



ACTUARIAL BUSINESS SOLUTIONS

# Revolutionizing the Insurance Industry with IFRS 17

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## Introduction

Did you know that now insurance companies, especially actuaries and accountants, are currently buzzing about new financial reporting standards (IFRS 17) that experts worldwide have been debating for nearly 20 years, regarding "Insurance Contracts" how they should be classified, valued measured, and disclosed information to be more appropriate.

Some might be thinking, "Is the current standard inappropriate?" While it may not be entirely inappropriate, let's understand the background and how this concept proposes to practice.

First, it's important to note that IFRS 17 is written by accountants and over 300 pages, making the language is mostly accounting jargon, and its principles-based Accounting (not Rules-based Accounting anymore). So, reading this standard requires interpreting the underlying principles and appropriately applying them.

Therefore, when reading IFRS 17, it's crucial to understand its objectives — "why is this being done?" Because IFRS 17 represents a fundamental change in the thinking around insurance contracts, which occurs once in a century (It took almost 20 years of debate to a conclusion). For the life insurance business, it will have a significant impact. The first noticeable change is the greatly reduced revenue recognition (but profits remain the same), and the change in revenue recognition methods, allowing for comparison with non-life insurance premiums.

## Why change?

The current financial reporting standard, known as IFRS 4 for insurance contracts, has still many doubts that make investors or financial statement readers still skeptical, such as allowing them to use their Generally Accepted Accounting Principles (GAAP) of their own country.

It's no surprise that Thailand's IFRS 4 (called TFRS4) quite different significantly from neighboring countries. An obvious example is the unique method for calculating actuarial reserves.

Moreover, the current financial reporting standard for insurance contracts is still difficult to compare with insurance companies, especially life insurance companies, due to their unique definitions and quite different accounting. This difference results in them being able to compare with other industries.

For example, if a life insurance company receives a premium of 1 million baht, its classified as an insurance contract, it can recognize the entire amount as revenue. However, if the same 1 million baht is deposited in a bank, the bank cannot recognize it as revenue, but only as fees. This discrepancy allows insurance sales through the bank to recognize the entire amount as revenue, often seen in news reports that sales are skyrocketing and have grown greatly, especially for endowment insurance, that can be indirectly recognized as revenue (Unlike banks, cannot recognize deposits received as revenue, because it is only allowed to recognize fees as revenue).

In summary, when IFRS 17 is used, financial statements of life insurance businesses to be compared with non-life insurance businesses and other industries like banks and financial institutions.

### **When will it start?**

Before delving deeper, let's take a look at how countries around the world are preparing for IFRS 17? The various financial reporting standards (IFRS ) have been resolutions by the International Accounting Standards Board (IASB) from Europe mostly. Therefore, European countries are very proactive. Now there is a mutual agreement and implementation date that has been postponed from January 1, 2021, to January 1, 2023. In Asia, Malaysia, Singapore, Hong Kong, and Korea are expected to implement IFRS 17 simultaneously with Europe. Moreover, China has also translated this standard into its own language and adapted it to suit its specific context. India, on the other hand, does not directly apply IFRS but instead uses a standard called 'Ind AS,' which is similar to IFRS 17 and came into effect on April 1, 2024..

Another country that needs to be watch is the United States, which does not use IFRS 17, but sticking with its U.S. GAAP (Generally Accepted Accounting Principles) that has been using for a long time (They even announced a U.S. GAAP phase 2, which will be fun for people to implement, because must understand both of these standards at the same time).

Let's return to Thailand. Thailand will implement IFRS 17 2 years after others, starting on January 1, 2025. However, it is important to note that when adopting the new financial reporting standard, new figures will not simply appear without prior preparation. There must be a comparison with the financial statements of the previous year (since when looking at numbers, it's not just about the results at that time, but also about the changes and trends from the previous year. That is truly reading the financial statements). This means that if it starts to be used on January 1, 2025, there must be numbers from 2024 for comparison. In other words, Thailand will have to prepare the financial statements according to IFRS 17 in the first quarter of 2024. This means there is not much time to prepare. By the end of 2024, preparation should be

completed, because anyone who is an accountant or actuary has ever implemented any financial reporting standard for the first time, will know that the preparation time left has passed very quickly, leaving no room to get ready. It's like blinking while looking in the mirror, and suddenly, noticing the first signs of aging.

## 5 key aspects of IFRS 17 that are more accessible to the needs of financial statement users

When consulting with auditors worldwide, there is a consensus that the current Insurance Accounting Standards are inconsistent, non-uniform, and non-transparent. This results in a lack of trust in the insurance business (as evidenced by the fluctuating insurance stock prices in Thailand, possibly due in part because of fluctuating financial statements).

The IFRS 17 aims to establish a single accounting approach as follows:

- **Provide up-to-date market consistent information of obligation including value of option & guarantee:**

Actuarial assumptions that are forward-looking and should be the most up to date (similar to the approach of using new assumptions to calculate estimated values) and consistent with the market. It's essential to consider the conditions and guarantees promised to customers (known as Options & Guarantees), such as a life insurance company promising the customers that the money deposited with the company will yield an interest rate not lower than x%. (From a technical perspective, such guarantees represent financial risks that arise from providing these assurances. Therefore, the company must calculate using the Stochastic Modeling methods as well.)

- **Reflects time value of money:**

Forward-looking actuarial assumptions must be converted to present value, which the insurance company already does as usual.

- **Reflects the characteristics of the insurance contract rather than the risk related to asset / investment activity:**

Insurance companies should reflect only the risks from the insurance contracts themselves, not reflect risks from the asset side or from investments.

