Department of Health & Social Care

IFRS 17 Insurance contracts - a beginner's guide

21 February 2024

Matters covered in this workshop

1	How to identify an insurance contract under IFRS 17
2	The FReM's interpretations and adaptations – see annex also
3	How to account and budget for an insurance contract including transition and disclosure

The principles and implications of IFRS 17

IFRS 17 requires entities to;

- Identify insurance contracts or insurance components of a contract, separating these elements from other non-insurance contracts and component, as well as grouping similar contracts
- Recognise insurance obligations when they first arise including when they become onerous, whilst recognising gains over the period of insurance coverage
- Use DCF to measure claims and fulfilment obligations reflecting risk and time value of money through appropriate discount rates
- Present insurance revenue and expenses separately from insurance financing income and expenses
- Disclose information that allows the impact on the entity's financial performance, position and cash flows to be assessed.

The implications for public sector bodies is;

- The standard develops a broad definition to what constitutes insurance
- Therefore, requiring a significant amount of judgements to be made by entities
- Complexity and breadth of Standard has led to a large number of interpretations and adaptations being applied to ensure consistency and relevance for the public sector context

How to identify an Insurance Contract

The elements of insurance contracts

Definition of an insurance contract

An insurance contract is a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

Contractual agreement between two parties exists and the enforceable rights and obligations are accepted by the parties

The contract transfers significant pre-existing insurance risk from the policyholder to the issuer

Elements of an insurance contract under IFRS 17

Uncertain future event exists (insured event)

Uncertain future event adversely affects the policyholder

What is a legally enforceable contract?

A contract is described in IFRS 17 as an agreement between two or more parties that creates enforceable rights and obligations. Enforceability is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices.

Unlike other contracts such as IFRS 15 and IFRS 16, IFRS 17 does not cover intra government arrangements that are not legally enforceable.

For the purpose of applying IFRS 17 legislation and regulations are not insurance contracts. That is because legislation is not a contract between the Government and individuals or entities. Thus, the responsibilities conferred by legislation on the NHS to provide healthcare services is not an insurance contract between the NHS and individuals.

Contracts that are subject to similar risks and are managed together form a portfolio of insurance contracts. IFRS 17 includes guidance on how to aggregate insurance contracts.

The definition of insurance risk

Insurance risk is any risk that is not a financial risk…

IFRS 17 defines a financial risk as;

The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

Financial risk compared to insurance risk

FINANCIAL RISK	INSURANCE RISK
Risk of a future change in one or more of a specified variable that drives cash flow and prices of financial assets	Any risk that is not a financial risk
Non-financial variable not specific to the insured as in the rate of employment impacting defaults	Risk specific to the insured such as cover for risk of premises being damaged from flooding
Financial variable e.g. investment returns not specific to the insured.	Annuity until death with a non-financial variable “mortality risk” is specific to the insured. Embedded in hybrid annuity contract
Transfer of risk not covered by IFRS 17	Transfer covered by IFRS 17 if significant in the contract.

Contract transfers significant insurance risks

Insurance risk is significant if, and only if, an insurance event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios which have no commercial substance.

IFRS 17 mandates that an entity can only consider scenarios that have commercial substance. IFRS 17 explains that scenarios with no commercial substance are those that have no discernible effect on the economics of the transaction.

If an insured event could mean that significant additional benefits would be payable in any scenario that has commercial substance, the contract is considered to transfer significant insurance risk even if the insured event is extremely unlikely, or if the expected (i.e., probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining contractual cash flows.

An entity should assess the significance of insurance risk contract by contract. Consequently, the insurance risk can be significant even if there is minimal probability of significant losses for a portfolio or group of contracts.

Pre-existing risks

To be considered an insurance risk under IFRS 17 the risk must be pre-existing. This means the entity must accept from the policyholder a risk to which the policyholder was already exposed. New risks created by the contract for the entity or policyholder are not insurance risk.

Consider a scenario in which a person/ entity is buying or leasing a car and taking out insurance cover for it. There is a pre-existing risk of incurring a liability (an adverse effect) if a specified uncertain future event occurs(an accident occurs while driving the car) when cover is agreed with the policyholder. So, a pre-existing risk need not be historical.

An example of a more historically formed pre-existing risk may occurs where flood risk is covered by an insurance policy due to a history of floods and related damage to property in a certain area.

Uncertain future event exists that adversely affects the policyholder

Uncertainty (or risk) is the essence of an insurance contract. Accordingly, at least one of the following is uncertain at the inception of an insurance contract:
(a) the probability of an insured event occurring;
(b) when the insured event will occur; or
(c)how much the entity will need to pay if the insured event occurs

The insured event can relate to losses discovered during the term of the contract even if the losses arose from an event that occurred before the inception of the contract. Equally insurance contracts can cover insured events that occur during the term of the contracts even if the event is discovered after the end of the contact term.

