

10 Questions regarding IFRS 17

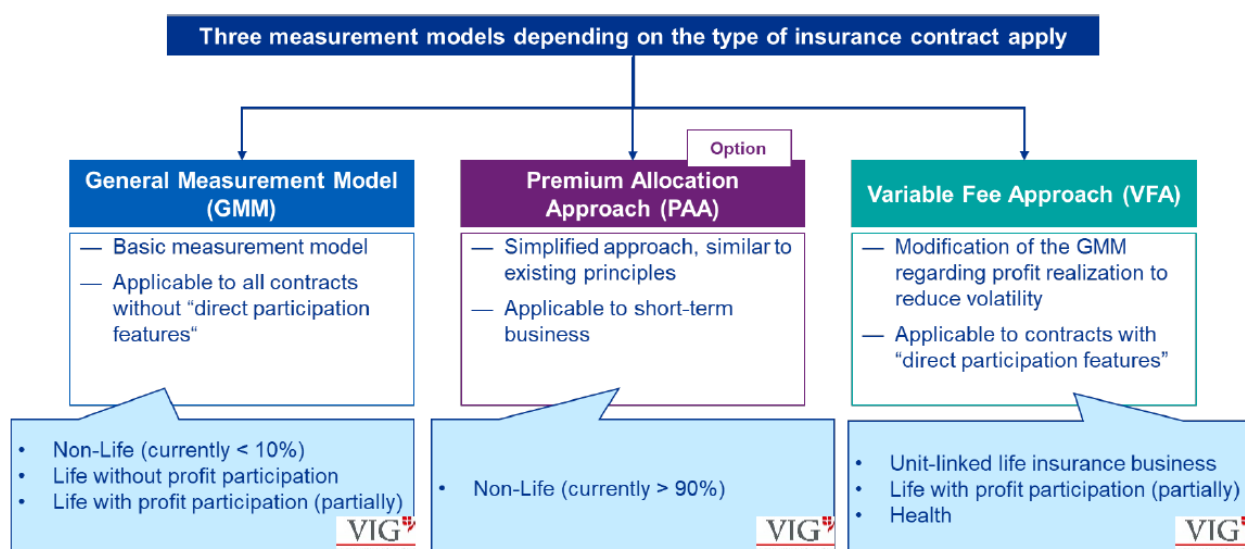
Vienna Insurance Group and KPMG

Question 1: Which are the measurement models in IFRS 17?

Unlike the regulatory-driven conventional European accounting rules, there is no differentiation by balance sheet division (life, health, property/casualty) with regard to measurement models.

Instead, IFRS 17 defines three measurement models (see figure below) according to which insurance contracts are to be accounted for depending on their content.

1. General Measurement Model
2. Premium Allocation Approach
3. Variable Fee Approach.



1. General Measurement Model („GMM“)

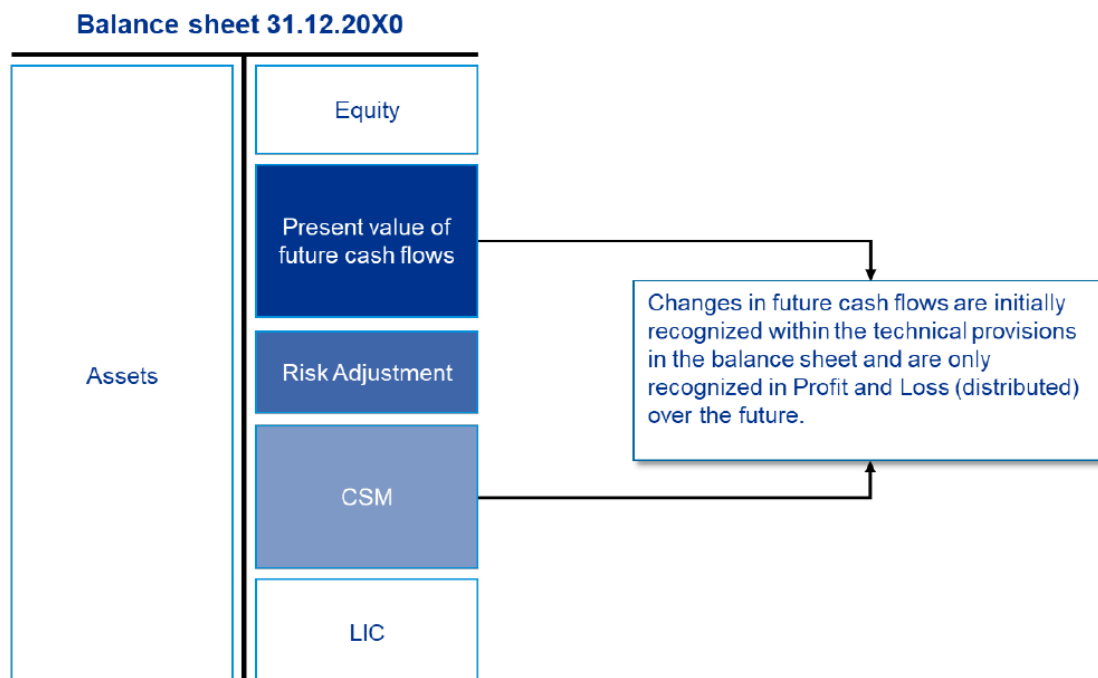
In the fundamental model of IFRS 17, the so-called **General Measurement Model**, the profit is recognized as part of the technical provisions when the contract is concluded in order to avoid immediate recognition in the income statement that would otherwise arise. This profit margin is referred to as the **“Contractual Service Margin” (CSM)**. The General Measurement Model is generally applicable to all types of contracts.