- **Provides separate information about the investment and underwriting performance:**

Normally, life insurance companies and non-life insurance companies have two components of profit. The first part is called Underwriting Profit, which is similar to operating profit, generated from the

effective management of underwriting risks, making a profit by managing risks well. The second part is called Investment Profit. Usually, the company sets a target for the expected return from investments for each type of insurance policy. If the insurance company earns more from investments than the target, it is considered a profit in this area. The IFRS 17 clearly separates these two types of profits for transparency and to clearly shows the ingredients that come from these profits.

- **Treats service provided by underwriting activity as revenue and expense in a comparable way to other non-insurance businesses:**

This is one of the key points why there is a global push to implement this IFRS 17. It allows insurance companies to define revenue and expenses in a way that can be compared with other industries outside the insurance business, as exemplified about the comparison with bank deposits by mentioned earlier.

## Separation of Investment Components from Insurance Components

The separation of investment components from insurance components is essential for comparing the insurance business with the banking business. Deposits are often referenced, especially with the comparison example between depositing 1 million baht in a bank versus paying 1 million baht for life insurance (with a sum assured of 1.1 million baht) with different accounting recognition and revenue recording.

If anyone has seen the financial reporting standards for insurance contracts known as IFRS 4 (currently in use), it will notice that it already classification of contracts called insurance contracts and investment contracts. This differentiation can still use the same criteria, the investment contract will be viewed as a Distinct Investment Component and accounted for under IFRS 9 instead.

The insurance contract under IFRS 17 is divided into two components: insurance components and non-distinct investment components. This is considered another revolutionary for those required to implement IFRS 17.

A clear example would be whole life insurance products where the coverage amount is 1.5 million baht, and at that time the cash surrender value is 1 million baht. These 1 million baht would be considered as part of the deposit. For IFRS 17, these 1 million baht would not be included in the profit and loss statement.

Although non-distinct investment components are considered part of insurance contracts under IFRS 17, these investment components are disaggregated and not shown in the profit and loss statement, as per the disaggregation requirement under IFRS 17. Particularly, deposit components resembling will no longer be included in the profit and loss statement going forward.



The following table illustrates the key differences in the calculation of Profits or Losses under IFRS 4 and IFRS 17:

IFRS4	IFRS17		
Written Premium	Insurance Revenue (Earned Premium)	} Insurance Service Expense (ISE)	} Insurance Service Result
- Incurred Claims & Benefits	- Incurred Claims and Expenses		
- Change in Insurance Contract Liability	- Acquisition Costs - Gains / Losses from Reinsurance		
+ Investment Income	+ Investment Income - Insurance Finance Expense (IFE)	} Net Financial Result	
<u>Profit or Losses</u>	<u>Profit or Losses</u>		
+ Other Comprehensive Income (OCI)	+ Other Comprehensive Income (OCI)		
<u>Total Comprehensive Income</u>	<u>Total Comprehensive Income</u>		

From the illustration, it can be seen that

- The components of the profit and loss statement under IFRS 4 are  

$$\text{Premium} + \text{Investment Income} - \text{Incurred Claims \& Benefits} - \text{Change in Insurance Contract Liability} = \text{Profits or Losses}$$
- The components of the profit and loss statement under IFRS 17 are  

$$\text{Insurance Revenue} - \text{Insurance Services Expense (ISE)} + \text{Investment Income} - \text{Insurance Finance Expense (IFE)} = \text{Profits or Losses}$$

In both IFRS 4 and IFRS 17, whether it's Profit or Loss + Other Comprehensive Income (OCI), combined result in Total Comprehensive Income (TCI), just as before.

In IFRS 17, investment components are separated from insurance components, which require actuarial principles to disaggregate these components.

For IFRS 4, when an insurance company paid out a death claim, it is recorded as an expense incurred from a claim, but for IFRS 17 goes deeper. The true insurance coverage portion must be separated into the insurance component, and the part resembling a release in cash surrender value that the policyholder is entitled to must be classified as an investment component.

For example, consider a life insurance policy with a coverage amount of 1.5 million baht. It turns out that the policyholder passes away and the cash surrender value at that time is 1 million baht, for IFRS 17, the 1.5-million-baht payout would be deducted of 500,000 baht for the insurance coverage (which is the excess of the coverage amount over the reserve, technically known as the Net Amount at Risk (NAR)), and 1 million baht as the release of the cash surrender value, which would be classified as an investment component.

In the same example, if the policyholder surrenders the policy, the life insurance company would have a cash outgo, which IFRS 17 will be classified as investment components as well.

Another point can be noted that in IFRS 17, there will be no due premiums or prepaid premiums anymore. In terms of recording insurance revenue, it will be based on service on an earned basis, which if this approach aligns will be consistent with other industries that are not insurance businesses.

IFRS4	IFRS17
<p><u>Assets</u></p> <ul style="list-style-type: none"> <li>• Reinsurance Contract Assets</li> <li>• Deferred Acquisition Costs</li> <li>• Value of Business Acquired</li> <li>• Premium Receivable</li> <li>• Policy Loans</li> </ul> <p>Liabilities</p> <ul style="list-style-type: none"> <li>• Insurance Contract Liabilities</li> <li>• Unearned Premiums</li> <li>• Claim Payable</li> </ul>	<p><u>Assets</u></p> <ul style="list-style-type: none"> <li>• Insurance Contract Assets</li> <li>• Reinsurance Contract Assets</li> </ul> <p>Liabilities</p> <ul style="list-style-type: none"> <li>• Insurance Contract Liabilities</li> <li>• Reinsurance Contract Liabilities</li> </ul>

Under IFRS 17, all components are consolidated into Insurance Contract Assets/Liabilities or Reinsurance Contract Assets/Liabilities to avoid presenting different results. Notably, IFRS 17 balance sheets no longer include premium receivables as financial assets. Additionally, acquisition costs are not presented as intangible assets. Instead, deferred acquisition costs in IFRS 17 are embedded in the calculation of insurance contract liabilities and are gradually recognized through actuarial methods, contributing to the Contractual Service Margin (CSM), which will be discussed further.