Some insurance contracts cover events that have already occurred but the financial effect of which is still uncertain, e.g., the discovery of the ultimate cost of claims for events that have already occurred.

Contracts that are specifically exempt from the scope of IFRS 17

- Warranties (IFRS 15, IAS 37)
- Employers' assets and liabilities from employee benefit plans (IFRS 2 and IAS 19)
- Contractual rights and obligations contingent on the future use of, or right to use, a non-financial item (IFRS 15, IAS 38, IFRS 16)
- Contingent consideration payable in a business combination (IFRS 3)
- Financial guarantee contracts (IFRS 9)
- Residual value guarantee except those that are not embedded in the lease contract.

Self-insurance and reinsurance contracts

UK central government entities generally self-insure against risks as this represents value for money. Bearing the risk of an uncertain future event adversely affecting an entity does not create an insurance contract as there is no agreement with another party.

However, if there was a specific contract in place between a department and an ALB agreeing to cover damages incurred from a specified uncertain future event this would be an insurance contract if there was a transfer of significant insurance risk

The definition of a reinsurance contract under IFRS 17 is an insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity (underlying contracts).

IFRS 17 requires that reinsurance contracts are accounted for separately from the underlying insurance contracts to which they relate.

Fixed fee service contracts

IFRS 17 provides a scope exception for fixed fee service contracts so that such contracts may be accounted for under either IFRS 15 or IFRS 17.

An entity may fix the fee agreed with a contractor for the provision of services under a maintenance contract. Such contracts could meet the definition of an insurance contract

The accounting policy choice allowed under IFRS 17 has been withdrawn. HMT mandate that these contracts should be accounted for under IFRS 15 if:

- the entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer;
- the contract compensates the customer by providing services, rather than by making cash payments to the customer; and
- the insurance risk transferred by the contract arises primarily from the customer’s use of services rather than from uncertainty over the cost of those services.

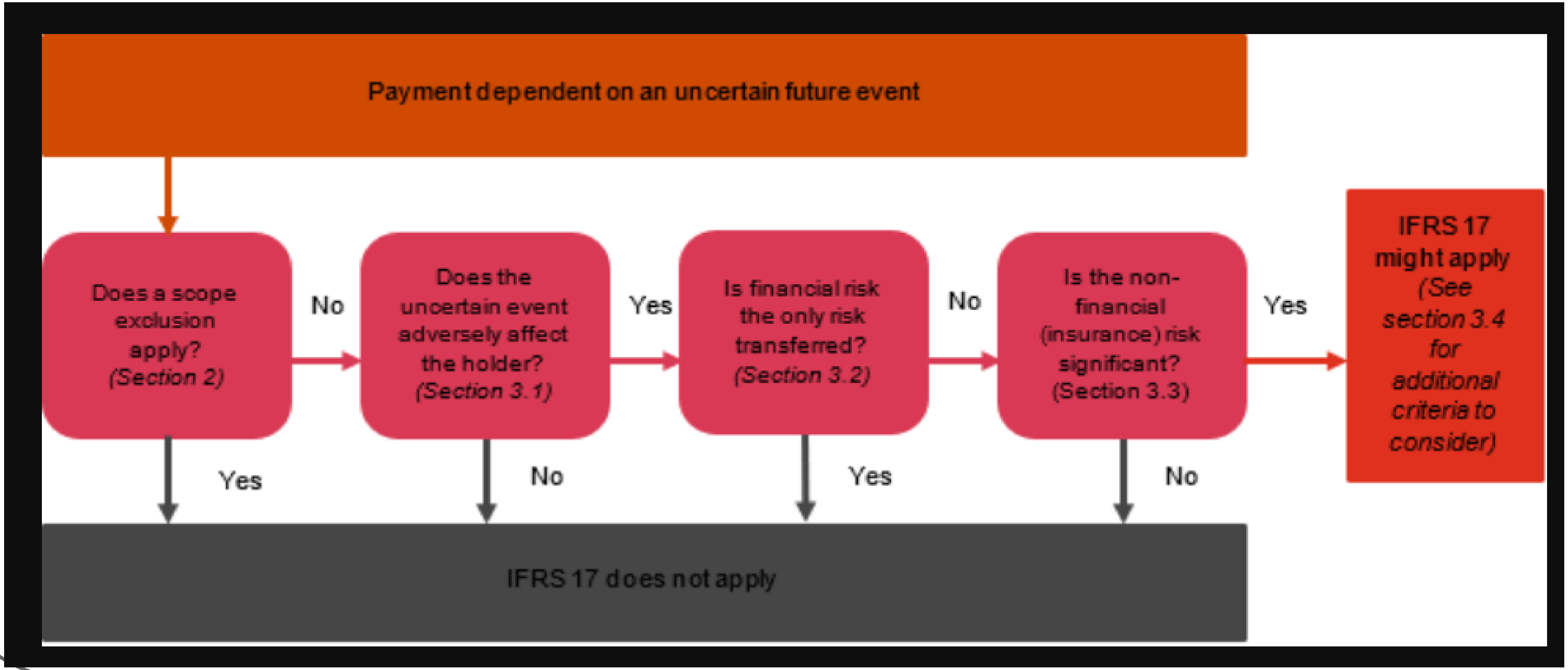
Financial guarantee contracts

Financial guarantee contracts transfer significant credit risk by requiring the issuer to reimburse the holder for a loss it incurs due to the debt repayments not being received.