In this model, the technical provisions consist of:

1. **„Liability for Remaining Coverage“ (LRC)**, which corresponds to the actuarial reserve known today in life and health insurance, and the
2. **„Liability for Incurred Claims“ (LIC)**, which corresponds to the claims reserve.

Liability for Remaining Coverage, in turn, consists of three components:

- a. **„Present Value of Future Cash Flows“ (PVFCF)**, which corresponds to the present value of all future cash flows from premiums, insurance benefits and costs attributable to the contract. These cash flows are always based on current, realistic assumptions and are discounted using the current yield curve. In principle, this value corresponds to the “best estimate” of technical provisions under Solvency II (underlying assumptions may differ in individual cases, such as cost or interest rate assumptions). The PVFCF is recalculated at each reporting date using current assumptions and the current yield curve. Normally (for non-onerous contracts), at the beginning of the contract term, the present value of premiums for adequately calculated contracts is higher than the present value of insurance benefits and costs, which is why this part of the LRC has a negative value (thus corresponds to an asset) at the beginning of the contract.
- b. **„Risk Adjustment“ (RA)** is the risk premium for the fact that realistic assumptions may be too prudent. The RA represents, again as in Solvency II, a separately presented amount of technical provisions. The RA is recalculated at each reporting date using a method to be chosen by the insurance company, but the method must be consistent in terms of a subsequent valuation.
- c. **„Contractual Service Margin“ (CSM)** is the profit originally priced into the contract, which is shown as a separate component of technical provisions. There is **no equivalent in Solvency II** for this component of technical provisions. Furthermore, the CSM is only actuarially calculated at the beginning of the contract. In subsequent years, the new level of the CSM “stems” from the roll-forward of the CSM (as defined in the standard). The main components of change that are recognized in the income statement are, on the one hand, the interest (which is reported as interest expense) and, on the other hand, the release to be made, which is reported in the income statement as revenue (“insurance revenue”) and will in future constitute **by far the most significant component of an insurance company’s earnings**. Another component of change in the CSM results from the interaction between the change in the Present Value of Future Cash Flows described under a. and the Contractual Service Margin. Actuarial assumptions change from year to year, which also results in **fluctuations in the PVFCF** over the term of the contract. To the extent that these fluctuations relate to future years, the change in the Present Value of Future Cash Flows is not recognized in the income statement, but is reclassified to the contractual service margin within the technical provisions **without affecting profit or loss** (see figure below).



Only if the CSM becomes negative, the negative portion has to be recognized as an expense in the income statement in order to immediately recognize loss from the further settlement of the contract. The lower limit of the Liability for Remaining Coverage is thus the sum of the Present Value of Future Cash Flows and Risk Adjustment, since the CSM can never become negative. Consequently, the CSM also serves as a **buffer to buffer fluctuations in earnings** resulting from the updating of assumptions regarding future cash flows. The CSM must be disclosed in the financial statements. As a result, the quality respectively the profit potential of a contract portfolio will be disclosed directly in the financial statements in the future.