## Types of Contracts Related to IFRS 17

In this new standard, there are two definitions of insurance contracts: Onerous Contracts and Contracts with a Contractual Service Margin (CSM), which is the most important part of this standard. This concept is referred to as the asymmetric of profit recognition in insurance contracts.

### 1. What is an Onerous Contract?

Onerous means burdensome or having excessive obligations. Therefore, an Onerous Contract refers to a contract with excessive obligations or, in other words, a loss-making insurance policy. According to IFRS 17, actuarial assumptions will reflect market conditions at all times. Even if an insurance policy is designed to make a profit, it may become loss-making in the future due to changing market conditions (e.g., lower investment returns than initially projected).

In the case where an insurance contract is assessed and found to incur losses at the time of issuance, it would be categorized as an Onerous Contract. The entire expected loss must be recognized immediately. For example, if an insurance contract has a period of 10 years and annually assessed to incur a continuous loss of 10 million baht annually, the recognition of the loss in the profit and loss statement would reflect a total loss of 100 million baht immediately (10 million baht per year for 10 years, assuming no discounting rate involved).

### 2. What is Contractual Service Margin (CSM)?

In this context, "Margin" refers to profit, typically known as Profit Margin. However, in IFRS 17, it uses the word "Service Margin" because it views this as profit from service fees. This is because IFRS 17 no longer recognizes insurance premiums as revenue goes forward (everything will change to fees). Given that IFRS 17 will be based on fee income when recognizing profits from insurance contracts, it is termed as Contractual Service Margin (CSM).

An insurance contract that is assessed to have profit when issued will have a Contractual Service Margin (CSM), which cannot be recognized as profit immediately in its entirety. Instead, it must be amortized over the duration of the contract. For example,

"This insurance contract has a duration of 10 years and will have a total present value profit of 100 million baht. When recognizing profit in the profit and loss statement, the entire 100 million baht

cannot be recognized. Instead, this amount must be gradually recognized over the 10-year period of the insurance contract. It's like taking 100 million baht, anticipated as total profit on the day the policy was issued, and placing it into a reserve dam to be gradually released."

And as time passes, the water gradually releases from the dam, slowly recognizing the profit. Sometimes, Contractual Service Margin (CSM) may be called Profit Reserve, wouldn't be wrong.

When comparing Onerous Contract with Contractual Service Margin (CSM), it observes that losses must be recognized immediately in full, whereas profits must be gradually recognized over the contract's duration. This asymmetrical recognition of gains and losses under IFRS 17 reflects the principle of "enjoy happiness gradually, endure suffering all at once."

### What if there is an Onerous Contract on day one, but it becomes profitable later?

On the first day a contract is classified as an Onerous Contract, it doesn't mean that we recognize the loss and then forget about the loss figures from the insurance contract. Even though all losses have been recognized, we must still keep a record of the amount of loss component previously recognized for each policy. If management later generates a profit, we must offset this profit against the previously recorded loss figures until the loss is fully covered. Any excess profit beyond that point will be recognized as Contractual Service Margin (CSM), and when excess CSM will then be gradually recognized as profit again in the future.

It is important to emphasize that, under IFRS 17, the loss component previously recognized from being an onerous contract can only be offset by increases in expected profit arising from changes. However, past profits cannot be used to offset losses, as those profits have already been accounted for and reflected in prior periods' financial statements. For example, consider an insurance contract with a duration of 10 years. When the policy was sold, the company recognized a loss of 100 million baht (the Loss Component). If, after three years, the company will have an additional profit of 70 million baht in the future, which exceeds initial expectations, IFRS 17 allows these 70 million baht will be recognized as profit immediately within that financial year. (No need to be gradually recognized as profit like the Contractual Service Margin (CSM)) because the company previously recorded a loss of 100 million baht. This increased future profit might result from changes in actuarial assumptions leading to higher profits or better-than-expected in future operational performance, reducing the fulfilment cash flows.

If the company continues its operations for another five years, realizes an additional profit of 80 million baht, this amount must be divided into two parts. The first part, 30 million baht, can be immediately recognized as profit to offset the remaining accumulated loss of 30 million baht (a previously recognized loss of 100 million baht when the policy was sold, with 70 million baht already recognized as profit by the end of the third year). The second part, 50 million baht, must be recognized over the remaining five years (the contract has a duration of 10 years, and will be exactly 5 years when this account is entered). This means that 10 million baht will be recognized as profitable annually for the next five years.

### **What if there is a Contractual Service Margin on day one, but a loss occurs later?**

When profit is gradually recognized from having a Contractual Service Margin (CSM) and then suddenly an adverse event occurs, causing future loss projections, the estimated loss must be offset against the remaining CSM. Subsequently, the remaining profit reserve is recalculated and spread over the remaining period. This means that if there is a CSM and a loss occurs in a given fiscal year, the company does not immediately recognize the loss. Instead, the loss is deducted from the accumulated CSM, which may reduce profit recognition in the future.

The losses arising from future projections are due to changes in actuarial assumptions that result in lower calculated profits than initially expected or forecasts of operating results in the future that are worse than the initial assumptions. These results in an increase the fulfillment cash flows for policy obligations.