IFRS 17 explicitly excludes from its scope financial guarantee contracts **unless** the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts.

Central government interpretation: the accounting policy choice in IFRS 17 paragraph 7(e) is withdrawn. All entities shall account for financial guarantee contracts using IAS 32, IFRS 7 and IFRS 9.

Decision tree considering whether IFRS 17 applies

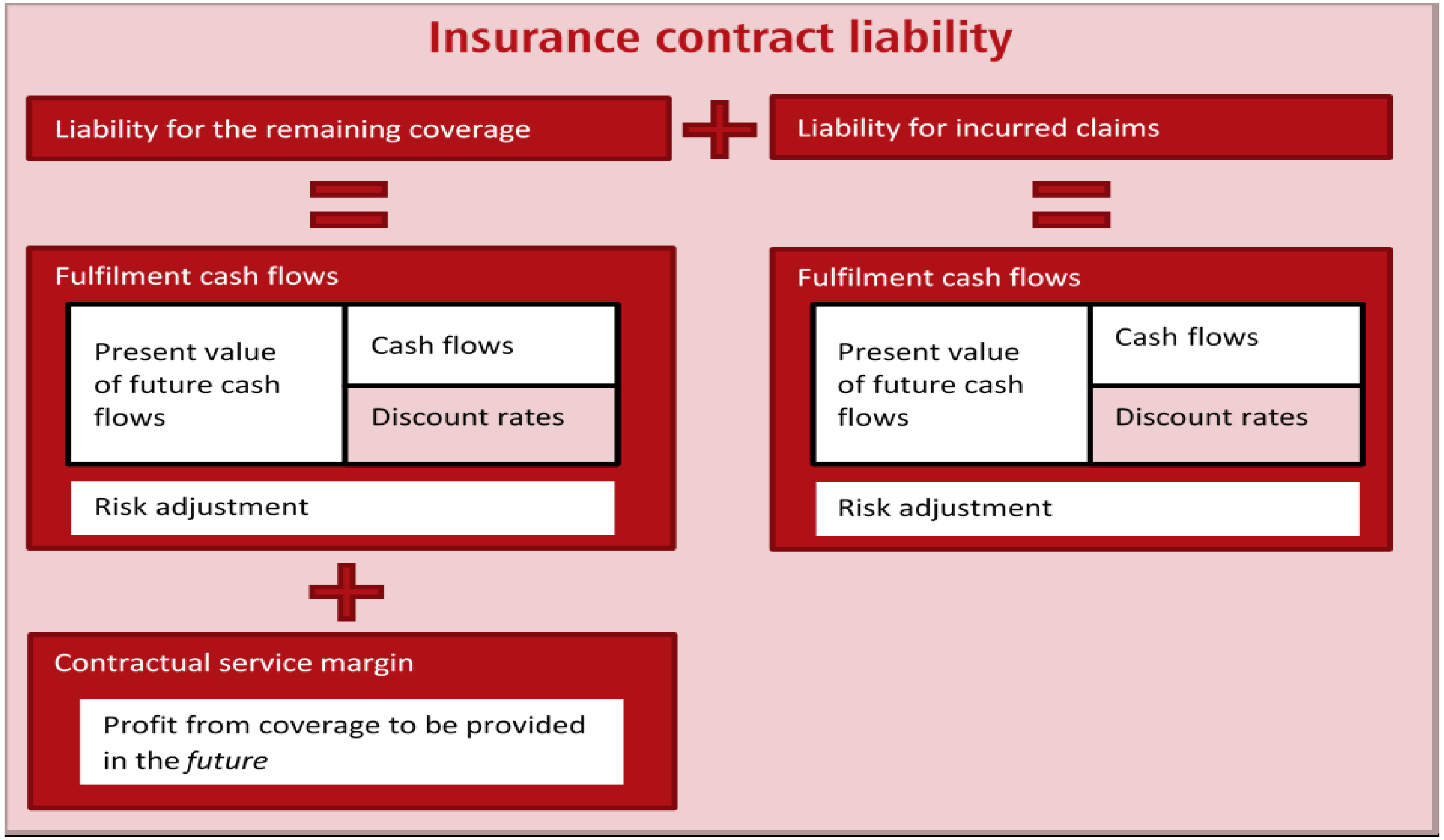


Accounting for elements of Insurance Contracts

Accounting for insurance liabilities on the SoFP

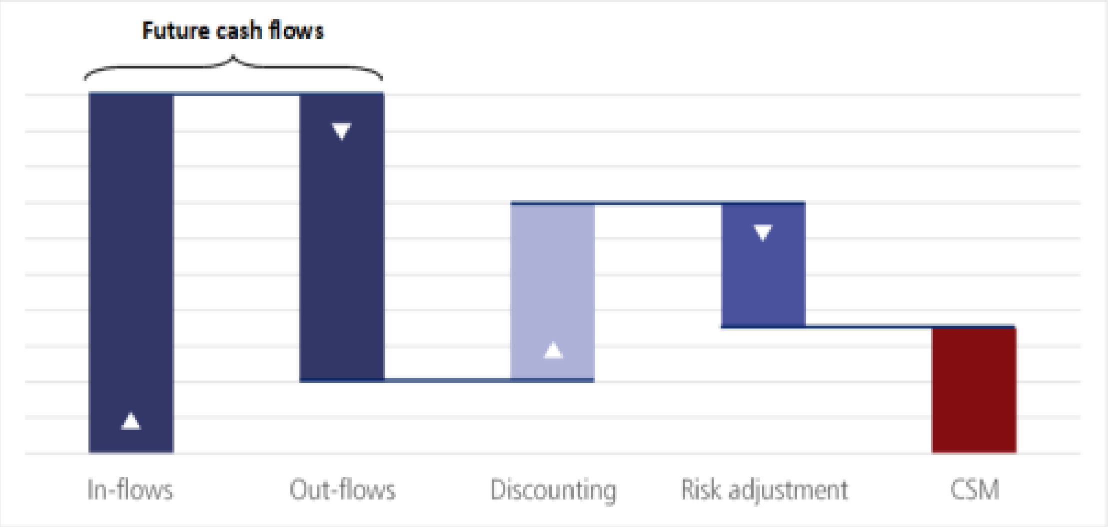
The value of the IFRS 17 insurance contract liability on the SoFP is made up of several separate moving parts.

Each element contributes to creating a full, updated picture of the insurance provider's commitments.



The moving parts of the contract liability

Both the liability for incurred claims and the liability for the remaining coverage are measured at current value at every SoFP date. In both cases this is achieved by calculating the present value of future cash flows and then making a risk adjustment. This is graphically represented below:



Both insurance and reinsurance contracts are measured using a probability-weighted average estimate of all future cash flows within the contract boundary with a risk adjustment to reflect the uncertainty in the timing and amount of cash flows that arises from non-financial risk. Determining which cash flows should be included is an area of judgement.

Cash flows are within the contract boundary if they arise from substantive rights and obligations imposed by the contract that exist during the reporting period and directly related to the fulfilment of the contract.

Discount rates to use