However, the **(interest) volatility** resulting from the discounting of cash flows at current interest rates is not offset by the CSM but recognized directly in profit and loss in the financial result. The resulting volatility in the income statement can, nonetheless, be reduced to a large extent by the option ("OCI option") of recognizing the corresponding effects in other comprehensive income ("OCI")

The **Liability for Incurred Claims** („LIC“) is identical in principle to the **claims provision** currently recognized in the balance sheet. However, there are major differences in the valuation: While significant hidden reserves are currently included in the claims reserves, these will no longer exist in the future. The Liability for Incurred Claims therefore consist of the best possible estimate of future claims payments and directly allocable claims handling costs for claims incurred prior to closing date. Furthermore, in contrast to the Austrian Commercial Code (UGB), IFRS 17 provides for a portfolio valuation. Discounting is mandatory, and a risk adjustment must also be taken into account. The value of the Liability for Incurred Claims is therefore very close to the best estimate for claims reserves under Solvency II.

Application at VIG:

The General Measurement Model will tend to be of secondary importance for the time being, as the other two measurement models are primarily used by the large VIG Group companies. However, if the yield curve continues to rise substantially, the share of GMM could increase, as in this case long-term property insurance could be valued using this model instead of the Premium Allocation Approach (below) in the future. VIG always checks whether the Premium Allocation Approach ("PAA") can be used before applying the GMM in property insurance.

2. Premium Allocation Approach („PAA“)

For contracts with a term of less than one year, the so-called **Premium Allocation Approach** can be used for reasons of simplification. For contracts with a longer contract boundary, this only applies if the use of the Premium Allocation Approach leads to substantially the same result as the General Measurement Model. This simplified approach **corresponds in its fundamental idea to the previous accounting in property and casualty insurance**.

In this model, the technical provisions in turn consist of the

1. „**Liability for Remaining Coverage**“ (LRC), which is derived from the unearned premium, and the
2. „**Liability for Incurred Claims**“ (LIC), which corresponds to the claims reserve

In the case of the **Liability for Remaining Coverage** in the Premium Allocation Approach, the unearned premium known from previous accounting represents the starting point. The model provides for an implicit capitalization of acquisition costs: the acquisition costs to be taken into account are calculated separately and deducted from the liability item. Since the standard does NOT provide for separately recognizing receivables from and payables to policyholders, these are also netted out in the Liability for Remaining Coverage. The main difference to the current accounting treatment is the amount of acquisition costs to be capitalized, which differs from the previous recognition of acquisition costs based on different national models regarding cost basis and capitalization period. The annual impact on the income statement is expected to be of minor significance.

The basic concept of the **Liability for Incurred Claims** is identical to that of the claims reserve currently recognized in the General Measurement Model. Please refer to the descriptions of the claims reserve in the General Measurement Model.

Application at VIG:

The Premium Allocation Approach will continue to be the most significant measurement model in property insurance for the foreseeable future, applied to over 90% of property insurance business. For property insurance contract with a term up to one year, the PAA represents the standard measurement model and the preferred measurement model for multi-year contracts. However, in the event of a further substantial increase in the yield curve, it may be necessary in the future to measure part of the new business with a contract term of more than one year using the General Measurement Model. The decisive factor here is always the comparability of the result between PAA and GMM. VIG uses internal tools to ensure that comparability with the GMM is given in the case of valuation using the PAA.

3. Variable Fee Approach („VFA“)

One of the main reasons for the long genesis of the standard was always the question of how to represent participation in profits, not least because although all profit participation systems worldwide are somehow similar, in the final consequence they are never completely identical. This has been solved with the so-called **“Variable Fee Approach”**. The Variable Fee Approach is a special case of the General Measurement Model, in which the Contractual Service Margin is not rigid, but variable due to profit participation. However, the same observation regarding the high complexity of the standard also applies here.

The model is in fact only applicable to long-term life contracts with profit participation and health insurance. While the Premium Allocation Approach is optional, the Variable Fee Approach is mandatory if the requirements are met.