## Individual Calculation or Group Assessment?

Anyone who is an actuary knows that we have always had issues explaining individual calculations and group assessments. Actuarial calculations are group assessments, involving assumptions categorized by risk groups. However, when calculations, these refined assumptions are applied to individuals.

It's like when making Khanom Krok, where multiple ingredients are mixed together in one pot, and after thorough blending, the mixture is poured into individual molds.

The issue is, how do we mix the ingredients? If the company had five types of risks, we would likely mix five separate pots (each corresponding to a different flavor or type). We wouldn't mix everything into one pot, right?

Therefore, the level of aggregation is an important issue that is brought up first, in the draft version of IFRS 17, it was specified that calculations had to be done on a per-policy basis cannot grouping. However, this approach was contested as being use a sledgehammer to crack a nut. Consequently, the latest version of the standard now permits group calculations.

## Grouping by Level of Aggregation

Grouping the types of insurance policies is done at the policy inception. Once a policy is grouped into a specific category, it remains in that category until the contract expires. The types of insurance contracts can be grouped according to the following steps:

### 1. Portfolio

Organize into portfolios first, which are groups of policies with similar risks and managed together. For example, single premium policies and regular premium annuity policies should be in a different portfolio. Similarly, motor insurance policies should be in a different portfolio from non-motor insurance policies. These examples are quite clear, but to make it even more practical, the grouping of these insurance policies can at least align with the product categories used in the Risk Based Capital (RBC) reporting to the Office of Insurance Commission (OIC).

### 2. Cohort

First, group contracts that were issued within one year of each other. This means that when grouping policies, we should organize them by the year the policies are sold. For instance, policies sold in 2017 should be in a different group from policies sold in 2018, even if they are the same type of policy and sold to the same person. This is because IFRS 17 assumes that policies issued at different times will have different actuarial assumptions based on the market conditions at that time. If anyone has ever estimated reserves or taken fellowship exams under U.S. GAAP, they will understand that cohort grouping is a principle borrowed from U.S. GAAP.

### 3. Profitability

Before diving in, it's important to note that when insurance actuaries calculate premiums, they also estimate the profitability of each policy, determining the expected profits each year after the sale. Therefore, insurance companies can assess whether the policies they are about to sell will be profitable or unprofitable (given current market conditions). Because of this, grouping policies by profitability involves determining whether an insurance contract falls under the category of an Onerous Contract or not.



- 3.1. **Onerous Contract** are classified as the first group, meaning there will be sure a loss from the outset. These should be separated, akin to a virus that needs to be quarantined and should not be grouped with profitable contracts. Otherwise, financial statement readers will not know which contracts are profitable or loss-making. This could result in subsidies (hiding profits and losses together to present an overall profitable picture), which lack transparency. Therefore, insurance policies classified as Onerous Contracts are required to reflect all losses immediately (Timely Reflection).
- 3.2. **No Significant Possibility of Becoming Onerous** are those will be sure a generate profit from the outset (Profitable Group). These contracts are not allowed to reflect all profits immediately but must gradually recognize profits through the Contractual Service Margin (CSM) throughout the contract period. This results in what is known as Asymmetric Treatment, where there is a different approach between Profitable Contracts (gradual profit recognition) and Onerous Contracts (immediate loss recognition).
- 3.3. **Other Group** is the last group. This means that while the contract is currently profitable, there is no significant indication that there will be a loss if sold now. (However, future events could change this status. This assessment might be determined through sensitivity tests or internal information about changes in future estimates.) Essentially, this group is profitable but not sure, with the potential to become an Onerous Contract in the future. When organizing into groups, the process should start with a broad group such as the portfolio level. After defining the portfolio, the next step is to consider the cohort grouping, and the most detailed level is profitability classification to determine whether it is Onerous or not.

For example, consider a company has 3 portfolios, each portfolio has 4 cohorts, and each cohort has 2 types of profitability: Onerous and Profitable. Therefore, when organizing the Level of Aggregation, there are  $3 * 4 * 2 = 24$  subgroups. Even if there are 1 million policies, calculations are only performed 24 times (similar to having 24 pans of Khanom Krok, but the calculations result in 1 million servings of Khanom Krok).

Some have asked whether, for the life insurance business, we should separate the basic policy and the rider. This is because sometimes we calculate premiums and sell them separately, but most of the time, they lapse together. Should we consider them combined or separate? The rough principle is to compare

the basic policy only (Basic Only) with the rider (Basic + Rider). There is a difference in the nature of risk, if attaching the rider actually changes the overall risk, then it should be considered separately.

At this time, the working group for IFRS 17 tends to view the basic policy along with the rider (Basic + Rider) as a single combined contract.

## Reinsurance

Many people are interested in IFRS 17, focusing only on how to calculate and account for insurance contracts. Then, the question arises: "What impact will reinsurance have on IFRS 17?" Upon analysis, it appears that there is no significant financial impact. However, complying with IFRS 17 involves considerable complexity.

"For example, if an insurance company engages in reinsurance and the reinsurance cost is deemed onerous for the reinsurance contract, this would create a Contractual Service Margin (CSM) for the reinsurer. Under the practice of IFRS 17, this profit does not need to be recognized immediately but can be offset with onerous contracts from the insurance company."

This approach is referred to in IFRS 17 allowing for Symmetric Treatment only for reinsurance contracts (immediate recognition of both profits and losses). This differs from the principle of Asymmetric Treatment typically applied to general insurance contracts. Therefore, a reinsurance contract must be linked with the primary insurance contracts for IFRS 17.