Under IFRS 17 the discount rates used to measure the present value of future cash flows need to reflect not just the time value of money but also liquidity characteristics of the insurance contracts themselves.

HM Treasury currently provide central discount rates to be used in the accounting for financial instruments, leases, provisions, and pensions.

HM Treasury therefore adapts IFRS 17 in respect of discount rates to have a rebuttable presumption that the financial instrument discount rate stated in the PES paper is used to discount IFRS 17 liabilities, except for regulated insurers and entities whose principal business is insurance or reinsurance activities.

The rebuttable presumption to use the HMT discount rate means the HMT discount rate is not mandated for certain central government entities.

Risk adjustment for non-financial risk

The risk adjustment is the compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts.

Whilst IFRS 17 doesn't specify estimation techniques to employ it does provide a list of characteristics the adjustment should have in paragraph B91 including; that where risks with low frequency and high severity will have higher adjustments than high frequency and low severity risks and when looking at similar risks a contract with a longer duration will have a higher risk adjustment than those with contracts of a shorter duration.

There are several disclosure requirements associated with the risk adjustment, one of which is paragraph 119 of IFRS 17, requiring entities to disclose the confidence level used to determine the risk adjustment for non-financial risk. However, this requirement has been withdrawn as a HMT adaptation as the costs of preparing the disclosure is considered to outweigh the benefits in the central government context.

