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An auditors' view of the changing financial reporting landscape

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15 September 2015

Agenda

- Review of the 2014 Solvency II balance sheet audits, likely future requirements and external disclosures
- What happens to financial reporting following 1 January 2016?
- Current developments in IFRS

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Audit of the Solvency II balance sheet

What did we learn and what are the likely future requirements?

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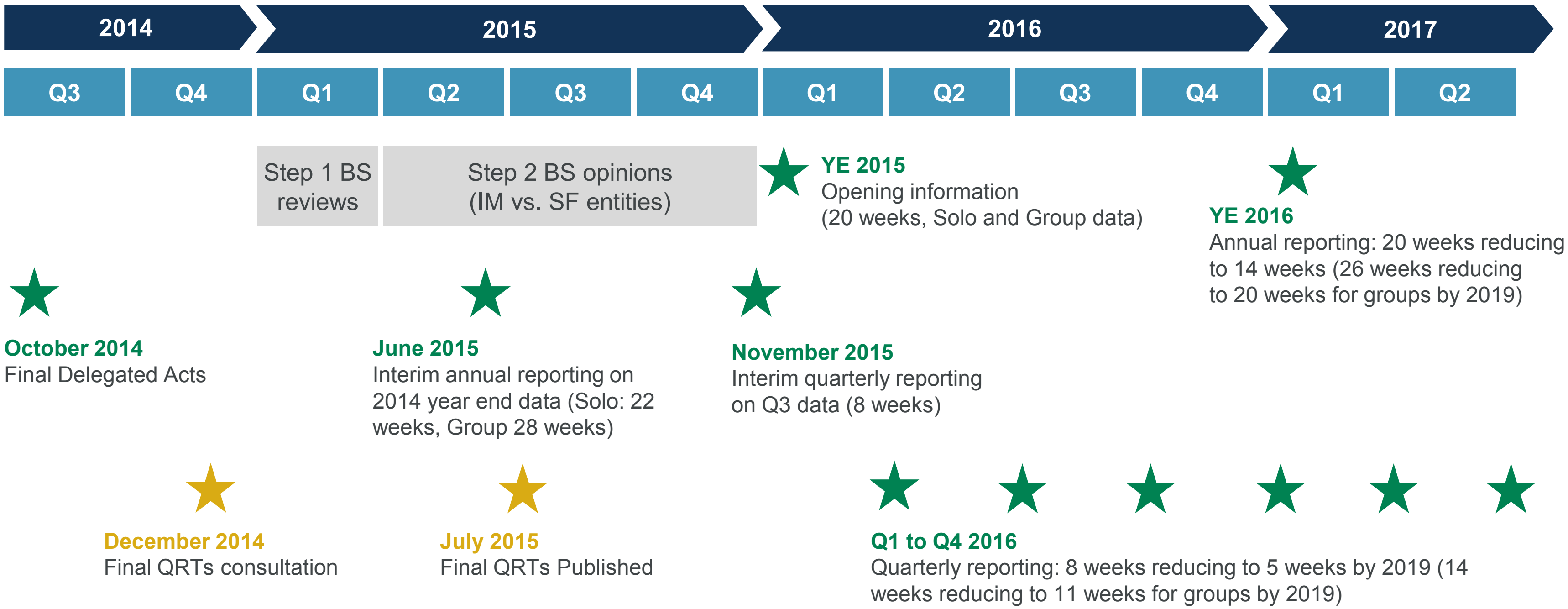
Pillar 3 timeline

Regular quarterly and annual reporting from 2016



Technical milestones

Reporting deadlines

Note: Deadlines are based on a 31/12 year-end

How mature is your Solvency II balance sheet?

Most firms have…

- **Scoping:** Identified the areas of the balance sheet which are most judgmental or difficult.
- **Methodology:** Performed detailed analysis on individual adjustments to determine methodology and approach.
- **Initial calculation:** Calculated a summary Solvency II balance sheet / own funds at least twice.
- **Reconciled:** Performed a high level reconciliation between their IFRS / EV / GAAP and Solvency II balance sheets.
- **Review:** Presented and discussed the balance sheet with the board/other relevant governance committees.
- **Infrastructure:** Started building the reporting infrastructure to support ongoing production – e.g. ledger / consolidation tools.
- **Own Funds:** Really understood the components of Own Funds (group and solo) and what options this provides.
- **Assurance:** Gained assurance over their Solvency II balance sheet from external auditors/parties (both controls and results).