## How to assess the value of insurance contract liabilities IFRS 17.

The International Financial Reporting Standard 17 (IFRS 17) specifies three models for calculating the value of insurance contract liabilities:

1. **General Measurement Model (GMM)** is the most commonly used approach, based on the Building Block Approach (BBA). It divides the Fulfillment Cash Flows, which include the Risk Adjustment, and ends with the Contractual Service Margin (CSM).
2. **Premium Allocation Approach (PAA)** is a method that is similar to recognizing Unearned Premium Reserves (UPR). It is typically used for riders of life insurance companies and non-life insurance contracts.
3. **Variable Fee Approach (VFA)** is specific and applies to insurance contracts that include dividends, Unit Linked or Universal Life, that meet specified conditions. In Thailand, only Unit Linked meets the conditions and can use this approach. (Further reasons can be found under the section “Can Universal Life and Unit Linked insurance use the General Measurement Model (GMM) approach?”)

In the early drafts of IFRS 17, there was a method called the Building Block Approach (BBA), which involves segmenting various components, similar to stacking bricks in layers. Later on, this approach was set as a general standard method and called a new name, the General Measurement Model (GMM), which can be applied to general insurance contracts universally.

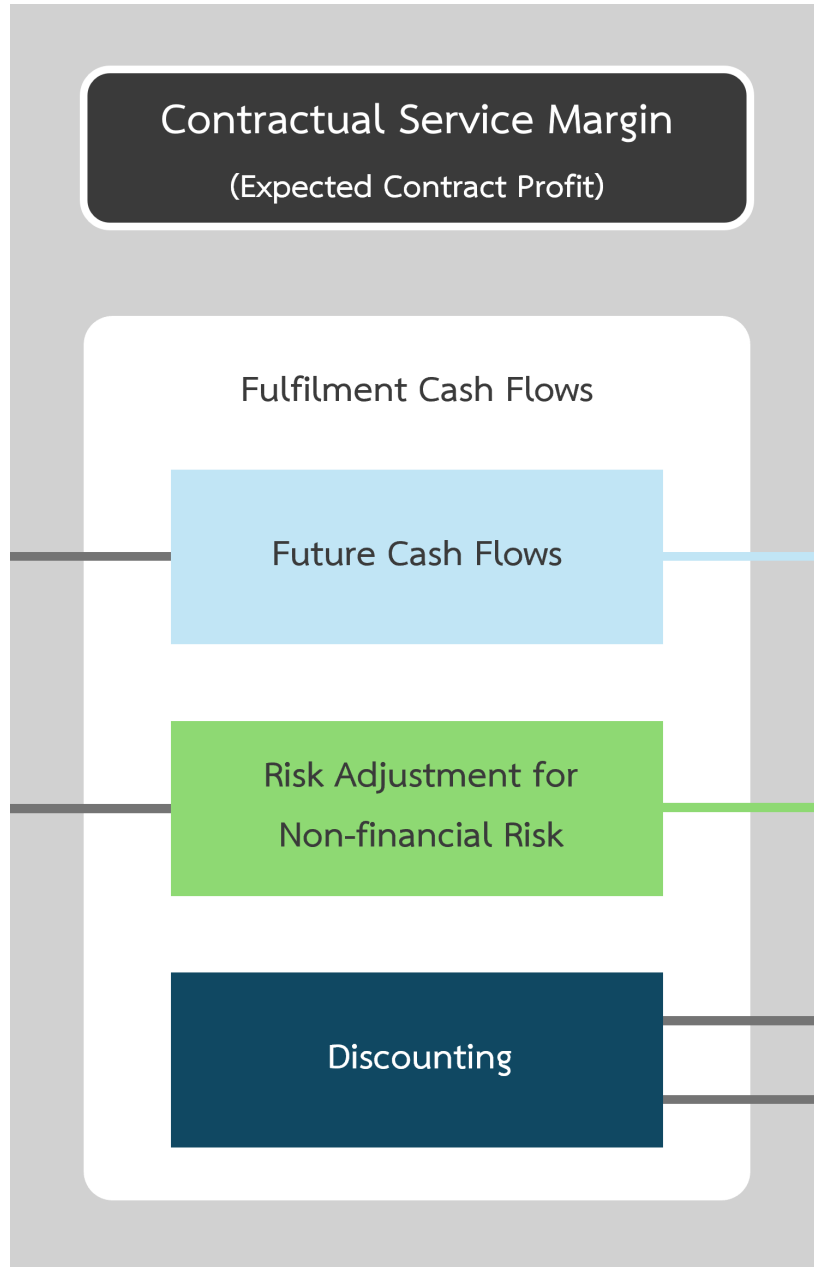
## The key components of the General Measurement Model (GMM)

1. **Fulfillment Cash Flows** is like the cost of an insurance contract, which the obligation to pay out average cash flows over various future periods. The simple calculation steps are as follows:
  - 1.1. Estimate Future Cash Flows using actuarial assumptions to make the best estimate assumption, considering factors such as morbidity rates, mortality rates, lapse rates, and expenses.
  - 1.2. Add the Risk Adjustment for Non-financial Risk to reflect potential risks and deviations from the best estimate assumptions. The calculation accounts for variability, ensuring that the average cash flow will be sufficient to meet obligations even during periods of volatility. This principle is similar to Risk-Based Capital (RBC), which requires setting aside a Provision for Adverse Deviation (PAD), a concept familiar to many. Examples of non-financial risk assumptions that need to be provisioned include morbidity rates, mortality rates, lapse rates, and expenses.
  - 1.3. Use the cash flows derived from the best estimate assumptions and the Risk Adjustment for Non-Financial Risk to calculate the present value by applying the discount rate.
2. **Contractual Service Margin (CSM)** is also known as Expected Contract Profit. The calculation of CSM involves finding the difference between the following two values:
  - 2.1. The present value of estimated average cash flows to paid obligations, where these obligations are estimated as if all premiums received in the future will have no profit at all and will be used to pay the obligations of the policy.
  - 2.2. The present value of estimated cash outgo of Fulfillment Cash Flows. When taking the difference in present value between "Debt intended to have no profit" are subtracted with "Debt from Best Estimate + Risk Margin," and will be obtained the "Expected Profit" in the form of Contractual Service Margin (CSM).