Contractual service margin

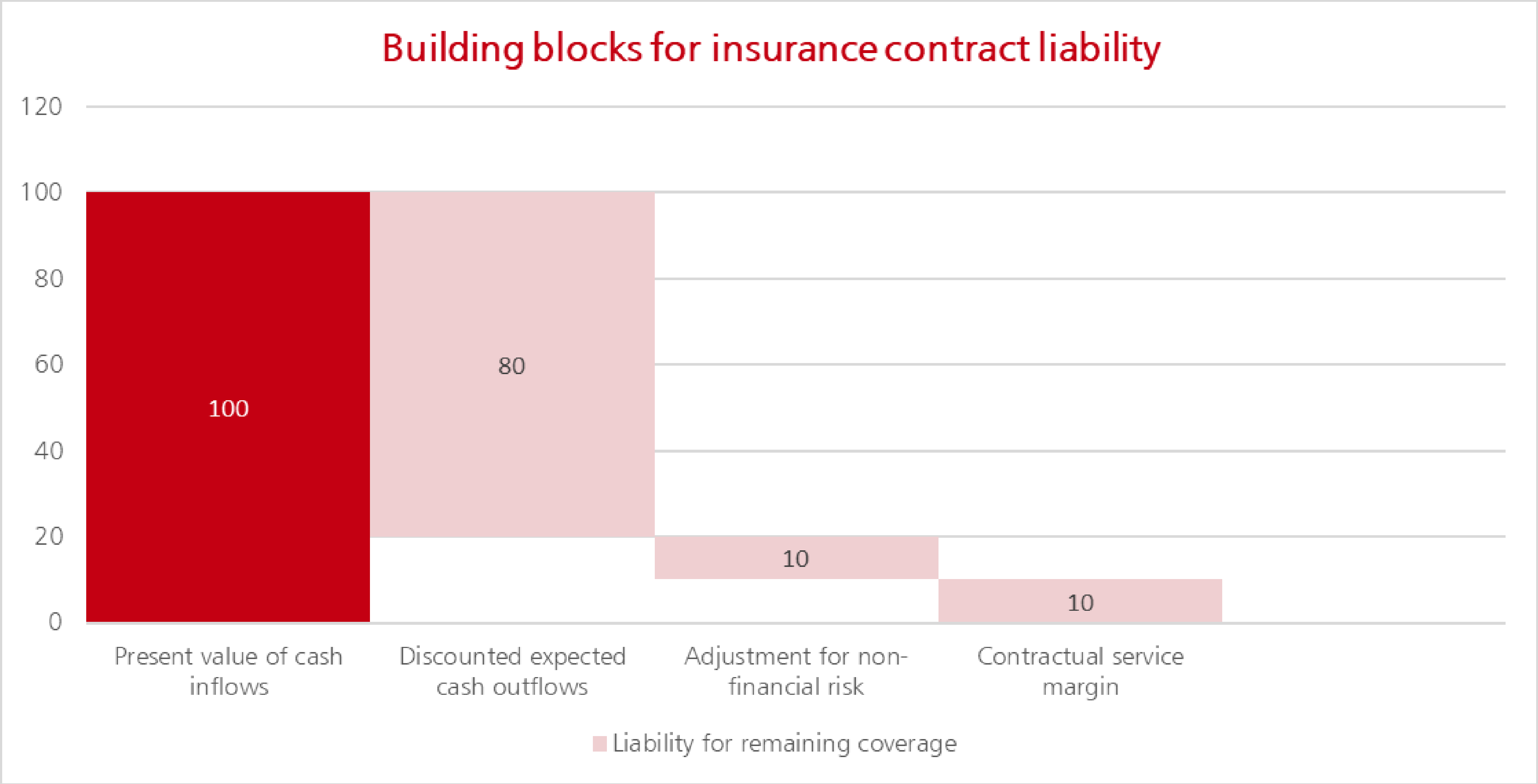
The contractual service margin (CSM);

- represents the unearned profit on an insurance contract or group of insurance contracts
- relates to future service to be provided under the insurance contracts issued by the entity
- represents the margin the entity has charged for the insurance services it is providing in addition to bearing risk.

This unearned profit is recognised over the coverage period of that contract (or group of contracts) as and when insurance services are provided by the insurer to the policyholder.

If the expected present value of cash inflows related to a group of insurance contracts are greater than the expected present value of cash outflows that difference is the profit for that group of contracts. The unearned element, updated at each SoFP date, is the contractual service margin, forming part of the insurance contract liability.

The CSM is the balancing figure included on the SoFP to avoid profit being recognised on day 1 of the contract being issued.