The fundamental idea of the model is that certain reference assets (so-called “Underlying Items”; e.g. underlying assets) are actually held economically for the account of the policyholder and the insurer only receives a **variable remuneration** (“Variable Fee”),

As a result, all income and expenses from the “underlying Items” (e.g. investments of unit-linked life insurance), including the change in fair value of these investments, are recognized in profit or loss in the income statement against the Liability for Remaining Coverage (Present Value of Future Cash Flows) (**Step 1**). Consequently, the income and expenses from the underlying items and the income or expense from the change in the Liability for Remaining Coverage balance each other out. Subsequently, the actuaries calculate the Present Value of Future Cash Flows as of the respective reporting date (**Step 2**). The difference between the value calculated in step 1 and the value calculated by the actuary in step 2 is then recorded in the Contractual Service Margin – this explains the term “Variable Fee”. This step is followed by the annual **release of the Contractual Service Margin, which is the only significant profit component in the income statement under the Variable Fee Approach.**

As a consequence of this approach, the **result in the Variable Fee Approach is, as expected, very little volatile**, but can also hardly be influenced in the short term. As in the General Measurement Model, the CSM must not become negative. In this case, the negative CSM must be charged off against expenses.

For the Variable Fee Approach, there is a **separate OCI option** to avoid any purely accounting differences between the income and expenses of the underlying items to be recognized according to other standards and the accounting entry against the Liability for Remaining Coverage. According to this option, the income statement result relating to the underlying items is set to zero by definition and any differences are thus disclosed in OCI. In particular, in the case of underlying items measured at amortized cost, the OCI option should be used. The **Liability for Incurred Claims** should be recognized in the same way as for the other two measurement models.

Application at VIG:

The Variable Fee Approach will be the dominant approach in long-term life insurance at VIG, as the VFA is mandatory for insurance contracts with direct profit participation features. Both the Austrian unit-linked and traditional participating life insurance business will be reflected in the VFA in line with the industry. In the CEE region, unit-linked and index-linked products are also mapped in line with the standard using the VFA.

There was a long discussion in Austria about which measurement model should be used for health insurance. After consultation with the FMA responsible for this (which did not make a statement) and the IASB (which pointed out that it was a discretionary decision and, according to the minutes of the VVO from September 6, 2021, considered the argumentation cited to be sufficient) by the Austrian health insurers, the health insurers uniformly decided to apply the VFA also for the health insurance business.

Question 2: What happened on January 1, 2022?

One point has not been mentioned so far: Like every IFRS, IFRS 17 must also be applied retrospectively, i.e. the values of the opening balance sheet must be derived as if IFRS 17 had always been applied. As this is extremely time-consuming in some cases and in other cases simply impossible, especially in the event of insurance contracts that have been in force for a very long time, the standard offers three different models:

1. the Full Retrospective Approach – the full retrospective roll-up. If this is not possible, either
2. the Modified Retrospective Approach – a simplified roll-up, or
3. the Fair Value Approach – the current market value approach can be utilized.

Under the Fair Value Approach, it is assumed that the underlying portfolio will be taken over by another insurer and that the existing obligations will therefore be superseded. A so-called Bottom-Up Approach is used to calculate the fair value, which is in principle as follows:

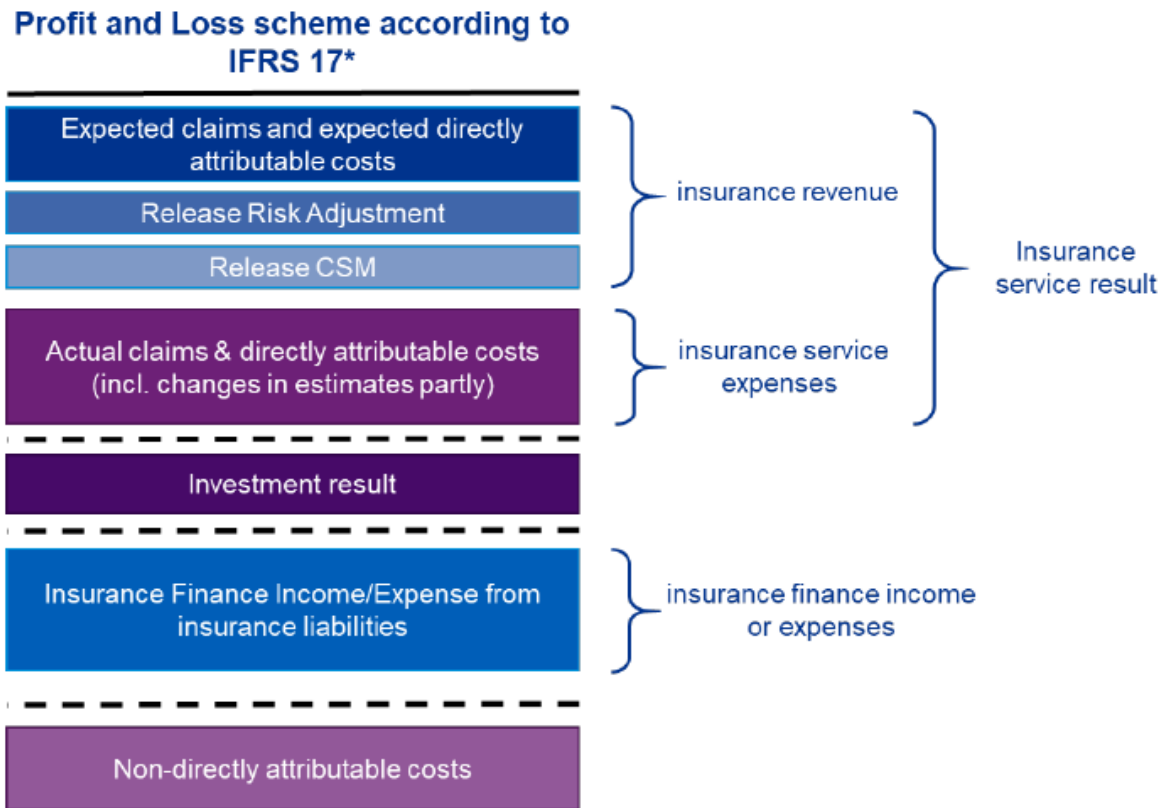
The acquirer of an insurance portfolio will require that the Present Value of Future Cash Flow and the Risk Adjustment be superseded. If only these two elements are superseded, however, the acquirer would no longer be able to earn anything from the purchased portfolio but would have to maintain a considerable amount of own funds, for which in turn its owner would demand a corresponding return. Thus, the acquirer will demand as a profit margin at least the amount that its capital providers expect for holding the corresponding own funds under Solvency II (**Cost of Capital Approach**). For this purpose, **the Solvency II capital requirement for the portfolio is extrapolated** as part of the model calculation and multiplied annually by the **cost of equity** (which corresponds to the discount factor from the impairment test). The present value of these expected returns then equates (essentially) to the **Contractual Service Margin at the opening balance sheet date**.

Application at VIG:

As shown, the Premium Allocation Approach is used almost exclusively for the **property insurance business**. These portfolios are treated using the **Full Retrospective Method**. For **all other portfolios**, VIG has opted to widely use the **Fair Value Method**.

Question 3: What will the income statement look like?

In its main components, the income statement will look as follows:



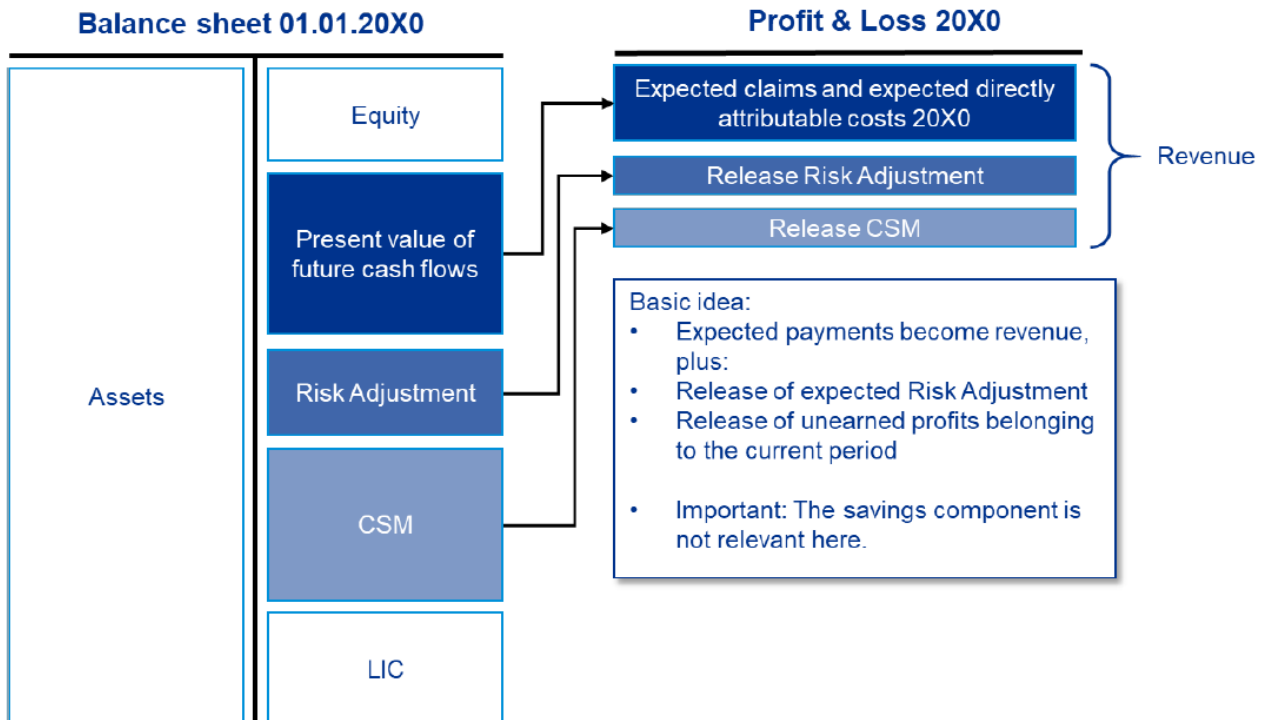
The income statement of an insurance company will continue to start with a revenue line item. However, this revenue will no longer correspond to the annually prescribed premium and will therefore be referred to as **Insurance Revenue** rather than premium. Insurance Revenue is primarily comprised of the discounted estimates of all future cash flows attributable to the contract from premiums, insurance benefits, costs, release of risk adjustment for non-financial risks and Contractual Service Margin.