This means that for policies sold on the inception date, a shortcut method can be used to calculate the Contractual Service Margin (CSM) by taking it directly from the present value of Fulfillment Cash Flows. This is because profitable policies will have a negative present value of Fulfillment Cash Flows (similar to

Risk Based Capital (RBC) where Gross Premium Valuation in the first year can be negative for non-loss policies), and that negative value can be directly representing the Contractual Service Margin (CSM).

When using the General Measurement Model (GMM) and time passes, how will accounting entries be recorded?



1. **The Contractual Service Margin (CSM)** will gradually recognized profit by releasing it. The release of the CSM value will reduce the CSM, and the reduced portion will be recognized as profit in the profit and loss statement. The CSM is recorded as a liability because it represents unrecognized profit. Additionally, the CSM value must be compared with the balance sheet. There have been cases that

CSM value was too high, causing equity to turn negative. In such cases, the CSM must be constrained to prevent negative equity.

2. **Future Cash Flows** from actuarial assumptions based on the best estimate assumption and the Risk Adjustment for Non-Financial Risk are divided into considerations of the past/present and the future, as follows:

2.1. When there are changes in the estimated average cash flows related to past and present services, these should be directly reflected in the profit and loss statement.

2.2. If the changes are related to future services, most of it will be added to or deducted from the Contractual Service Margin (CSM). In cases where losses exceed the CSM and it is insufficient, the remaining amount will impact on the profit and loss statement, indicating that the insurance contract has become onerous. These losses must be recorded and recognized in the profit and loss statement immediately.

3. The discount rate in IFRS 17 is intended to reflect both the risk-free rate and the illiquidity premium of the insurance contract. The discount rate can be determined using either a Top-Down Approach or a Bottom-Up Approach.

3.1. The Top-Down Approach can be derived by taking the portfolio yield and subtracting the credit risk. This means the discount rate = portfolio yield - credit risk.

3.2. The Bottom-Up Approach can be derived by adding the risk-free rate to the illiquidity premium directly. This means **the discount rate = risk free rate + liquidity risk** and **Portfolio Yield = Risk Free Rate + Liquidity Risk + Credit Risk**.

The important aspect that IFRS 17 addresses and improves upon from IFRS 4 is the effort to ensure that insurance contracts with similar cash flow estimates can be valued the same. Under the current IFRS 4, this is not possible because IFRS 4 allows companies to use their own investment return rates as discount rates, which can result in inequality in accounting.



IFRS 17 also allows the segmentation of fulfilment cash flows into those that varying fulfilment cash flows, such as expected surrender outgo or death benefit outgo linked to the account value of unit-linked products.

Another type of cash flow is the non-varying fulfilment cash flows, such as general cash flows for paying life insurance benefits from traditional insurance policies or medical expenses from health riders. These cash flows remain unchanged regardless of changes in financial risks or variables.

In principle, varying fulfilment cash flows and non-varying fulfilment cash flows can use different discount rates to reflect the type of these cash flows. Non-varying fulfilment cash flows typically use only the risk-free rate, while varying fulfilment cash flows use a higher discount rate that includes financial risk.

However, if separate discount rates are not preferred, IFRS 17 allows the use of a single set of cash flows and a risk-neutral discount rate.

When understanding the steps to find the discount rate, let's consider how to apply the results. The interest yield can be divided into two parts:

1. **Insurance Finance Expense at Locked-in Discount Rate:** Actuaries typically set this rate to ensure that policy reserves grow at a specific interest rate (unwind) each year. Generally, this rate is calculated when designing the insurance product. In IFRS 4, this might be called the Valuation Interest Rate or sometimes the Target Profit Rate. This interest rate is set during the insurance product design phase with the intention that this insurance policy must invest to achieve the anticipated profit. This interest rate is considered one of the insurance businesses that must ensure the funds grow as expected.
2. **Investment Return > Locked-in Rate:** Any excess from the previously mentioned rate can be considered an investment margin. This excess can be accounted for in the Insurance Investment Result on the income statement.

## Do non-life insurances require to assess using the General Measurement Model (GMM) only?

Financial reporting under TFRS 17 offers more flexibility than many understand. While most non-life insurance involves short-duration contracts, this does not necessarily mean that the General Measurement Model (GMM) must always be applied exclusively.

One alternative approach presented is the Premium Allocation Approach (PAA), which can be utilized for short-duration insurance contracts, particularly when the contract term does not exceed one year or when the results from PAA do not significantly differ from GMM. The allowance for PAA aligns with the intent of TFRS 17 to reflect the characteristics of actual insurance contracts and enables companies to adopt a simpler method for liability calculation.

PAA is similar to the calculation of Unearned Premium Reserve (UPR) used in the Risk-Based Capital (RBC) framework, focusing on recognizing unearned premiums for the remaining contract duration, which is a familiar method for non-life insurance companies. This familiarity makes the transition to PAA under TFRS 17 relatively straightforward.