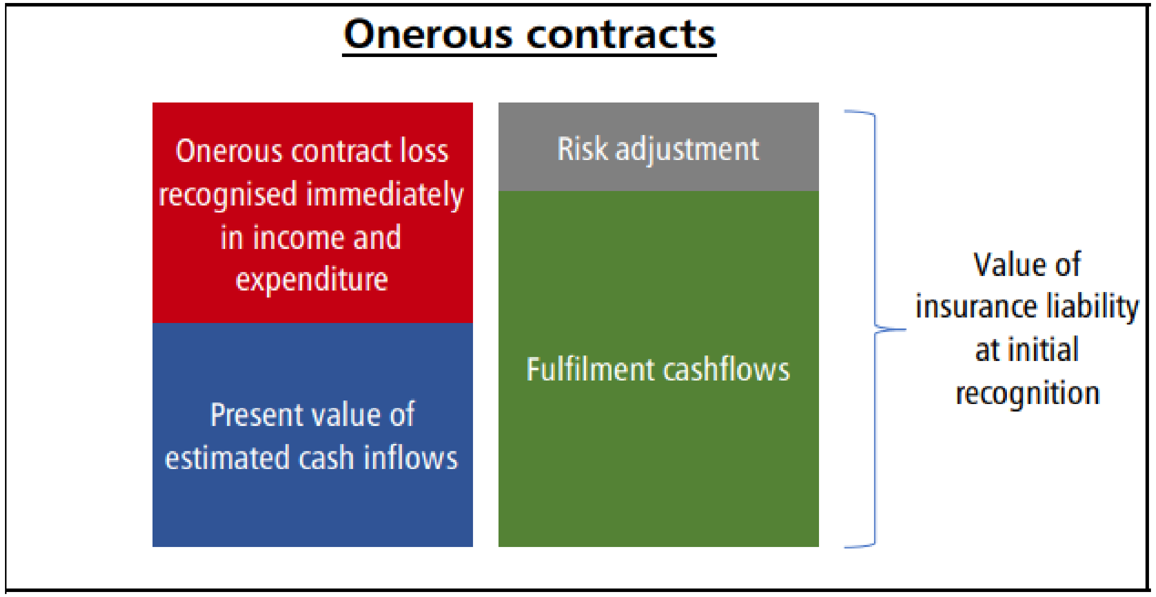

Building blocks for insurance contract liability
120
100
80
60
40
20
0
100
80
10
10
Present value of cash inflows
Discounted expected cash outflows
Adjustment for non-financial risk
Contractual service margin
Liability for remaining coverage

Onerous contracts

When an insurance contract is issued and the expected cash outflows are expected to exceed inflows, the insurance contract is onerous.

The CSM cannot depict unearned losses.

If a contract or group of contracts is onerous from inception or becomes onerous so that no profit is ever anticipated, then there is no contractual service margin. In the case of onerous contracts, the loss on the contracts is recognised through income and expenditure immediately as insurance service expenditure.



Statement of consolidated net expenditure (SOCNE)

In each period the entity recognises the revenue for the coverage provided in that period, as well as any expenses incurred in that period.

As time passes some of the uncertainty associated with the original insurance contract(s) is reduced, and the risk adjustment is accordingly released.

IFRS 17 paragraphs 41 and 42 set out the amounts recognised as income and expense

To ensure consistency of accounting all entities shall recognise insurance finance income and expense for the period in the SoCNE.

SoCNE entries

Insurance service result

Insurance revenue	+	Revenue for coverage provided in the period
	+	Revenue for the release of risk adjustment in the period
Insurance service expenses	—	Expected claims and other insurance service expenses
	+/—	Changes in cash flows and risk adjustment that relate to coverage provided in the period and in the past

Insurance finance expenses

—	Unwind of discount rates
+/—	Changes in discount rates

Transition

The date of initial application is 1 April 2025 unless an entity adopts IFRS 17 earlier

The transition date is the beginning of the annual reporting period immediately preceding the date of initial application, so 1 April 2024 for NHS bodies.

There are several considerations to evaluate as part of the transition to IFRS 17 including

Inform, train and support stakeholders about the requirements and applications of the standard

Identifying and grouping contracts

Assessing materiality for disclosure

On transition entities shall apply IFRS 17 on a fully retrospective basis

Approach to transition – Fair value approach

If full retrospective restatement is impracticable, entities shall apply the fair value approach per IFRS 17 paragraphs C20-C24.

