors to comprehend and compare insurers’ results.

Most interested parties agree on the necessity of a unique globally consistent valuation method but, nonetheless, many positions vary as to what it should be.

¹² Speech delivered at the Accountancy Europe’s event in Brussels on 18th September 2017

1.2.2 IFRS 17, an Accounting Revolution

IFRS 17 has been 20 years in the making and it is expected to fundamentally change accounting for the insurance industries. The main goal is to make insurers' economics results proportional and comparable to all other types of revenues under IFRS.

The IFRS 17 *Insurance Contracts* was issued by the Board (IASB) in May 2017 as a replacement of the interim Standard IFRS 4 and it will be effective starting from the 1st of January 2021. It was attentively developed after a careful consideration of all the feedback and comments from the public existing at each stage of the process.

According to Lars Nielsen, Hong Kong insurance leader at PricewaterhouseCoopers, "The standard is the biggest change for the industry since IFRS first came in¹³".

It applies to insurance contracts issued, reinsurance contracts held and investment contracts with DPF (but in this case only if they are released by a company that also issues insurance contracts¹⁴). In the same way as for the IFRS 4 before, the newly published standard requires a separation for non-insurance components, regulated by the IFRS 9¹⁵.

In this regard, insurance companies were also allowed to benefit from the possible postponement in the application of IFRS 9 for accounting for financial investments, aligning the date of first application with that of IFRS 17. This opportunity will allow the adoption of the two principles in parallel. However, the postponed application of IFRS 9 still demands for some minimum requirements in disclosures, as well as for the need to deepen and understand in time any interactions between the two principles.

Being the first comprehensive and international accounting principle, which establishes the necessary requirements that will be applied for the reporting of the information regarding insurance and reinsurance contracts, companies are given a reasonable amount of time of approximately 3 years to develop the implementation process.

The long lead time reflects the complexity in its implementation.

¹³ *Accounting and Business* (China) magazine, September 2017

¹⁴ This underlines a difference with IFRS 4

¹⁵ Replacing IAS 39 for financial instruments

IFRS 17 provides the principles for the classification and distribution of contracts and for the representation of the profits in the financial statement. The argument is arranged in 3 macro-areas:

- recognition, aggregation and evaluation of insurance contracts;
- reinsurance;
- presentation of the financial statements supplemented with a disclosure report.

The new Standard delivers a completely renewed approach that urges the companies to report insurance contracts as the total of:

- a) the fulfilment cash flows (FCF): a current estimation of the cash flows the insurer expects to receive as a result of collected premiums and benefits and pay out (assumptions are updated at each reporting date with relevant market information);
- b) the contractual service margin (CSM) or unearned profit: basically, the difference between the positive and negative cash flows both discounted and risk adjusted; it indicates the level of profitability and the cost of the contract.

Thanks to the constantly updated information that are part of the fulfilment cash flows, any variations in the insurance liabilities due to changes in the economic and financial framework will be immediately mirrored in the insurer's financial statements. This will allow the users to analyze the effects reflected on the company's financial position as well as its risk exposure and insurance obligations.

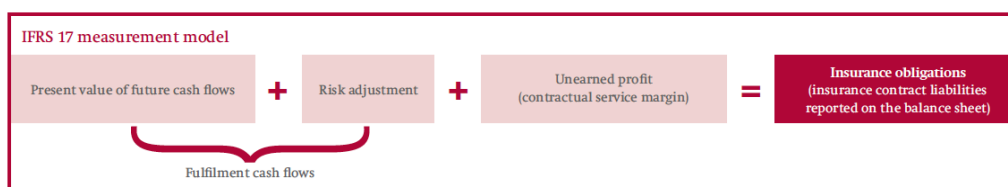


Figure 1.4: IFRS 17 measurement model

The economic, financial and operating implications connected to the adoption of IFRS 17 vary according to the specific nature of the company or group. However, the new

principle will result in a substantial change in accounting policies for the majority of the sector.