Although most non-life insurance companies sell short-duration contracts, there are circumstances where the use of PAA may be insufficient, such as:

- If long-term claim payments (exceeding one year) are anticipated.
- If liability reserve estimates need to consider the impact of time factors and discounting.

In these cases, companies must utilize the GMM, which is more complex, as it requires forecasting future cash flows and accurately recognizing changes in liabilities, necessitating reserves to be maintained differently from the previous system.

In the realm of insurance reserving and financial reporting according to international standards, the focus is not on whether a business operates as a life insurance or non-life insurance company based on its license. Instead, it hinges on the nature of the contracts, determining whether they are classified as long-duration or short-duration insurance contracts. Notably, life insurance companies can sell short-duration

insurance contracts and utilize the Premium Allocation Approach (PAA), while non-life insurance companies can also offer long-duration contracts, such as cancer insurance.

## What should be done when starting to calculate and perform for the first time?

Some people might wonder, since the principles of IFRS 17 have changed so significantly, what should be done on the first day of implementing IFRS 17? How should the calculations be made, especially regarding the Contractual Service Margin (CSM) that needs to be embedded with each policy?

When the insurance company has already sold policies, suddenly valuing these insurance contracts along with the Contractual Service Margin (CSM) under IFRS 17. It is akin to retrospectively looking back as the first day of selling the policy and then bringing that valuation forward to the present time.

This first method is called the Full Retrospective Approach (FRA). In practice, it likely has not retained all the historical data, making the method difficult to implement. Therefore, IFRS 17 allows using estimations from the past with estimated variables (without needing actual historical data). This second method is called the Modified Retrospective Approach (MRA).

This method is similar to when life insurance companies want to change the method of calculating policyholder dividends and reevaluates what it will be. It must be retrospectively studied from the past to the present for each policy. Sometimes, estimations from the past are used with estimated variables. Therefore, it is like a modified version of the Full Retrospective Approach (FRA).

That's good news! If we prefer not to use the Full Retrospective Approach (FRA), we can use the prospective approach. This third method, called the Fair Value Approach (FVA), involves calculating the Contractual Service Margin (CSM) from fair value subtracted by the current value of Fulfilment Cash Flows. Details can be studied from the General Measurement Model (GMM) calculation method of IFRS 17, as mentioned earlier.

### The frightening realities that must be considered...

In IFRS 17, there's one point that's different from before: there are no Balancing Items, or a category labeled "Others" in the disclosure notes anymore. This means that when calculating the numbers are not perfect, there won't be a catch-all category to put. Which can be considered a significant issue for those at the operational level, because anyone who has calculated and reconciled knows that there can be small differences that don't materially impact the totals, even if the variance is as slight as 0.1%.

Therefore, we will have to wait and see where this will be reported if it cannot be reconciled. It is advisable to consult or inform the auditors early on regarding this matter.

## Can Universal Life and Unit Linked insurance use the General Measurement Model (GMM) approach?

The answer is that there is another calculation method available for companies selling these types of insurance. This method is called the Variable Fee Approach (VFA), which is similar in principle to the General Measurement Model (GMM) but includes additional features related to Participating Contracts. In the case of participating products in life insurance, despite the similar name, the contents do not yet have mechanisms to tie in dividend payment formulas (or another way to put it, true profit sharing is not yet established). Therefore, the General Measurement Model (GMM) must still be used. Only Universal Life and Unit Linked policies can be calculated using this method. If the conditions mentioned above and met there are clearly segregated asset funds, Universal Life policies currently sold in Thailand still do not have clearly separated asset funds, it cannot utilize the Variable Fee Approach (VFA).

## When the change happens, will people understand?

This is something that cannot be overlooked. The financial statements of insurance businesses will change significantly with the adoption of IFRS 17, potentially causing confusion or misinterpretation among those familiar with the old standards, especially those who do not fully understand IFRS 17 yet. Therefore, before implementing IFRS 17, it is necessary to prepare investors, business owners, employees, policyholders, and the media to understand what will change. Even though it may seem complex and difficult to understand at first, IFRS 17 will clearly separate underwriting from investment considerations. It also redefines the recognition of revenue/fees (no longer insurance premiums), allowing life insurance and non-life insurance to be compared with each other and with other industries. Additionally, it is important to understand how profits and losses will be recognized asymmetrically. The key principles of **Onerous Contracts** (when there is a loss) and **Contractual Service Margin (CSM)** (when there is a profit).

One noticeable change after adopting IFRS 17 will be the significant drop in revenue recognition for life insurance premiums, now it will be treated like fees (life insurance premiums can no longer be recognized as revenue). For non-life insurance businesses, there will also be changes in revenue recognition and the breakdown of financial statements into more complex items. Many people may misunderstand that the insurance business is revenue has decreased, potentially causing stock market volatility if investors do not understand IFRS 17. Especially, with this misunderstanding will particularly affect endowment insurance products sold through banks, as they will no longer be recognized. For example, a premium of 100,000 baht might be recognized as revenue of only 1,000-baht fee.

For life insurance businesses, the recognition of profits and losses will be different. If there is a loss, it must be fully recognized immediately, but if there is a profit, it must be gradually recognized until the contract period. This means that IFRS 17 will slow down profit recognition for life insurance companies compared to the previous standards. However, many people misunderstand that IFRS 17 will reduce profits, which is not true.