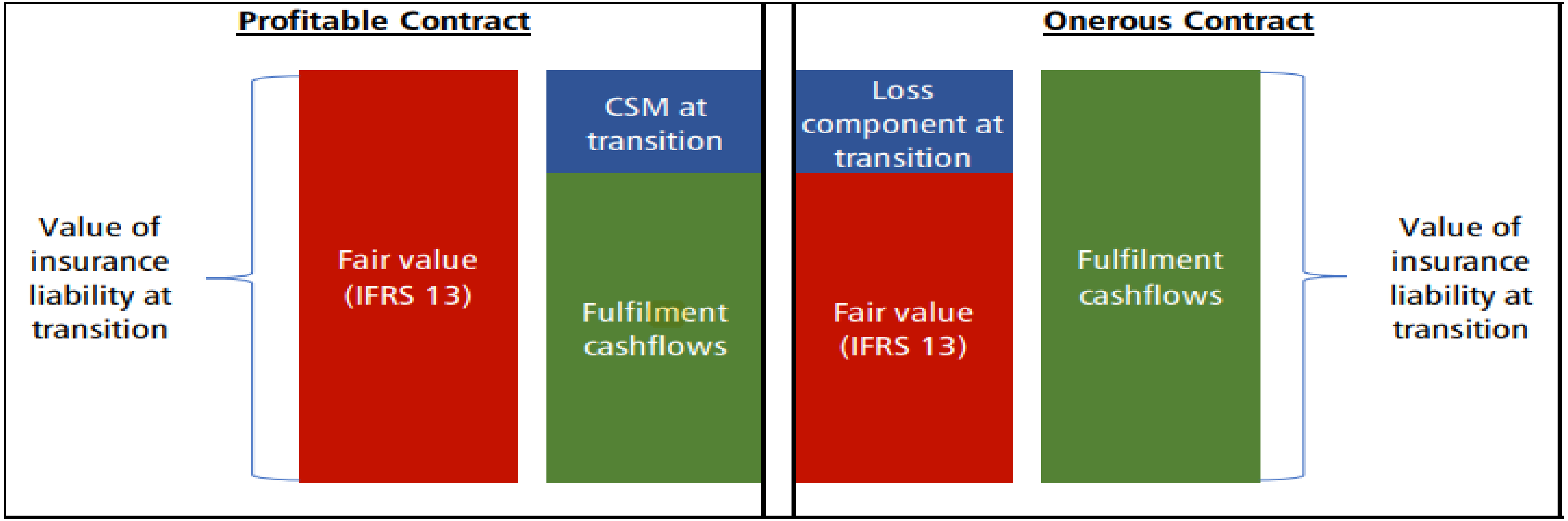
As noted in IAS 8 entities must make every reasonable effort to apply a new standard retrospectively before concluding impracticability.

The insurance liability at transition using the fair value approach is measured at the higher of the fulfilment cashflows and fair value amount (these are graphically illustrated in the slides below):

The fair value approach calculates CSM prospectively on the transition date (1 April 2024).

- If the fair value amount is higher than the fulfilment cashflows at transition, then the insurance liability is measured at the fair value amount. There is a CSM in this scenario, being the difference between the fair value and the fulfilment cashflows at transition.
- If the fair value is less than the fulfilment cashflows then the insurance liability at transition is measured at the fulfilment cashflows amount. There is a loss component in this scenario, being the difference between the fair value amount and the fulfilment cashflows at transition.

The insurance liability at transition: fulfilment cash flows v fair value



FReM adaptation regarding fulfilment cashflows

For insurance contracts where a nil premium is charged and the fair value approach is being used to transition to IFRS 17 for those contracts, entities must measure the transition value of those contracts at fulfilment cashflows.

This is to avoid situations where the transition value of insurance contracts with a nil premium charged results in a significant CSM being recognised on transition for central government contracts.

IFRS 17’s measurement basis allows the recognition and measurement of insurance liabilities on a more realistic and consistent basis reflecting the entity’s risk profile and cash flow characteristics more closely than market participant’s assumptions about identical exit values under IFRS 13.

Transitional Disclosure reliefs

To improve consistency of central government annual reports and accounts the transition relief noted in IFRS 17 paragraph C28 is mandated. On transition entities shall not disclose previously unpublished information about claims development that occurred earlier than five years before the end of the annual reporting period in which it first applies IFRS 17.

In addition, entities can take advantage of IFRS C3 (a) to avoid disclosing details of the effects of IFRS 17 on each financial statement line for the current period and each prior period presented.

Budgeting under IFRS 17

Budgeting approach to IFRS 17

Under IFRS 17, insurance liabilities will be accounted for in a more consistent way than under IFRS 4

The budgeting treatment reflects both IFRS and national accounts impacts, in a very similar way to provisions shown on the next slide.

The budgeting treatment recognises the movements of the liability on the SoFP as well as the initial recognition and any movements that appear in the SoCNE.

Scoring the separate elements to the transaction in this way ensures that the information required for the national accounts is available and allows HM Treasury to control spending in support of the fiscal framework.

The HMT guidance gives worked examples two of which are reproduced in the following slides after providing a quick refresher on budgeting for provisions.

Table 3.B: Example of standard provision in respect of DEL spending

Resource budget Impact	Year 1	Year 2	Year 3	
Recognition of provision	+£10			Resource AME
Revalue provision upwards		+£2		Resource AME
Utilisation of provision			-£12	Resource AME
Make a payment			+£12	Resource DEL

Budgeting Example 1: Onerous Contract

Scenario:

- entity issues insurance contracts in Y0 for coverage in Y1 and Y2
- £nil premiums charged
- total discounted outflows = £80k, expected to be incurred equally over Y1 and Y2
- for the purpose of this example please ignore experience adjustments, discounting and assume the risk adjustment for non-financial risk crystallises and forms part of the insurance expenditure.

