

FRS 117 Insurance Contracts Vs MAS' Risk-Based Capital 2 (Part 3)

Guidance from ISCA's IFRS 17 Working Group

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TAKEAWAYS

- Under FRS 104 *Insurance Contracts* (FRS 104), many insurers align the measurement basis for MAS reporting and the statutory financial statements, resulting in efficiency. However, this will not be possible under FRS 117 *Insurance Contracts* (FRS 117).
 - This article explores specific considerations around the measurement of insurance liabilities for the life insurance business under FRS 117 and RBC 2 in five areas, namely level of aggregations, component of liabilities, contract boundaries, valuation methodology, and expense.
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The measurement of insurance liabilities under the Risk-Based Capital 2 (RBC 2) framework is mainly prescribed in the Insurance (Capital and Valuation) Regulations 2004 and MAS Notice 133 *Notice on Valuation and Capital Framework for Insurers*. Under FRS 104 *Insurance Contracts* (FRS 104), many insurers align the measurement basis for MAS reporting and the statutory financial statements, resulting in efficiency. However, this will not be possible under FRS 117 *Insurance Contracts* (FRS 117).

FRS 117 states that the accounting standard shall be applied to all components within an insurance contract, except distinct investment components, embedded derivatives, and any promise to transfer to a policyholder distinct goods or services other than insurance contract services. This requirement implies that the measurement of insurance liabilities under FRS 117 may include various components that are not part of policy liabilities under RBC 2, for example, policy loans, premium receivables and claims payable. Conversely, certain components such as distinct service components, investment components or embedded derivatives may be excluded from measurement under FRS 117 but not RBC 2.

This third article continues the discussion from the first two articles, which were published in this *IS Chartered Accountant Journal* in July and September 2022. Here, the IFRS 17 Working Group, in collaboration with the committee members of the Singapore Actuarial Society (SAS) Life IFRS 17 Workgroup, explores the specific considerations around the measurement of insurance liabilities for the life insurance business under FRS 117 and RBC 2 in the following areas:

1. Level of aggregations,
2. Component of liabilities,
3. Contract boundaries,
4. Valuation methodology,
5. Expense.

LEVEL OF AGGREGATIONS

FRS 117 emphasises that an insurance contract is the lowest unit of account. Highly interrelated basic plans and their riders are to be measured as single insurance contracts. Treatment of other basic plans and riders that are not highly interrelated will depend on the facts and circumstances, such as the legal form of the contracts.

Consequently, there may be insurance contracts for which the basic plans and their riders could be written in different insurance funds or sub-funds, and have very different risk characteristics. They would be measured under FRS 117 on a combined contract basis, but could be measured separately under RBC 2. Additionally, FRS 117 groups contracts into three profitability groups at initial recognition, namely contracts that are onerous, contracts that have no significant possibility of becoming onerous subsequently, and remaining contracts in the portfolio.

FRS 117 requires that a reinsurance contract held be measured as a separate contract, independent of the measurement of the underlying contract. The requirements on how the various components in an insurance contract can or cannot be separated apply to reinsurance contracts as well, and it is expected that many different coverages under one reinsurance treaty could be measured as a combined reinsurance contract. While reinsurance contract liabilities are being reported separately at the fund level under RBC 2, RBC 2 does not require the aggregation of reinsurance cash flows at the contract level that may straddle across insurance funds. Similar to insurance contracts, FRS 117 groups the reinsurance contract into three profitability groups at initial recognition, namely net gain, no significant possibility of a net gain arising subsequently, and remaining contracts in the portfolio.

2. COMPONENT OF LIABILITIES

Under FRS 117, insurance contract liabilities comprise a best estimate of future cash flow (best estimate liability or BEL), an explicit allowance for non-financial risk (risk adjustment or RA) and contractual service margin (CSM).

Measurement of the policy liabilities under RBC 2 comprises an estimation of future cash flows and a provision for adverse deviation (PAD). The policy liability should not be less than zero.

Although there are differences, a parallel can be drawn in the areas below:

- FRS 117 BEL vs best estimate cash flows component within RBC 2 policy liabilities; and
- FRS 117 RA vs RBC 2 PAD component.

The reserves are required to be floored at zero at policy level under RBC 2, but there is no corresponding requirement in FRS 117. This difference reduces comparability between the two bases and this difference would also extend to the comparison between reinsurance FRS 117 BEL and RBC 2 reinsurance share of policy liabilities.

3. CONTRACT BOUNDARIES

Contract boundaries determination affects the BEL to be included in the measurement of insurance contract liabilities. FRS 117 sets out several criteria for identifying the contract boundaries of insurance contracts in general. RBC 2 only has specific requirements for assessing contract boundaries of long-

term medical policies. This could result in differences in the BEL used for measurement under FRS 117 and RBC 2.

4. VALUATION METHODOLOGY

Generally, both the valuation of FRS 117 BEL and RBC 2 policy liabilities involve estimation of future cash flows and incorporate time value of money. FRS 117 requirements and guidance for the estimation of future cash flows are largely principles-based, while RBC 2 is more prescriptive with specific projection approaches for selected classes of business, for example, universal life.

RBC 2 policy liabilities are required to be floored at zero, but such adjustments would not be required under FRS 117 as the CSM component would be set up similar to the concept of flooring initial reserves to zero, and subsequently recognising the initial negative reserves or initial profits over the lifetime of the contracts.

In addition, RBC 2 specifically requires that shareholder transfer for participating policies be included in the policy liabilities. Under FRS 117, these amounts would not form part of BEL but are part of CSM and released to profit or loss over time.

Under FRS 117, time value of financial options and guarantees (TVOG) is required to be included in the BEL where relevant, but there is no such requirement under RBC 2.

5. EXPENSE

FRS 117 allows only attributable expenses to be included in the measurement of insurance contracts. Attributable acquisition expenses are included in the estimates of future cash flows and are capitalised on Day 1 in CSM. Acquisition expenses that are incurred before the group of contracts are capitalised as an asset (that is, preresognition acquisition expenses) and the amount relating to the recognised contract will be derecognised from the asset and recognised into the liability for remaining coverage. Non-attributable expenses such as product development and training costs are excluded from FRS 117 BEL.

In addition, FRS 117 is more explicit in the types of investment management expense that are attributable. Only the cost incurred to perform investment activities to enhance policyholder benefits and to provide investment-related and investment-return service are attributable. Hence, an investment expense related to policies that does not have these features, such as traditional term contracts, would be viewed as non-attributable under FRS 117.

Under RBC 2, expenses are allocated to their respective funds, with specific requirements on participating fund expense allocation to protect policyholder interests. There is no concept of capitalisation and amortisation of acquisition costs under RBC 2 for the life business.

In Part 4 of the series, to be published in the January 2023 issue of this journal, the IFRS 17 Working Group, in collaboration with the SAS Life IFRS 17 Workgroup, will discuss specific considerations

around the measurement of insurance liabilities for the life insurance business under FRS 117 and RBC 2 in the following areas:

1. Economic assumptions,
2. Risk adjustment vs provision for adverse deviation,
3. Contractual service margin and profit emergence.

This is the third in the series of articles from the IFRS 17 Working Group (set up under the ambit of the ISCA Insurance Committee) to help insurers in Singapore navigate through the differences between FRS 117 and RBC 2.

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