FA Module 21: Insurance contracts: IFRS 17 general measurement approach (overview)

(The attached PDF file has better formatting.)

IFRS 17 governs insurance contracts in most countries (but not the United States) and becomes effective on January 1, 2022. This module covers:

- Fulfilment cash flows
- Risk adjustment for non-financial risk
- Discount rates
- Insurance acquisition cash flows
- Contractual service margin

The exercises and practice problems on the discussion forum show the types of final exam problems.

IFRS 17 has three approaches:

- The general measurement approach (building block approach) applies to most insurance contracts.
- The premium allocation approach is an alternative permitted for certain short duration contracts.
- The variable fee approach is used for contracts with discretionary participation features.

The “building block approach” is the IFRS 4 term; IFRS 17 refers to the “general requirements of IFRS 17.” The phrase “building block approach” is still common, though it is not used in IFRS 17.

This course covers the general measurement approach and the premium allocation approach. The variable fee approach applies to policies with direct participation features and is not covered in this course.

The general measurement approach (building block approach) has four pieces (“blocks”):

- Probability weighted mean of future cash flows
- Discount rate that depends on the maturity, currency, and liquidity of the cash flows
- Risk adjustment for non-financial risk
    - the combination of the three items above is the fulfilment cash flows
- Contractual service margin that defers profit from initial recognition to the rest of the contract period

The discount rate is set by the insurer, using principles-based approaches, in contrast to the fixed rates for most statutory accounting, GAAP, and solvency regulation (Solvency II and risk-based capital). The accretion of interest is separate for future cash flows vs the contractual service margin.

Risk is distinguished between financial risk and non-financial risk.

- Financial risk (time value of money, duration, and liquidity) affects the discount rate.
- The risk adjustment for non-financial risk is set by the insurer, remeasured at each valuation date, and reported separately.

IFRS 17 is principles-based: it explains what the item represents, but firms decide the appropriate techniques. Insurers determine the discount rate most appropriate for their contracts. Maturity and liquidity are influences on the discount rate, but IFRS does not prescribe specific methods. Similarly, IFRS 17 does not specify the method to determine the risk adjustment, though it requires disclosure of the confidence interval.

The module explains the cost of capital method of setting the risk adjustment for non-financial risk in Solvency II and the Swiss Solvency Test, which is likely to be used by many insurers for IFRS 17 as well.

Acquisition costs that are directly attributable to the portfolio of insurance contracts are included in the fulfilment cash flows. Other acquisition costs are expensed when incurred.

The postings on the discussion forum illustrate the accounting entries for the general measurement approach.