The most important adjustments generated by the introduction of the newly published standard concern both the accounting and the operative spheres; they are briefly listed below:

- the definition of *units of accounts* for the evaluation of insurance liabilities and the recognition of profits. There are at least 3 groups: 1) onerous contracts in which the costs needed to fulfill the terms are generally higher than the financial and economic benefits that will be received, 2) non-onerous contracts that are unlikely to become onerous and 3) all other contracts;
- the computation of insurance liabilities according to 3 valuation methodologies;
- the introduction of a performance measurement:
 - the P & L no longer collects premiums but their profitability (insurance revenue) instead
 - future profits (CSM) are released to P & L over time (profit for the period) and adjusted in the presence of revisions of forecasts and risk adjustments
 - discounting rates for liabilities are a company's choice;

The discount rate can be determined using either:

Bottom-up approach*	Top-down approach
<p>An entity first determines a yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk and adjusts it to reflect the illiquidity of the insurance contract compared to the instrument for which market information is available.</p> <p>The illiquidity adjustment reflects the fact that policyholders often either cannot terminate insurance contracts at all or can terminate them only subject to surrender penalties. Thus, the discount under the bottom-up approach represents a risk-free rate plus an illiquidity premium.</p>	<p>An entity first determines a yield curve reflecting the current market rates of return for a reference portfolio of assets (which could be the assets supporting the liability) and adjusts it for characteristics that are irrelevant for insurance contracts, such as duration mismatches, expected credit losses and the market premiums for credit risks. There is no requirement to adjust differences in liquidity characteristics between the insurance contracts and the replicating portfolio. To determine the yield curve, an entity should maximise the use of relevant observable market inputs.</p>

* Only when cash flows do not vary with the underlying items.

Figure 1.5: Determination methodologies for discount rates

- reinforcement of the disclosure report with reconciliation between openings and closings requirement: the introduction of current, transparent and consistent financial information about insurance contracts and the removal of the diversities in accounting that existed prior to the issuance of the new principle.

1.2.3 The three evaluation methodologies

The IFRS 17 includes three main measurement approaches:

- the General model (also referred as the BBA-building blocks procedure) is the core valuation and should apply to all the insurance contracts;
- the Variable Fee Approach (VFA), applied to contracts with a direct participation feature and
- the Premium Allocation Approach (PAA) which is an optional simplification for liability measurements related to specific types of contracts, including those with a coverage period of one year or less.

The General Model (BBA)

The first one, the general model, relates to a 'building blocks' technique and consists of two components: the fulfilment cash flows (FCF), already introduced in the preceding subparagraph 1.2.2, and the Contractual service margin (CSM).

The CSM is a measure that will acquire a fundamental importance since - similarly to what happens today in the life portfolios, even though with different calculation methods - it will allow to know the value of all contracts, life and property and casualty, and consequently, of an entire portfolio of an insurance company.

A key feature of the CSM is that it is initially recognized and subsequently re-measured at the end of each accounting period, with the obligation to track and provide adequate disclosure of the changes in profitability between the original measurement and subsequent disclosures. It can be said that the CSM represents the accounting value of a portfolio, the amount of which is released over time on the basis of the service rendered (risk coverage).

Basically, insurance contract liabilities will be calculated as the present value of future insurance cash flows with a provision for risk; the discount rate used for this purpose should account for the time value of money, reflect the liquidity characteristics and the solvency of the insurance policy and be consistent with market variables.

If the present value of future CFs produces a gain at the time a contract is issued, the model will require a margin, amortized over the life of the contract itself.

It is not specified in the standard how the risk adjustment computation will be addressed but it is clear it should follow the principles of longer duration, higher severity and wider distribution; higher risk is followed by an even greater risk adjustment.