However, the **most significant difference** to current accounting arises in endowment life insurance, as **the savings premium component in life insurance is no longer recognized as income in IFRS 17**, but is booked directly as a liability, as in the case of a savings deposit. Similarly, (survival and surrender) benefits that are to be seen as a payout of the savings component are no longer to be recognized as insurance benefits. This will reduce the revenue of life insurance companies to a fraction of today's premium income. Under US-GAAP, this approach (referred to as deposit accounting) previously existed for Central European contracts only in unit-linked and index-linked life insurance.

Revenue is derived directly from the contract calculation and is directly related to LRC accounting. The individual revenue components are primarily:

- the claims and expenses attributable to the contracts expected for the respective period at the beginning of the year,
- the release of the Risk Adjustment,
- the release of the Contractual Service Margin.

The connection with the Liability for Remaining Coverage is shown in the following figure:



The above applies to the General Measurement Model and the Variable Fee Approach. **In the Premium Allocation Approach (for property insurance), insurance revenue consists of the premiums allocated to the period, as before.**

The next income statement item, **Insurance Service Expenses**, shows the insurance services actually incurred and the costs attributable to the execution of the contract (“Insurance Service Costs”). There will always be differences between the benefits and costs expected for the respective year (which are recognized as revenue in sales) and the costs actually incurred, which (with the exception of traditional life insurance and health insurance by type of life insurance, for which the VFA is applied) are recognized in profit or loss.

The ratio between Insurance Service Expenses and Insurance Service Revenue is equal to the **Combined Ratio** in the Statement of Comprehensive Income. Due to the fact that savings components in life insurance and health insurance are no longer recognized in the income statement, the Combined Ratio will also become relevant in life and health insurance.

One more remark needs to be made about **costs**. Only those costs that are **directly attributable to insurance operations may** be allocated to **Insurance Service Expenses**. General administrative costs and costs not directly attributable to contracts (e.g. training costs) must be included under “other expenses”. In order to ensure adequate allocation of directly attributable costs, a Group-wide “Cost Allocation” project has been set up at VIG to improve the associated data quality.

There will be no significant differences in the **investment result** compared to the current presentation, but reference is made to questions 5 and 6.

A new item is **Insurance Finance Income/Expense from insurance liabilities**. This item shows the compounding component from the present value calculation of insurance reserves. This is similar to the present value calculation of interest on technical provisions. Whereas in today’s VAG/UGB financial statements in life and health insurance there is a transfer of investment income to the technical account, in IFRS 17 all technical components are adjusted for interest effects. Instead, these are reported in the financial result as Insurance Finance Expense. In order to avoid earnings volatility resulting from changes in the interest rate, the **OCI options**

described in the **General Measurement Model** and **Variable Fee Approach** lead to a reclassification of the non-period amounts from Insurance Finance Expense to OCI (other comprehensive income).