		SoCNE		SoFP		Budgeting impact	
Period	**Transaction**	**DR**	**CR**	**DR**	**CR**	**DEL**	**AME**
Y0	Recognise £80k loss on contract	80 (insurance expenditure)			-80 (Liability for remaining coverage)		80
Y1	50% of claims occur in Y1 as expected and are fully paid out before the year end			40 (Liability for remaining coverage)	-40 (Cash)	40	-40
Y2	50% of claims occur in Y2 as expected and are fully paid out before the year end			40 (Liability for remaining coverage)	-40 (Cash)	40	-40

Budgeting Example 3: Profitable Contract

Scenario:
- entity issues insurance contracts in Y0 for coverage in Y1 and Y2
- premiums charged = £100k, charged in Y0 for full coverage period
- total discounted outflows = £80k, expected to be incurred equally over Y1 and Y2
- for the purpose of this example please ignore experience adjustments, discounting and assume the risk adjustment for non-financial risk crystallises and forms part of the insurance expenditure.

		SoCNE		SoFP		Budgeting impact	
Period	**Transaction**	**DR**	**CR**	**DR**	**CR**	**DEL**	**AME**
Y0	Entity issues 100 insurance contracts at charging £1k each, with expected claims being £80 over the life of the contract			100 (Cash)	-100 (Liability for remaining coverage)		
Y1	50% of claims occur in Y1 as expected and are fully paid out before the year end	40 (Insurance expenditure)			-40 (Cash)	40	
Y1	Recognise 50% insurance revenue		-50 (Insurance income)	50 (Liability for remaining coverage)		-50	
Y2	50% of claims occur in Y2 as expected and are fully paid out before the year end	40 (Insurance expenditure)			-40 (Cash)	40	
Y2	Recognise 50% insurance revenue		-50 (Insurance income)	50 (Liability for remaining coverage)		-50	

Work to discover potential insurance contracts

Review underlying contracts for possible insurance risks

Review classification between financial and insurance risk

Consider the possibility and criteria for reclassification between other standards and IFRS 17

IFRS 4 imposes no limitations on when contracts can be assessed for significant insurance risk.

This slide pack gets you started but isn’t a substitute for HMT’s guidance or IFRS 17 which must be read to get the full technical understanding.

HMT interpretations in the IFRS 17 Application Guidance

- For the purpose of applying IFRS 17 in central government, legislation and regulations, in isolation, are not equivalent to insurance contracts. Legislation and regulations can include binding rights or obligations, can facilitate the creation of arrangements that fall within the definition of a contract and can form part of the implied terms of a contract, but in themselves are not agreements between parties.
- The accounting policy choice to account for contracts meeting the criteria set out in IFRS 17 paragraph 8 under has been withdrawn. All entities applying the FReM shall account for contracts meeting the criteria in IFRS 17 paragraph 8 under IFRS 15.
- The accounting policy choice in IFRS 17 paragraph 7(e) is withdrawn. All entities shall account for financial guarantee contracts using IAS 32, IFRS 7 and IFRS 9.
- The accounting policy choice under IFRS 17 paragraphs 88 and 89 has been withdrawn. All entities shall follow IFRS 17 paragraphs 88(a) and 89(a) and recognise insurance finance income and expense for the period in the SoCNE.
- For insurance contracts that limit the compensation for insured events to the amount otherwise required to settle the policyholder's obligation created by the contract (for example, loans with death wavers), entities shall account for these contracts under IFRS 9.

HMT Interpretations continued

• If an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group applying IFRS 17 paragraph 16, it shall measure the set of contracts to determine if the contracts are onerous and assess the set of contracts to determine if the contracts have no significant possibility of becoming onerous subsequently.

• In applying the premium allocation approach, an entity shall recognise any insurance acquisition cash flows as expenses when it incurs those costs, provided that the coverage period of each contract in the group at initial recognition is no more than one year.

• Entities shall include the entire change in the risk adjustment for nonfinancial risk as part of the insurance service result.

• An entity shall present the income or expenses from a group of reinsurance contracts held (see paragraphs 60–70A), other than insurance finance income or expenses, as a single amount.

• Entities shall include insurance finance income or expenses for the period in the SoCNE.

• On transition entities shall restate retrospectively following the requirements of IFRS 17 paragraphs C3-C4. If full retrospective restatement is impracticable, entities shall apply the fair value approach per IFRS 17 paragraphs C20-C24.

HMT adaptations

• There is a rebuttable assumption that the financial instrument discount rate provided in PES papers will be used to discount IFRS 17 insurance liabilities, except for insurers regulated by the Prudential Regulation Authority (PRA) and entities whose principal business activity is insurance or reinsurance.

• Where entities use the financial instrument discount rate stated in PES papers, reporting entities do not need to disclose the yield curve used to discount cash flows as required by IFRS 17 paragraph 120.

• The requirement of IFRS 17 paragraph 119 to disclose the confidence level used to determine the risk adjustment for non-financial risk has been withdrawn.

• For insurance contracts where a £nil premium is charged and the fair value approach is being used to transition to IFRS 17 for those contracts, entities must measure the transition value of those contracts at fulfilment cashflows.