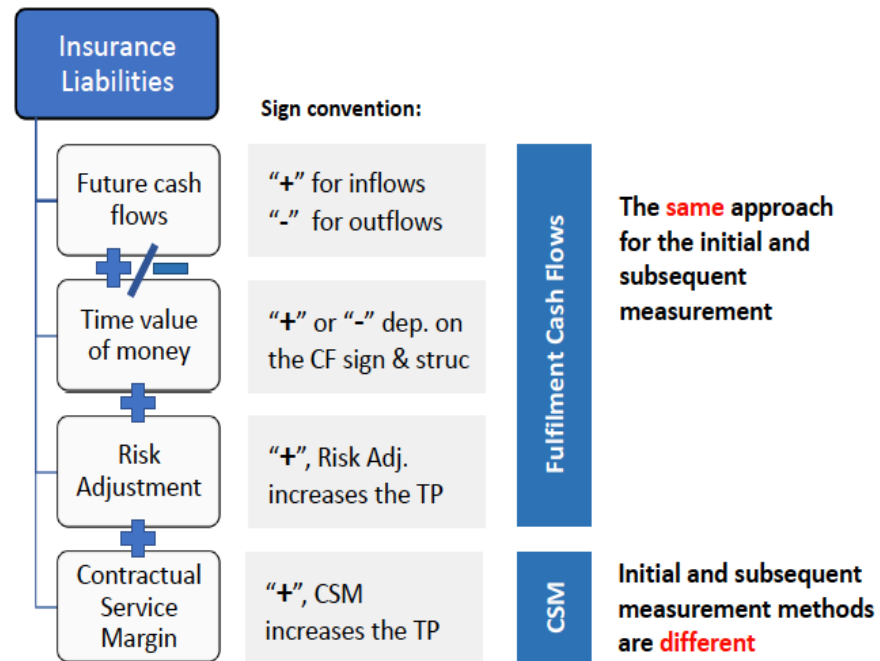


Figure 1.6: The General Model is a default IFRS 17 insurance liabilities measurement approach

The Variable Fee Approach (VFA)

The VFA is a variation of the General model and should be applied to contracts in which there is a contractual and, consequently, an economic relationship between the investment activity of the collected premiums and the value of the benefits to be paid to the insured. The life insurance policies typically fall within this category.

Normally, a contract is eligible for the VFA approach if it follows the criteria listed below:

- participates in a clearly identified pool of underlying items;
- pays to the policy holder a substantial share of the returns;
- substantial proportion of the cash flows vary with underlying items.

The substantial difference between the VFA and the BBA is that in the VFA the CSM is also fueled by changes in the fair value of the assets invested for the insurance contract. Unlike in the General Model, this includes variations in estimates related to the time value of money and financial risks, since for DPF contracts these are considered associated with future coverage. After all the adaptations, part of the CSM is recognized as revenue to reflect the transfer of services in the period.

The Fulfilment Cash Flows does also include a variable fee, which will be deducted from the underlying assets at fair value in exchange for the future service provided by the insurance contract.

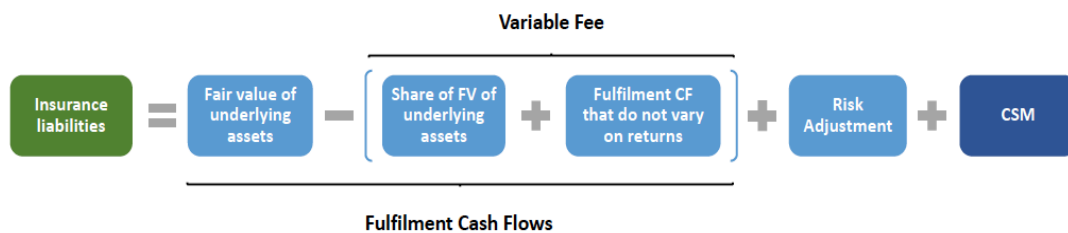


Figure 1.7: VFA measurement model

The Premium Allocation Approach (PAA)

PAA is a simplified method, applicable to risks with a low level of volatility in estimates, whose contractual duration does not exceed twelve months, and which are presumed not to be onerous at the time of initial recognition. The PAA can be used to measure a group of agreements only if at the inception:

- a) the entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage that would not differ materially from the one that would be produced applying the general model. A reasonable approximation does not apply when the entity expects significant variability in cash flows;
- b) the coverage period for each contract in the group is one year or less.