Current market average

...many haven't ...

- **Business as usual:** Developed the Solvency II balance sheet/own funds production into an 'as usual' process.
- **Financial control:** Extended their financial control framework (including documentation) to cover the Solvency II balance sheet / QRTs and mapped out how the reporting requirements will be achieved from YE 2015 given IFRS / GAAP / EV / 'final' Solvency I reporting.
- **Economic profits and losses:** Fully understood the period to period movements.

…almost none have…

- **Final requirements:** Moved from the YE 2014 basis of preparation to the final Solvency II requirements.

Overarching themes

- Governance
- Documentation
- Valuation methods
- Actuarial function
- Basis of preparation
- System architecture
- Silo mentality
- Financial controls and business as usual

Technical challenges

Balance Sheet

Best Estimate Liabilities (BEL)

- Contract boundaries – Definition of discernible benefits, unbundling etc.
- Assumptions – EV vs. Solvency II, ENID, tax cash flows etc.
- With profits – Shareholder transfers, restrictions on own funds, interactions with surplus fund and expense arrangements.
- Timing of EIOPA FY14 risk free rate.
- Matching adjustment / VA – Working assumptions.
- Transitional measures – Impact and presentation.
- 'Greyed-out' cells and classifications in TP QRT.

Assets and other liabilities

- Deferred tax assets – Where recognised and projections to assess recoverability.
- Staff pension schemes.
- Initial investment gains under IAS 39.
- Own credit risk in financial liabilities.
- Contingent liabilities.
- Intercompany loans.
- Investments in participations.
- Treatment of investment funds.

Technical challenges

Own funds and Groups

Own funds

- Impact of cancellation of dividends on tiers of capital.
- Extent of ring fenced funds.
- Assessing restrictions on own funds.
- Measurement, grandfathering and presentation of hybrid debt.
- Surplus funds and interactions with BEL.
- Definition of EPIFP.

Groups

- Treatment of complex groups and intermediate holding companies.
- Solvency II vs. IFRS / GAAP consolidation rules.
- Aggregation for BEL – Intra-group transactions, service companies (across sectors) and transitional measures.
- Group level tax adjustments and relief.
- Fungibility/transferability restrictions.
- Availability of hybrids, net DTAs etc. to support Group SCR.
- Issues with preparatory phase group own funds QRT.
- Whether consolidated investment funds needed to be listed on the scope of the group QRT.

Future scope of Solvency II assurance

Considerations

- PRA / EIOPA requirements
- Same scope as YE 2014?
- Transition from basis of preparation to ‘full’ Solvency II
- ICA assurance for technical provision transitional measure
- Risk margin assurance
- SCR assurance – standard formula versus internal model?
- External market disclosure, other QRTs and narrative assurance
- FY15 vs. thereon; Public vs. Private; and Annual vs. Quarterly

External market disclosures of Solvency II

- Approach for 2015 vs. 2016
- Possible metrics / disclosures:
  - Eligible own funds, SCR, ratio, sensitivities.
  - Breakdown of SCR by risk category, segment, IM versus SF etc.
  - Reconciliation from IFRS (or EV) equity to Own funds.
  - Own funds tiers and capital composition (i.e. debt and equity information including hybrids).
  - Analysis of change in own funds (SCR?) – including new business value?
  - Run-off profiles of risk margin and SCR?
  - Qualitative disclosures including risk appetite, management of risk etc.
- How to present transitional measures, capital add-ons, D&A / OFS undertakings and equivalence?
- Linkage to other metrics and potential volatility – cash, distributable earnings, liquidity

A consistent minimum level of disclosure and use of terminology across the European market is required to maximise the benefits from Solvency II

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Impact of Solvency II on financial statements

What happens to IFRS / UK GAAP after 1 January 2016?