Under the Variable Fee Approach, the amounts credited to Liability for Remaining Coverage under Step 1 described above are recognized in Insurance Finance Expense.

Question 4: What are the main sources of results and how volatile will the results be?

- In **property and casualty insurance**, when applying the **Premium Allocation Approach** the result is still to be derived from premiums, less claims and expenses plus financial income. Although the result will not correspond to the “old” IFRS 4 result, **no significant differences in results** are to be expected. The differences stem on the one hand from a slightly different premium distribution (due to the allocation of acquisition costs), and on the other hand from benefits due to the difference in accounting for the claims reserve (best estimate instead of prudence principle). With regard to the claim reserve, no significant differences are expected for the income statement of the individual years. However, in the opening balance sheet, the **reduction in claims provisions** will result in a **significant increase in Group equity as of Jan. 1, 2022, from this title**. By using the OCI option, the interest volatilities (from the discounting of claims reserves) can be largely avoided.
- If the **Variable Fee Approach** is used (especially in **traditional life insurance and health insurance by type of life insurance**), the result will consist **almost exclusively of the release of the Contractual Service Margin** and (to a lesser extent) the risk adjustment. As a result of the utilization of the OCI option, the distribution of earnings is expected to be **very stable but will no longer be able to be influenced in the short term**. In the extreme case that the value from the update of the CSM would become negative and would have to be derecognized with an effect on losses, this loss would also be recognized in the income statement. The financial result only includes the contribution to earnings attributable to the equity portion (attributable to shareholders), as the result of the underlying items is credited to policyholders as described above (see the comments on Insurance Finance Expense above).
- When applying the **General Measurement Model**, the release of the CSM is also the dominant earnings figure. In addition, there is the release of the risk adjustment and the difference between expected and actual benefits and costs in the underwriting result. Furthermore, in the case of the General Measurement Model, the Investment Result and the Insurance Finance Expense are also fully recognized in profit or loss. By using the OCI option, the interest rate volatilities (from discounting the LRC and the claims reserves) can be avoided to a large extent. As with the Premium Allocation Approach, the most significant volatility results from fluctuating loss experiences (as is already the case today).

Application at VIG:

In addition to interest rate volatility, the OCI option also allows inconsistent valuations of assets and liabilities (accounting mismatch) to be offset through equity rather than through profit or loss. Such differences can arise, for example, in the case of participating life insurance contracts. If the business model requires a corresponding valuation, the OCI option is used to minimize the accounting mismatch. In the VIG Group companies, the decision to apply the OCI option under IFRS 17 is based primarily on the measurement of financial assets under IFRS 9 in order to offset measurement inconsistencies as far as possible

Question 5: What is the impact of the change in accounting for financial instruments from IAS 39 to IFRS 9?

Compared to the impact of IFRS 17, the impact of IFRS 9 is relatively small. IFRS 9 introduces a new method for categorizing and valuing financial assets. The new requirements will in future determine whether investments are measured at fair value, at fair value through other comprehensive income or at amortized cost. For VIG, the reconciliation between investments under IFRS 9 and insurance contracts under IFRS 17 is particularly important in order to avoid valuation inconsistencies in accounting. The changes mainly result from other allocations, which lead to an increase in the proportion of investments that must be measured at fair value through profit or loss. For equity investments, there is a valuation model that results in only dividends being recognized as income in the income statement anymore, and thus no extraordinary income from the sale of equity investments is possible.

For debt instruments, there is a change in the modeling of the recognition of default risks (Expected Credit Loss Model).

However, it should be noted that in traditional life insurance and health insurance, the application of the **Variable Fee Approach** in conjunction with the use of the OCI option almost exclusively leaves the release of the contractual service margin and (to a lesser extent) the risk adjustment “stuck” in the result. In addition, only the valuation of the share of investments attributable to insurance companies (thus not serving as underlying item) has an **impact on the operating result**.

Question 6: Are there also any changes in the accounting for real estate?

The standards on accounting for real estate (IAS 16 and IAS 40) are unaffected by the entry into force of IFRS 9 / IFRS 17.

Application at VIG:

VIG's Accounting Manual does not allow the fair value measurement of real estate in IFRS “OLD” as well as in IFRS “NEW”. The properties continue to be measured at amortized costs as before. Accordingly, no effects of the new standards on the accounting of real estate are expected.

