

IFRS 17

Insurance Contracts

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National Bank of Ukraine



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Questions and answers

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Question 1

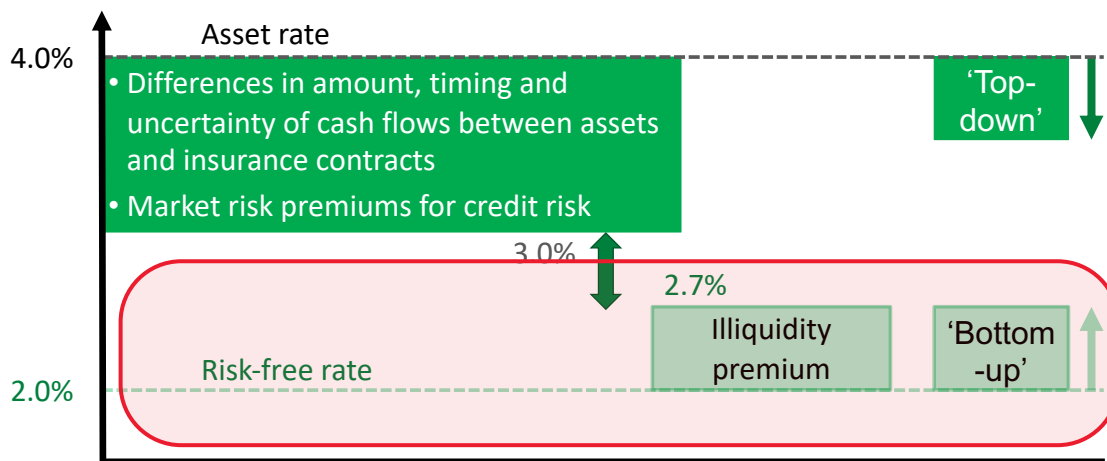
What techniques and methods are used in practice to calculate "illiquidity premium" in the "bottom up approach" for calculating the discount rate? Could you please propose something for Ukraine?

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Question 1

Determining the discount rates



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Question 1

Criteria in steps

» Applying the 'bottom up' approach requires:

1. Identify the **risk-free liquid yield curve**
2. Determine an **appropriate illiquidity premium**
3. Adjust the **liquid curve** for illiquidity

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Question 1

Step 1: Identify the risk free curve

- » Typically this is drawn from one of two sources:
 - » Unadjusted government rates (eg treasury yield curve or similar)
 - » Adjusted swap curve
 - » The two curves typically follow a similar shape, however the swap curve will typically include a swap spread:
 - » Demand and supply
 - » Cost of the swap
 - » Liquidity
- } Requires an understanding of the current swap spread decomposition
- In a liquid market, it will primarily be the cost element

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Question 1

Step 1: Identify the risk free curve

Note:

- » Typically interest rates are based on currency, so:
 - » USD assets/liabilities are subject to USD interest rates (and therefore US conditions)
 - » EUR to euro interest rates etc
 - » Hryvnia assets will be subject to Ukrainian conditions
- » Therefore, if and to the extent, insurance liabilities are denominated in eg USD, USD rate is likely the relevant rate to use to start

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Question 1

Step 1: Identify the risk free curve

Ukraine currently has the following available information:

- » Central Bank rate fixed at 25%
- » A Ukrainian government own currency yield curve does exist
- » However, this yield curve will likely need to be adjusted

An alternative mechanism arises from calculating implied interest rates by reference to foreign exchange rates

- » This may be a more liquid indicator
- » Captures the primary time value of money components

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Question 1

Step 1: Identify the risk free curve

Considerations. Can:

- » The NBU publish a 'risk-free' curve using their available data?
- » Ukrainian banks, or banking sector, collectively publish a swap curve ideally with an analysis of elements?
- » Insurance companies or the insurance regulator collectively determine and publish an interest rate curve?

If the answer to any of the above is yes, then:

- » Consider requiring consideration of that curve on a 'use or explain basis'

Source of curve important because of implied liquidity

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Question 1

Step 2: Illiquidity premium

Principle:

- » A policyholder is 'investing' money in the insurer
- » The policyholder demands compensation for time value of that money
- » Policyholder, like any investor, values flexibility, eg
 - » Withdraw money to meet other needs
 - » Withdraw money to reinvest on other assets
- » Policyholder will demand higher compensation for reduced flexibility
- » Government debt trades in a liquid market and therefore flexibility is high

Illiquidity is considered from the point of view of the policyholder

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Question 1

Step 2: Illiquidity premium

» Characteristics of the insurance contractual cash flows:

- » Rights to lapse the policy in full or in part – absence increases illiquidity
- » Penalties upon full or partial lapse – penalties increase illiquidity
- » Tax incentives – incentives that encourage retention increase illiquidity
- » Options or guarantees or smoothing benefits – valuable benefits increase illiquidity
- » Duration – illiquidity increases with length of time
- » Access to replacements – limits on alternatives increase illiquidity
- » Currency and availability of settlement currency

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Question 1

Step 2: Illiquidity premium

Sources of information

- » Contract terms
- » Regulation and law
- » Historical information on lapses
 - » Considering economic scenarios and other circumstances

Remember: Illiquidity premium is considered **relative to** the underlying curve

- » For example:
 - » If the selected yield curve is wholly illiquid, and insurance contracts are too, there is no further illiquidity premium

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Question 1

Step 2: Illiquidity premium

Best method for determining illiquidity premium is **market assets**, eg:

- » Swap spreads on liquid and illiquid assets
- » Assets for which there is **limited liquidity** (such as **unlisted debt**) will trade at a premium to similar assets that are liquid
- » Assets that are **fundamentally illiquid** (such as **fixed term bank loans**) will trade at a premium to assets to similar products
- » Assets that are **inherently illiquid** (such as **property**) will trade at a premium

These premiums establish a baseline for considering price of illiquidity

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Question 1

Step 3: Adjust the liquid curve

- » Adjust the liquid curve to reflect extent of incremental illiquidity
- » Note that illiquidity may vary over a contract term eg
 - » Some benefits of a contract may become more or less valuable
 - » Tax incentives etc may change eg relief at age 60
- » Consider bucketing contracts according to implied liquidity
- » Consider existing regulatory applications

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Question 1

But....

- » Don't forget top-down approach
- » Generally considered the easier approach
- » Is a free choice under IFRS 17

In the existing Ukrainian environment, this may be considerably easier
Broader, deeper source of data

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Question 2

You told us on the previous seminars about the uneven distribution of insurance revenue for the PAA method if there was seasonality in loss ratio. What is the international best practice for such approach for the insurance contracts with duration less or equal 1 year? Is it really material to use in such cases the uneven distribution of insurance revenue?

'If expected pattern of release of risk differs significantly from passage of time, then recognise revenue on the basis of the expected timing of incurred insurance service expenses'

- » Effect of seasonality needs to be **significant** and **material**
- » In practice, offsetting risk and client behaviour means this **happens very infrequently**

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Question 3

The Company has a direct settlement in obligatory MTPL. So, the Company settle the claim of its client, who is the victim, and then through the direct settlement system receives compensation from the Insurance Company of guilty part in accordance with the contract of guilty part. Are the cash flows related to the contract of guilty part related to IFRS 17?

Yes

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Question 3 *continued*

Scope of cash flows:

- » IFRS 17 **defines** an insurance contract (IFRS 17 definitions)
- » IFRS 17.10-12 **deal with what to separate out**
- » IFRS 17.13 states that **IFRS 17 is applied to all remaining components** of a contract after separating out
- » IFRS 17.33 **defines the measurement** of insurance contracts to include **all future cash flows within the boundary**
- » IFRS 17.33 applies to GMM and to PAA LIC measurement

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Question 3 *continued*

» IFRS 17.34

'Cash flows are within the boundary of an insurance contract if **they arise from substantive rights and obligations that exist during the reporting period** in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with insurance contract services.'

- » Cash flows are within the boundary if they **arise from the rights and obligations** in the contracts

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Question 3 *continued*

Scope of cash flows (continued):

- » IFRS 17.B65 provides examples of cash flows within the boundary including:
 - » Premiums, claims and benefits ((a),(b) and (c))
 - » Claims handling costs, administration and maintenance costs, transaction based taxes and an allocation of fixed and variable overheads ((f), (h), (i) and (l))
- » IFRS 17.B66 provides examples of cash flows excluded:
 - » Cash flows from reinsurance contracts held;
 - » Costs that cannot be directly attributed

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Question 3 *continued*

Questions to ask:

- » Does the insurer have the right to receive the direct settlement from the insurer of the guilty party?
- » Does the insurer of the guilty party have the obligation to pay another insurer the direct settlement?
- » Would either this right, or this obligation, have arisen if the insurance contract was not issued?

These questions establish if there is a right or obligation, and if so, if that right or obligation arises from the contract

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Question 4

All the Companies which sell the obligatory MTPL pay fee to the fund MTIBU and then, from this fund the MTIBU settle the losses of the bankrupt insurance companies (solidary system). Then these payments of losses are recognized by the Company as expenses and fund MTIBU as assets. Are the cash flows related to these operations belongs to IFRS 17.

Yes

- » These are obligations (and rights) that arise from the MTPL contracts issued
- » They would not exist absent the contract
- » There may need to be an adjustment for credit

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Thank you

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