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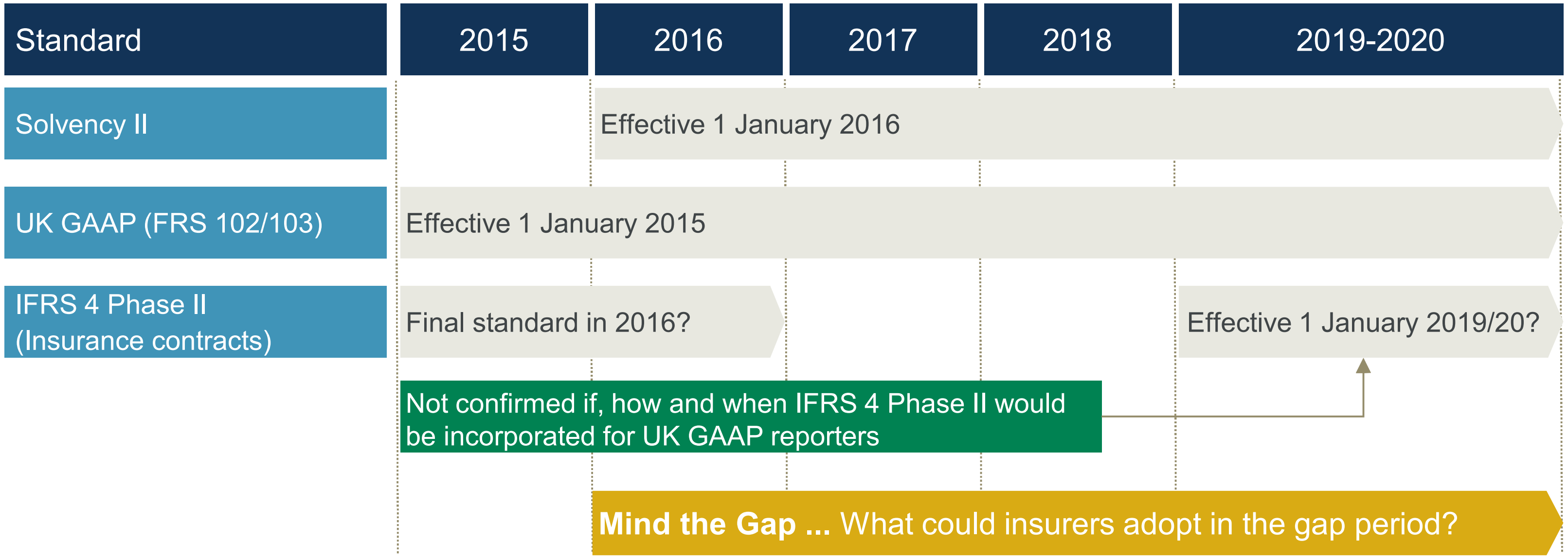
Timeline



- Disconnect between accounting and solvency reporting from 1 January 2016?
- Investment contract accounting (e.g. unit linked savings) is unchanged

Possible options during the gap period

1. Maintain current approach (linked to Solvency I / PRA return)
2. Adopt elements of Solvency II or a modified version
3. Application of ‘parent’ accounting policies for subsidiaries (for multinationals)
4. Others?

Relevance and reliability

- IFRS 4 permits an insurer to change its accounting policies for insurance contracts:
  - *"if and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to these needs" .*
- IAS 8 explains that an accounting policy is reliable if *"the financial statements:*
  - *represent faithfully the financial position, financial performance and cash flows of the entity;*
  - *reflect the economic substance of transactions, other events and conditions and not merely the legal form;*
  - *are neutral, i.e. free form bias;*
  - *are prudent; and*
  - *are complete in all material respects."*

Factors to consider

Auditor considerations

- ‘Relevant / reliability’ criteria
- Prudence and risk allowance versus current accounting
- Future investment margins – use of matching & volatility adjustment
- Non-uniform accounting policies (across Groups)
- ‘Direction of travel’ to IFRS 4 Phase II
- Deferral of day 1 profits – Shareholder-owned versus mutual
- Solvency II technical provision transitional measures
- Surplus funds and inclusion of contractual cash flows

Factors to consider (continued)

Business and operational considerations

- Impact on tax and distributable reserves
- Impact of Solvency II ALM / capital optimisation on IFRS performance
- Operational and cost benefits (e.g. model runs, multiple restatements)
- Availability of Solvency II data for restatement period
- Messaging to market (including comparability with peers)
- Wider impacts such as on intangible assets (e.g. DAC, DTAs etc.)
- Availability of EV profit projections for DAC/DTA recoverability
- Parent versus subsidiary accounts; or partial application

What are we hearing in the market?