Additionally, TFRS 17 will enable insurance businesses to recognize profits more consistently (smooth profit) and avoid the volatility experienced under TFRS 4

To reiterate, IFRS 17 should not reduce the profit recognition of life insurance and non-life insurance businesses. Only life insurance businesses will recognize profits more slowly (the profit pattern will change

annually). However, the total profit will remain the same under both the old (IFRS 4) or the new (IFRS 17) standards.



## With IFRS 17 in place, is RBC still necessary?

We shouldn't confuse IFRS 17 (International Financial Reporting Standard 17) with RBC (Risk Based Capital) because their objectives are entirely different. IFRS 17 is a financial reporting standard used for financial statements, impacting the profit and loss statement, balance sheet, and notes to the financial statements. On the other hand, RBC is a calculation of future solvency, commonly referred to as the Solvency Ratio. Specifically for RBC, it is known as the Capital Adequacy Ratio (CAR). The RBC calculation focuses primarily on the balance sheet. IFRS 17 aims to reflect the company's performance in the financial statements, while RBC aims to reflect the company's ability to meet its obligations (having funds to pay benefits to policyholders).

The outcome of IFRS 17 is financial statements in accordance with international accounting standards, whereas the result of RBC is the Capital Adequacy Ratio (CAR) according to the Life Insurance Act and the Non-Life Insurance Act.

The main working group for IFRS 17 consists of members from the Federation of Accounting Professions. In contrast, the main working group for RBC is from the OIC. However, the OIC is not complacent and is also setting up a working group to study the impact of IFRS 17.

Comparison	IFRS	RBC
Focus	Profit and loss statement, balance sheet, and notes to the financial statements	Balance sheet at fair value
Reflects	Reflects the company's performance in the financial statements	Reflects the company's ability to meet obligations (having funds to pay policyholders)
Outcome	Financial statements according to international accounting standards	Capital Adequacy Ratio (CAR) under the Life Insurance Act and the Non-Life Insurance Act
Main Regulator	Thailand Federation of Accounting Professions (TFAC)	Office of the Insurance Commission (OIC)

Although the objectives of IFRS 17 and RBC are entirely different, both are widely used measures globally to provide stakeholders with different perspectives. Accountants, actuaries, and related experts need to study and apply these standards to their organizations and industry, ensuring sustainable growth with a platform that will soon transform the insurance business.

## Similarities and Differences between IFRS 17 and VoNB/VIF

VoNB (Value of New Business) and VIF (Value of Inforce) are familiar terms in both the life insurance and non-life insurance businesses, especially when assessing a company's stock price or business value, particularly during mergers and acquisitions.

Contractual Service Margin (CSM) at the inception of the policy issuance is comparable to the Value of New Business (VoNB).

Contractual Service Margin (CSM) over time after the policy issuance is comparable to the Value of Inforce (VIF). By CSM looks retrospectively from the past to the present, while VIF is a prospective measure looking from the future back to the present.

This distinction highlights that the CSM in IFRS 17 may reduce the importance of VoNB/VIF calculations. Consequently, the Key Performance Indicators (KPIs) of insurance companies are likely to shift from using VoNB/VIF to use the CSM of IFRS 17.

## Conclusion

The International Financial Reporting Standard 17 (IFRS 17) for insurance contracts significantly impacts the classification, measurement, presentation, and disclosure of information for both life and non-life insurance businesses. This standard requires cooperation from many departments, such as actuarial science, accounting, and investment. Recognizing its importance, many entities within the insurance industry have been actively preparing and equipping themselves with knowledge to comply with IFRS 17. They have been working diligently to implement IFRS 17 effectively, ensuring that it brings the maximum benefit to the industry.

From reading IFRS 17, The Key Transformations in the Insurance Business are as follows.

1. The method of revenue recognition changes from premiums to service fees.
2. The method of profit/loss recognition from inception is asymmetrical. When there is a loss (Onerous Contract), it is recognized immediately, while gradual recognition of profits (Contractual Service Margin).
3. The method of recognizing profits/losses subsequently after day one requires keeping record of profits/losses until contract eventually ends due to asymmetry in recognizing in each side.
4. Profit will be defined in detail by separating into Underwriting Performance and Investment Performance.
5. The calculation of insurance contract reserves under the Building Block Approach (BBA), referred to as the General Measurement Model (GMM) in IFRS 17, includes specific methods such as the Premium Allocation Approach (PAA), commonly used in non-life insurance businesses, and the Variable Fee Approach (VFA), used by life insurance companies selling Universal Life (with clearly segregated asset funds, which currently do not meet the criteria in Thailand) or Unit Linked products must be used.

One thing to emphasize again is that while this standard changes the way revenue/income is recognized, it does not change the total profit. What will change be in the recognition of profit pattern/profit emergence each year, which may lead to a slower recognition over time.

And perhaps most importantly for preparing for IFRS 17, it's about preparing the data, systems, processes, and indispensably, ensuring that personnel, management, and even general investors. They say whoever grasps IFRS 17 can retire sooner because the more you study it, the more you realize how complex it is, and the more you just want to retire early.

In conclusion, as the former president of the Society of Actuaries of Thailand, I believe that implementing IFRS 17 will make financial statements more transparent, easier to understand, and more comparable with other industries, benefiting all parties. Specifically, it will enhance the credibility of insurance companies' financial statements. However, the implementation and cost of preparing financial reports in line with international standards will require detailed planning and appropriate execution. This includes preparing personnel, educating related experts, changing roles and responsibilities in various departments. Especially for actuaries, whose roles will change significantly. Additionally, the readiness of actuarial models, software systems, operational systems, and integration with existing systems in insurance companies must be ensured. Only then can the benefits to industry and the public be maximized, with controlled costs and timelines. This will truly be beneficial for all parties involved.



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