IFRS 17: Insurance contracts acquired

Key M&A considerations

Transformation in the insurance industry is expected to accelerate as insurance companies strive for sustainable profitable growth; Mergers and Acquisitions will play a critical role in enabling insurers to create value at scale.

When insurance contracts are acquired through a business combination in the scope of International Financial Reporting Standard (IFRS) 3 *Business Combinations* or in a transfer of insurance contracts that do not form a business combination, they will be **subject to the requirements of IFRS 17 *Insurance Contracts*.**

Even if the acquiree has implemented IFRS 17, the acquirer cannot simply adopt the acquirer's evaluation at the transaction date. A **fresh analysis is required,** reexamining contractual terms, economic conditions, and other key factors as of the **acquisition date**. This includes the requirement to treat acquired contracts as if they had been issued by the acquirer at that date.

The result is potentially significant differences in what is measured through profit or loss and the balance sheet, essentially **resetting the original IFRS 17 assessments.** This poses a unique set of challenges, necessitating detailed planning. It is therefore crucial to **involve accounting and actuarial teams from the beginning** to understand M&A implications and to proactively mitigate any potential issues that may arise later.

Key considerations

Step 1: Identify the nature of the transaction

Identify whether the transaction is a business combination or a transfer of insurance contracts

Step 2: Accounting policy application

Perform IFRS 17 scoping, level of aggregation and measurement model assessments based on the facts and circumstances existing at the acquisition date

Step 3: Measure

Measure the insurance contracts acquired based on facts and circumstances existing at the acquisition date

Step 4: Potential wider impacts

Potentially, manage multiple accounting treatments due to differences in reporting between the acquirer and acquiree post transaction

Detailed considerations:

Step 1: Identify the nature of the transaction

As outlined in our recent publication, Acquiring insurance contracts, some of the accounting for insurance contracts acquired depends on whether they are acquired in a business combination in the scope of IFRS 3 or through a transfer of insurance contracts.

Insurers will therefore need to determine whether the acquisition constitutes a business by performing a ‘substantive process’ test and an optional ‘concentration’ test. These tests come with their own set of judgements.

Step 2: Accounting policy application

Scoping, Separation, and Combination

The IFRS 17 scoping, separation and combination requirements for contracts acquired should be assessed based on the facts and circumstances that exist at the acquisition date.

Given that facts and circumstances at the acquisition date may be different compared to the inception date of the policy, the results may differ significantly. This may include conclusions as to whether the contracts acquired are within the scope of IFRS 17. These assessments require an exercise of judgment, such as determining whether insurance risk is significant.

What we see in practice – impact on scoping

Contracts acquired in their settlement period may have less insurance risk than when they were originally issued, or none – e.g., a contract for which a final settlement has been agreed but not yet paid. In such instances these contracts may no longer be within the scope of IFRS 17 and may fall under another accounting standard. As a result, it becomes imperative to distinguish these contracts from insurance contracts and account for them separately.

Level of Aggregation

Judgment is required in determining how acquired contracts should be grouped, applying the criteria of *similar risks* and *managed together*. The level of aggregation considerations will potentially be impacted by the measurement model classification considerations discussed later in this paper.

What we see in practice – approaches to level of aggregation

Insurers are looking for practical ways to group acquired contracts – e.g., either by grouping acquired contracts with issued contracts or grouping all acquired contracts together. In such instances insurers should evidence how grouped policies meet the criteria of similar risks and managed together post-acquisition.

Coverage Period

The coverage period determined for acquired contracts will usually differ from the original coverage period determined as at the original issue date. The coverage period for contracts issued usually relates to the period over which an insured event may occur. However, where insurers acquire contracts for which the initial coverage period has passed (i.e., contracts acquired in their settlement period) the coverage period will reflect the period in which a discovery of a new loss may arise or where there may be an adverse development of claims.

What we see in practice – differences in coverage period

Suppose an entity has a group of one-year coverage liability insurance contracts issued five years ago with long-tail claims. The entity then acquires a similar group of contracts, issued five years ago, from a third party.

The coverage period for the contracts issued by the entity is one year and the coverage period has ended. However, for the acquired contracts the insurance risk is now claims development risk and therefore the coverage period for the contracts acquired commences on the acquisition date and is determined based on the claim's development period, which is a different basis to the initial issued one-year coverage.

Measurement Model Classification

Contracts acquired should be assessed based on the facts and circumstances that exist at the acquisition date against IFRS 17 measurement model requirements. Given that facts and circumstances at the acquisition date may be different compared to the inception date of the policy, this may impact which IFRS 17 measurement model is used to measure groups of acquired contracts. This includes considerations around the coverage period, which may impact eligibility to apply the PAA.