- There is some concern in the analyst community about the basis of future financial reporting.
- There is wide acknowledgement that current financial reporting is not ideal, but there is some consistency (within the UK market).
- Analysts focus on Solvency II:
  - Both what is reported externally and formally to the regulator.
  - There is a view that this information will be reliable (audited?) and will give a direct basis for comparison.
- Some insurers are starting to consider what metrics will best represent the value in their business post Solvency II.

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Current IFRS developments

What are the implications of the current developments?

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Current known timeline

Standard	2015	2016	2017	2018	2019-2020
Insurance contracts (IFRS 4 Phase II)	Final standard in 2016?				Effective 2019/20?
Financial asset and liabilities (IFRS 9)				Effective 1 January 2018	
Revenue (IFRS 15)	Targeted amendments to new standard			Effective 1 January 2018?	

- All IFRS standards are subject to EU endorsement.
- IASB is examining options to mitigate the impact for insurers of IFRS 9 being effective in advance of IFRS 4 Phase II.
- Future amendments to other IFRS standards may also impact insurers, for example, IAS 38 (for acquired VIF) and IAS 1 (certain disclosures).
- FASB (the US accounting standard setter) decided in 2014 to make only targeted amendments to US GAAP, so there will be no global accounting standard.

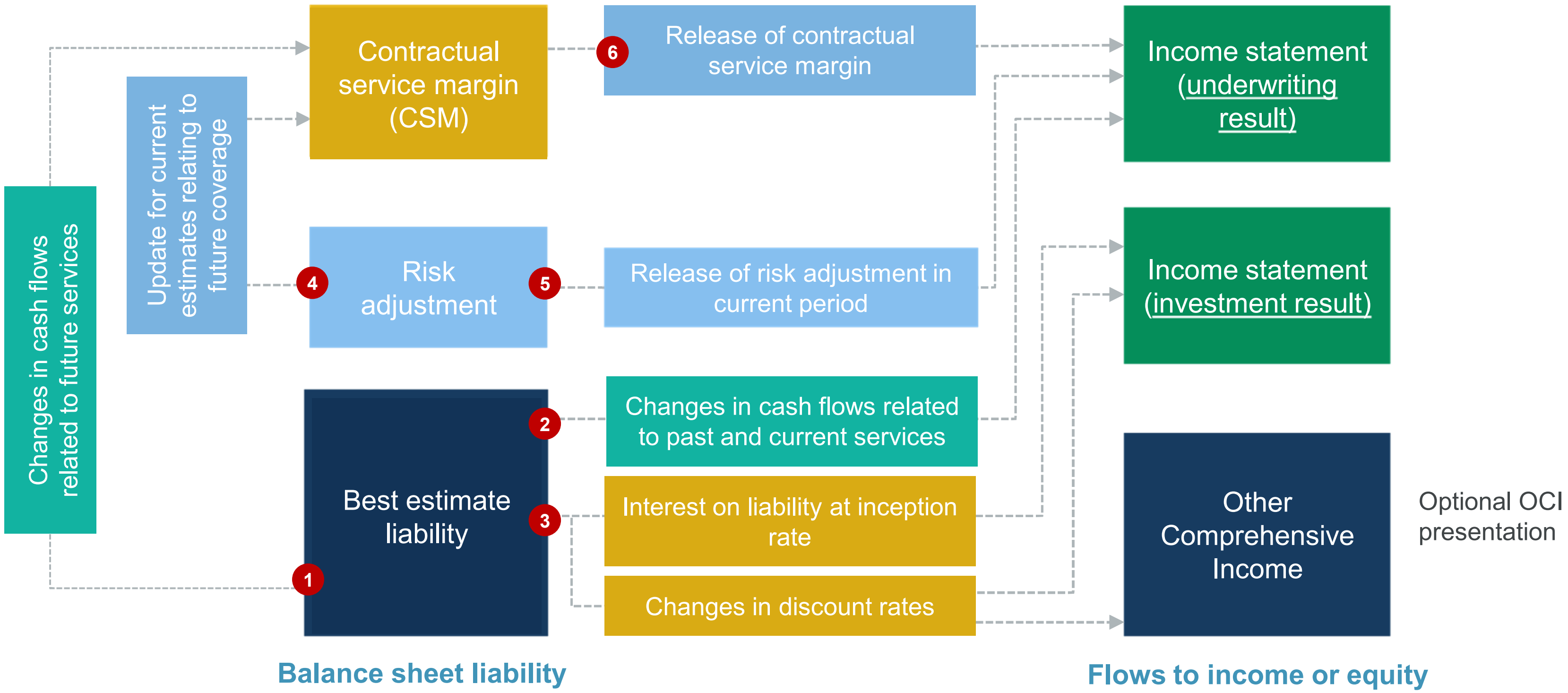
IFRS 4 Phase II – Direction of the liability model