Question 7: Will there be new balance sheet ratios/key performance indicators?

The most significant change results from the introduction of the Contractual Service Margin. The CSM discloses the total expected future profitability of the underlying business. Various conclusions can be drawn from the analysis of the CSM and its changes. This concerns not least the **sustainability of the result**. If the annual release of the CSM is higher than the addition from annual new business, this means that future results are likely to be lower than current results.

Another change arises from the fact that savings premiums are no longer recognized in the income statement and the entire interest component is not recognized in the insurance result. Consequently, the Combined Ratio, which was previously applied exclusively in property insurance, will also be relevant in all other lines of business.

Question 8: How should reinsurance be accounted for?

For assumed and ceded reinsurance, the same criteria and measurement models apply as for primary insurance. However, only the General Measurement Model and the Premium Allocation Approach are available; the Variable Fee Approach may not be used in reinsurance (assumed or ceded). The reinsurance measurement models are completely independent of the models applicable to the underlying primary insurance contracts.

All reinsurance must be combined in a separate line in the income statement and shown individually; the previously familiar “gross” and “net” view of premiums and claims thus no longer exists.

Application at VIG:

Within the VIG Group, there is an extensive intra-Group reinsurance program. Due to the Best Estimate Accounting of LIC, there will be an increased number of accounting differences between the ceding and assuming VIG Group company. In addition, the majority of ceded intra-Group reinsurance is accounted for in the primary insurance companies using the premium allocation approach. VIG Re, the largest intra-Group reinsurer next to VIG Holding, accounts for assumed reinsurance using GMM in order to be comparable with its reinsurance peers at the individual financial statement level.

All differences described above will lead to effects in VIG’s Group result in the course of the elimination of intercompany results at Group level.

Question 9: How much Solvency II is in IFRS 17?

There are many similarities, but also significant differences between the two sets of accounting standards, which are due to the purpose of the regulatory solvency balance sheet on the one hand and external financial reporting as information for the capital market on the other. The ultimate purpose of regulatory law under Solvency II is to ensure that insurance companies are able to meet the obligations they have entered into in respect of policyholders. In order to accomplish this, Pillar 1 of regulatory law focuses exclusively on the own funds of the solvency balance sheet and the solvency capital requirement. The question whether and how much profit (or loss) an insurance company makes in a period is of secondary importance. For accounting purposes, however, a company’s net assets, financial position and results of operations are of at least equal importance; in some cases, one cannot help thinking that the capital market attaches the greatest importance to the results of operations.

This difference in objectives is also where the most significant differences between the solvency balance sheet and IFRS 17 can be found:

In regulatory law under Solvency II, there is simply no income statement. Therefore, in the development of Solvency II, it is, or was, no further problem that de facto, when accounting according to solvency principles, the entire profit is already recognized in the own funds at the beginning of the contract, in the solvency balance sheet. However, the income statement is actually the more important part for IFRS 17, since the question of determining and distributing the CSM is ultimately only about how the profit of a contract portfolio is apportioned over the term of the contract.

Common features between Solvency II and IFRS 17 include:

- The Best Estimate concept and the use of expected values,
- the explicit consideration of the risk margin or rather risk adjustments,
- the consideration of contract boundaries in the modeling of future cash flows.

Differences between the two concepts include:

- the discount rate to be used
- the costs to be included in the modeled future cash flows (in IFRS 17, only directly attributable costs are recognized),
- the risk margin is defined in a principle-oriented manner under IFRS 17, whereas the concept is predefined in Solvency II,
- solvency laws do not recognize a CSM,
- ceded reinsurance is to be accounted for on the basis of its contractual boundaries under IFRS 17, whereas under regulatory law it follows the term of the primary insurance contract.

Question 10: In summary, what are the most significant changes?

1. **Reduction in revenue**, due to elimination of savings premiums,
2. **No hidden reserves in claims provisions**, due to „Best Estimate“ approach and discounting of claims reserve,
3. **Somewhat different profit trends in property insurance**, due to different valuation of claims reserves and different consideration of acquisition costs,
4. **Very stable earnings in long-term life and health insurance, which cannot be influenced in the short term**, due to the application of the completely new Variable Fee Approach
5. **Combined Ratio in life and health insurance becoming relevant**,
6. **Condensed presentation of the reinsurance-results in one line in the income statement**,
7. **Contractual Service Margin** as a key value driver.