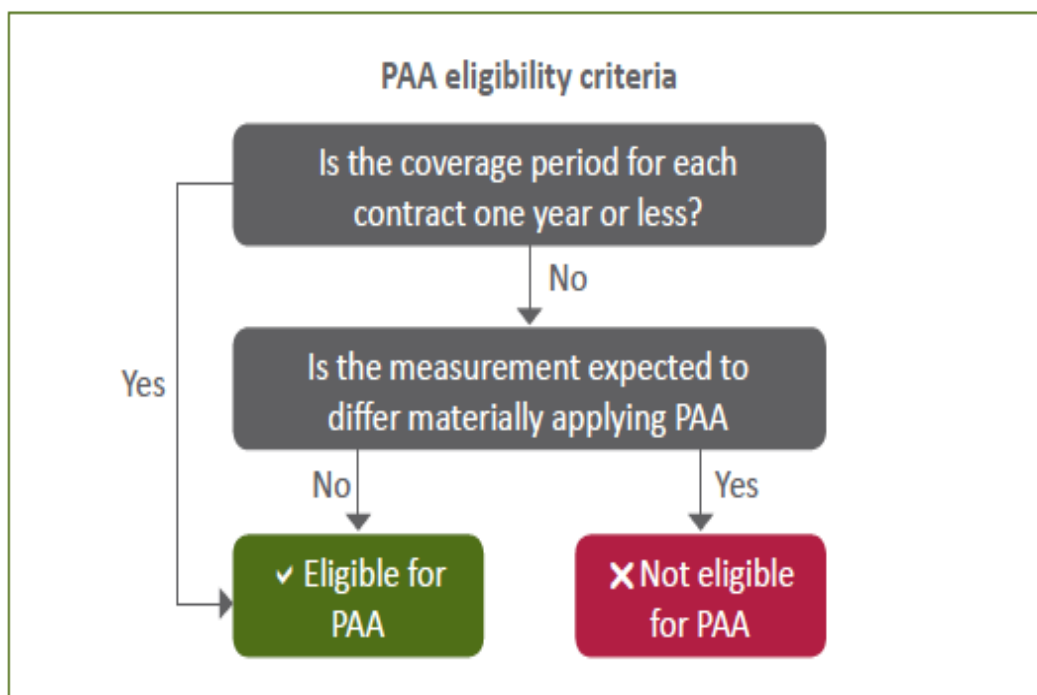


Figure 1.8: PAA eligibility criteria

The simplification for this method consists in the fact that, given the short duration of the contract, it does not require the detection and management of the CSM.

The liability for remaining coverage is initially recognized as the premiums, if any, received at initial recognition minus any insurance acquisition cash flows. If insurance contracts have a significant financing component, the remaining liability coverage needs to be discounted. However, this is not required if, at initial recognition, the entity expects that the time between providing each part of the coverage and the due date of the related premium is not more than a year.

Furthermore, a company may also choose to account any insurance acquisition cash flows as an expense when it incurs those costs.

Summary of approaches under IFRS 17

	Premium allocation approach (simplified model)	Building block approach (general model)	Variable fee approach
Participating / non-participating	Non-participating		Participating
Application	Short duration	Long and short duration	«directly» participating
Remeasure CSM	No CSM	No	Yes
Accretion of interest to CSM	-	Locked-in rate	Current rate
Insurance investment expense in P&L if OCI accounting policy	Locked-in rates		Current period book yield

Figure 1.9: Measurement Models

Provided that an insurance contract is considered to be a direct participating contract when:

- the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;
- the entity expects to pay the policyholder an amount equal to a substantial share of the fair value returns on the underlying items;
- the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in the fair value of the underlying items.