What we see in practice – impact on PAA eligibility

Suppose an entity has a group of one-year-coverage liability insurance contracts issued five years ago with long-tail claims and assume that these contracts were measured under the PAA (through automatic PAA eligibility) when issued.

Regardless, the coverage period for the contracts acquired is determined based on the claim's development period starting from the acquisition date, which may be greater than one year.

Therefore, automatic PAA eligibility criteria may not be met. As a result, the insurer will need to perform a PAA eligibility assessment of the acquired contracts. If the PAA eligibility assessment fails or isn't conducted, contracts should be measured using the GMM.

What we see in practice – impact on VFA qualification

Direct participating insurance contracts (initially measured by the issuer under the VFA) may have little or no remaining participation as at the acquisition date and therefore fall in scope of GMM measurement.

Step 3: Measure

Initial Recognition

For contracts acquired through a transfer, the consideration received or paid for the contracts is treated as a proxy for the premiums received (i.e., consideration is allocated to the contracts based on their relative fair value).

For contracts acquired in a business combination in the scope of IFRS 3, the consideration received or paid is used as a proxy for premiums received. This consideration is based on the contracts' fair value at the date of the transaction. This fair value is determined using the requirements in IFRS 13 *Fair Value Measurement*, except for the requirement that the fair value of a financial liability with a demand feature cannot be less than the amount payable on demand.

What we see in practice – onerous contracts acquired

Normally, IFRS 3 requires all identifiable assets acquired and liabilities assumed in a business combination to be measured at their fair values at the acquisition date. An exception to this accounting treatment occurs when onerous contracts are acquired. In such situations, the acquiree will need to apply judgment and estimates in determining the fulfillment cash flows of the acquired contracts, as the difference between the consideration received and the fulfilment cash flows will be treated as follows:

- Business combination in scope of IFRS 3 – part of the goodwill or gain on bargain purchase, with a loss component of the LRC established.
- Transfer of insurance contracts out of scope of IFRS 3 – a loss immediately recognized in profit or loss, with a loss component of the LRC established.

Subsequent Measurement

Once the newly acquired contracts have been initially recognized, an entity applies all the other requirements of IFRS 17 in the same way as for any other group of insurance contracts.

Step 4: Potential wider impacts

The acquirer and acquiree may both report under IFRS accounting standards or the acquiree may report under local GAAP. In both cases it is likely that insurance contracts acquired may be classified and measured differently in the acquirer and subsidiary accounts due to the different facts and circumstances assessed based on the differing date (i.e., date of issuance vs. date of acquisition) as discussed above or due to different accounting policies.

What we see in practice – dual Contractual Service Margin (‘CSM’)

In some instances, a ‘dual CSM’ may apply where the measurement of the same group of insurance contracts differs between the group and the subsidiary. This will impact data and system requirements and may require explanation to stakeholders.

Key IFRS 17 activities for integration of an acquiree

Pre-close

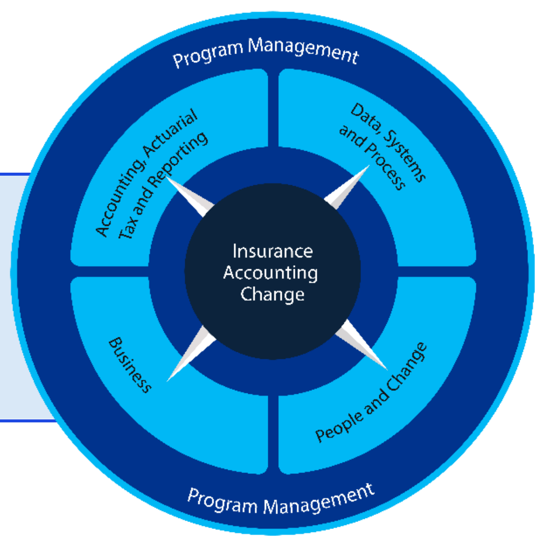
- Determine whether the insurance contracts acquired constitute a business.
- Understand the IFRS 17 requirements.
- Understand the high-level financial impacts.
- Understand and plan for the operational implications (e.g., systems, data, people).

Post-close

- Update relevant accounting policies, application guidance and methodology papers.
- Configure and implement the IFRS 17 solution (where relevant including the tracking of the dual CSM).
- Test and verify the solution configuration.
- Build additional disclosures and consider the impact on KPIs.
- Build appropriate process and controls in real-time.
- Validate and approve the financial statements.
- External auditor review.

How KPMG can help

KPMG has a global cross-functional team ready to provide your company with a suite of services to support you through pre- and post-accounting change implementation.
This team consists of technical accounting, actuarial, data, financial transformation, and other insurance sector specialists with deep experiences in their respective fields.



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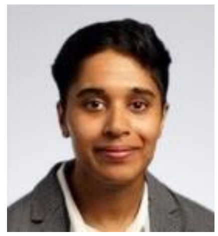

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