Classification	Description	Likely contracts	Model
'Short term' non-participating	• Optional simplified model permitted for short duration contracts (period of cover less than or equal to 1 year) or where a 'reasonable approximation'.	General insurance, short term life etc.	Pre-claims liability: Premium allocation approach Claims liability: Building block approach
'Long term' non-participating	• No cash flows that vary with returns from underlying assets.	Immediate annuities, protection etc.	**Building block approach**
'Direct' participating	• Participate in a defined share of clearly identified underlying items. • Expect to pay out a substantial share of the returns from these items. • Substantial portion of the expected cash flows vary with those from the underlying items.	UK with profits, unit linked etc.	**Variable fee approach**
'Indirect' participating	• Where direct criteria is not met.	Certain US universal life / fixed annuities	Building block approach with adjustments (in development)

- In addition, certain non-insurance components (distinct investment components, embedded derivatives and certain goods and services) are required to be separated out of IFRS 4 Phase II and are measured under other IFRS standards.

Building block approach

Immediate annuities and protection contracts



Variable fee approach

With profit and unit linked contracts

Similar principles to the building block approach with a number of technical revisions, including:

Topic	Building block approach	Variable fee approach
Changes in assets supporting insurer's share	• Not directly relevant, but would be recognised in P&L (for most UK insurers)	• Recognise in CSM (e.g. change in unit linked AMC, shareholders' share of future with profit transfers / estates)
Changes in value of options and guarantees	• Recognise in CSM (non-financial assumptions) or P&L / OCI (depending on option for changes in discount rate)	• Recognise in CSM • Open topic on economic hedges where changes in assets are recognised in P&L
Level of aggregation (unit of account)	• Objective of contract level, but some aggregation likely in practice • Onerous contracts cannot be aggregated with profitable contracts	• Higher level of aggregation is permitted if 'mutualisation' conditions are met
Release of CSM to P&L	• 'Straight-line' (so on basis of passage of time reflect the contracts remaining in force)	• No change, although potential uncertainty over application (e.g. open funds)
Rate for unlocking and accreting interest on CSM	• Inception discount rates	• Current discount rates

Remarks on the model and status

- IASB status: Distinct number of (significant) areas to be addressed: Accounting for economic hedges; Transition and disclosure for direct participating contracts; Indirect participating contract model; Unit of account; Mandatory use of locked-in rates for CSM; and Implementation / Deferral of IFRS 9.
- Profit recognition: It will be different to current IFRS/GAAP, notably; no day 1 profits; ‘smoothing’ effect of the CSM; and no longer ‘cash’ accounting for with profit contracts.
- Comparison to Solvency II: Liability model will be different, for example:
  - Best estimate liability – Different cash flows (e.g. certain expenses including for acquisition)? Different contract boundary?
  - Discount rate – Restrictions in Solvency II matching adjustment versus IFRS top down approach? Applicability of the Solvency II volatility adjustment in IFRS?
  - Risk adjustment – Calibration differences due to different philosophy? (e.g. fulfilment versus transfer value)
  - CSM – Not relevant in Solvency II and new modelling systems will be required for IFRS
- Transition: Importance of getting transition ‘right’ (financial, data, systems) as CSM is a retrospective concept.
- Market status: Limited engagement in the UK market with IFRS 4 Phase II to date (given Solvency II focus).

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Concluding remarks

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- Period of continuing change: Increased complexity, so communication and strength of reconciliations between financial, regulatory and supplementary reporting will be key.
- Recent Solvency II experience has shown the importance of robust governance and processes.
- Implications of divergence between accounting and regulatory reporting from 1 January 2016.
- Risk of mixed accounting practices in the UK during the gap period between Solvency II and IFRS 4 Phase II.
- Expect to see IFRS 4 Phase II becoming more significant when a standard is issued (2016?).
- Future of embedded value / supplementary reporting post-Solvency II to be determined (including implications for current IFRS).

Questions

Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.