1.2.4 Contracts with Discretionary Participation Feature (DPF)

DPF identifies a contract type according to which the underwriter receives from the issuer both *guaranteed benefits* and the right to participate in favorable performances (*additional benefits*) referable to a set of contracts or activities (or both).

Such participation feature is subject to the discretion of the issuer with regard to a variety of profiles ranging from the timing of recognition of benefits to the methods of liquidation of the same, up to the definition of the amount to be recognized.

They can have both an insurance and a financial nature. IFRS 4 provides a definition of the above said: the subscriber has the right to enjoy additional benefits that:

- a) represent a significant portion of the overall benefits;
- b) are subject to the discretion of the issuer with regard to the amount and timing of regulation;
- c) are commensurate to the performance of a corporate entity rather than to a set of contracts or activities.

The participating contracts which do not satisfy all three criteria are referred to as indirect participating contracts and are measured under General Model; only the direct participation contracts are eligible for the VFA.

The process through which the issuer recognizes the additional benefits to the subscriber of a participating contract can be traced back to three steps:

1. determination of the amount available for distribution (allocable amount);
2. allocation of a portion or of the entire amount to the policy holders;
3. distribution of the allocated amount.

Typical examples of DPF are universal life, unit-linked, variable annuity and with profit contracts.

1.2.5 Synergies between IFRS 17 and Solvency II

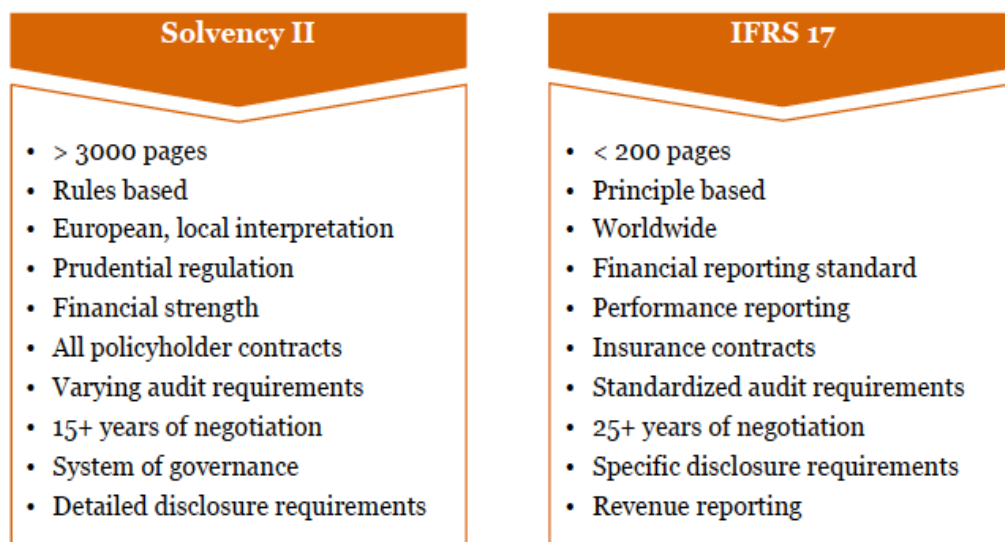


Figure 1.10: Key elements

There are indeed some similarities between Solvency II and IFRS 17 and some companies might also believe they are already prepared to handle the changes.

The key overlaps between the two frameworks are related to:

- detailed and extensive reporting requirements, both quantitative and qualitative;
- redefinition of processes and useful management key-figures: data gathering for internal control systems and governance;
- complex and risk-oriented classifications and calculations;
- regulative, risk-based valuation concepts and stress tests;
- harmonized data and detailed level of information for consistent reporting;
- additional resources to enable flexibility, velocity and quality in automation;
- more granular data to allow high level of process control and reliability;
- increased disclosure compared to IFRS 4.

Solvency II cash flows are starting point for many insurers implementing IFRS 17 with additional attention to the level of granularity, the contract classifications and boundaries and the allocated expense levels.

Although the two approaches can be considered similar in some way, significant differences remain; while the IFRS 17 standard uses a distinction for investment components, Solvency does not require any separation. The CSM eliminates day-one gains and defers profit over the coverage period (day-one losses are recognized at once), on the other hand with the European directive, day-one gains or losses are recognized immediately for all insurance contracts including reinsurance. Moreover, as in the standard, companies are allowed to have their own view of the compensation required for uncertainty arising for non-financial risks, Solvency II prescribes 6% cost of capital method with defined risks, level of diversification benefit and other components. Finally, under IFRS, investments are measured with IFRS 9 at either fair value, amortizing costs or using equity method¹⁶, however for the directive, the value of investments (Bonds, Loans, Mortgages and Real Estates) always reflects fair value. Solvency regulations and the new calculation system are two different frameworks that will need to be managed separately.

¹⁶ IFRS 17 requires fair value disclosure for financial assets that are not measured at fair value

1.3 Challenges

The implications of economic, patrimonial and operating costs related to the adoption of IFRS 17 vary depending on the specificity of the company or group.

The new principle however will result in a substantial change in accounting policies for the majority of the sector.

There are some opportunities and critical issues, identified by the early movers to optimize implementation, in terms both operational and financial results, listed below and discussed in detail:

- the duration of the implementation project: some groups have explained that, based on feasibility studies, it will probably require more than 3 years to handle the implementation of the principle, also considering the work queue to be managed in parallel on other significant projects still in progress (such as Solvency II);
- revisions of the current timing of the year-end closing processes;
- new approaches in terms of accounting policies;
- important new resources demand (internal and external) and coordination, given the lack of competence skills: internally there will be the necessity for a greater level of coordination between the administration, the actuarial and the risk management. Externally, there will be a limited number of resources with the indispensable skills in case of necessity, making decisive the anticipation of any recruitment needs.;
- management of market expectations before and after the implementation of the new principle: investors and analysts have expressed their perplexity on IFRS 17 that is revealing itself as more complex and with a greater discretion need than what the market originally expected. If the intent of the insurance industry is to reduce the cost of capital, the companies will have to pay close attention to how they will manage IFRS 17 in terms of accounting choices and metrics on which they will choose to be evaluated;

- it will be essential to be able to regulate the critical issues related to data collection and archiving;
- different business areas such as product development, remuneration policies and strategic planning will be impacted and new synergies will be obtained with Solvency II processes.

Some insurance groups have already started projects aimed at the implementation of IFRS 17 which include, depending on cases, gap analysis and evaluations regarding the financial, technical, architectural and governance impact on the specific entities.

Currently the companies that have already started to work on the project are engaged in the following areas:

- training and technical plans related to the education and awareness of the staff members;
- evaluation of impacts (economic, financial and operational);
- planning of the implementation project and allocation of the necessary budget, both in economic and resources terms;
- evaluation of possible interactions with ongoing and already planned projects, especially those related to themes of financial transformation.

A structured approach to project planning implementation of IFRS 17 helps overcome the challenges that the new principle presents but also to take advantage of the opportunities it provides.

In terms of the application scope covered by these initial activities, it may be useful to identify the key organizational units and entities within the group that are relevant to the current or planned expected profitability and IFRS 17 implications.

The gap analysis can be carried out through some workshops or through the use of diagnostic tools and the goal should be to identify gaps between current and future data systems, processes and requirements.

The impact assessment could therefore be carried out considering both the effects on the systems (Information Technology architecture, from the supplying systems to the

actuarial modeling tools to the accounting and reporting systems, including the general accounting plan), and economic and fiscal ones.