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Institute and Faculty of Actuaries

IFRS 4 Phase 2
Practical Implications

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11 November 2013

Outline of discussion topics

Overview

Significant areas of impact

Practical implications

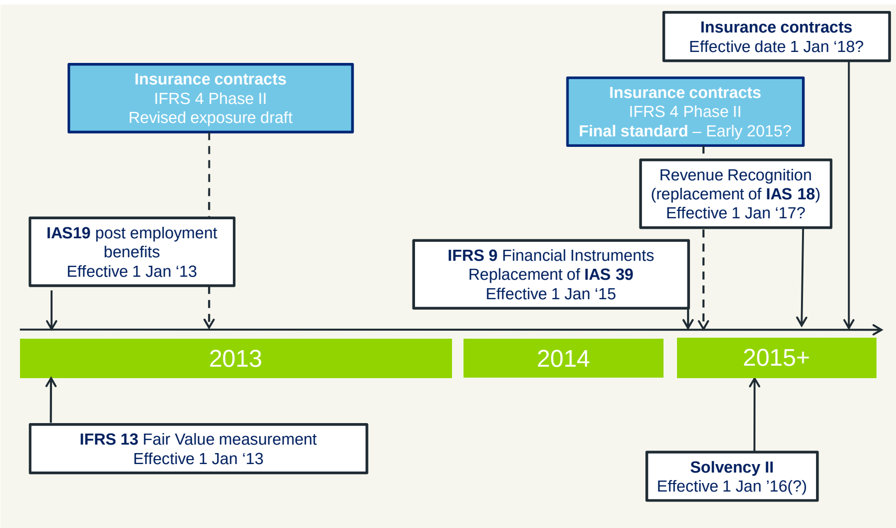
Industry challenges

Next steps

Overview

The IFRS 4 Phase II landscape

The wider IASB project horizon



Significant areas of impact

Insurance contracts project

Summary of ED proposals

- Introduces a **current value** approach to measuring insurance contracts
- Standard **applicable** to insurance contracts and reinsurance contracts
- Insurance contracts liabilities measured using a "**building block" approach**
- A simplified approach ("premium allocation approach") exists for **short term contracts**
- **Unbundling** of embedded derivatives, goods and non-insurance services, and distinct investment components of insurance contracts
- Investment contracts with discretionary participation features are **in scope**
- No recognition of accounting **profits** on Day 1 – a contractual service margin liability is added, to defer any expected profit. Day 1 **losses** are recognised immediately in the income statement
- Acquisition costs should be treated as contractual cash flows if they are **directly attributable** to a **portfolio** of insurance contracts. Expense all other sale costs
- Presentation and disclosure:
  - Earned premium approach, with premiums allocated to the period in proportion to the value of coverage provided
  - Underwriting result reflects:
    - profit/loss for services provided in the period
    - changes in measurement of uncertainty
    - changes in cash flows for past services
  - Changes in insurance contract liabilities arising from changes in the discount rate (current rate vs inception rate) are reported through Other Comprehensive Income (OCI)
  - Other changes in insurance contract liabilities are reported through the income statement

Insurance contracts project

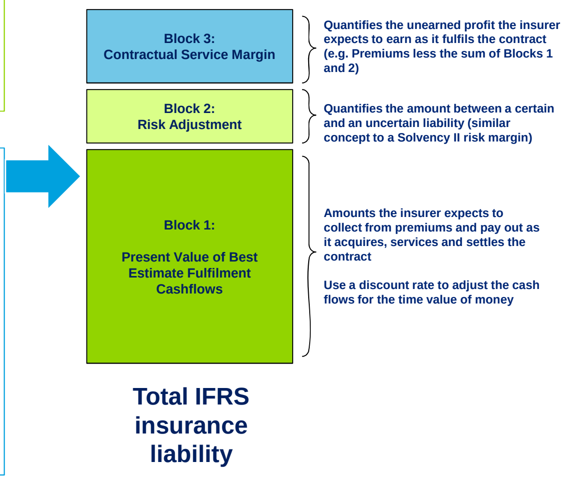
Building Block Approach (BBA)

This approach is relevant for insurance contracts with a coverage period of more than one year.

The alternative approach relating to contracts of one year or less is described on the next page.

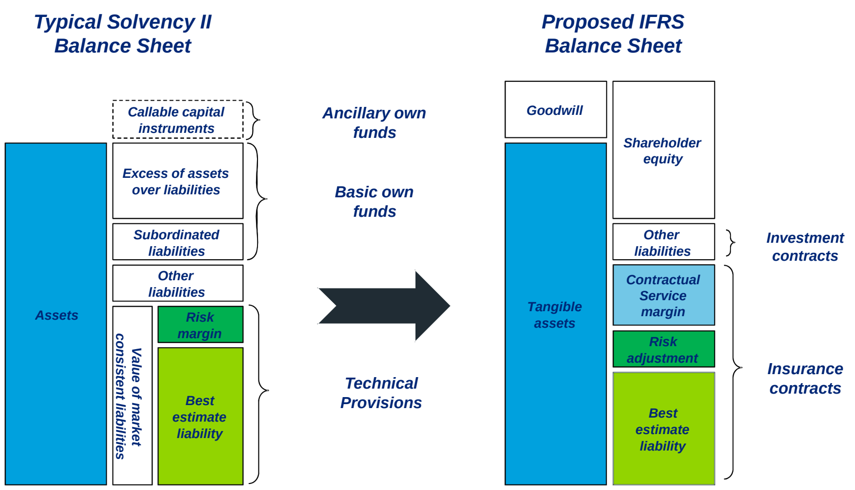
Principles

- Measurement is current – assumptions must not be “locked-in”
- Measurement objective is to represent the notion of the insurer’s “fulfilment of obligations under the contract”
- Discounting is done using either a “top down” or “bottom up” approach
- Risk adjustment is the amount required to compensate the insurer for uncertainty within the cash flows
- Contractual service margin eliminates the recognition of any accounting profit at inception



Comparison of IFRS 4 Phase II with Solvency II

Balance Sheet components



IFRS 4 Phase II vs Solvency II

Key challenges

Differing goals	Solvency II	IFRS 4 Phase II
	To establish a single common regulatory framework to maintain capital adequacy and risk management standards	To improve transparency and comparability of insurers' financial statements, regardless of sector, geography or products.

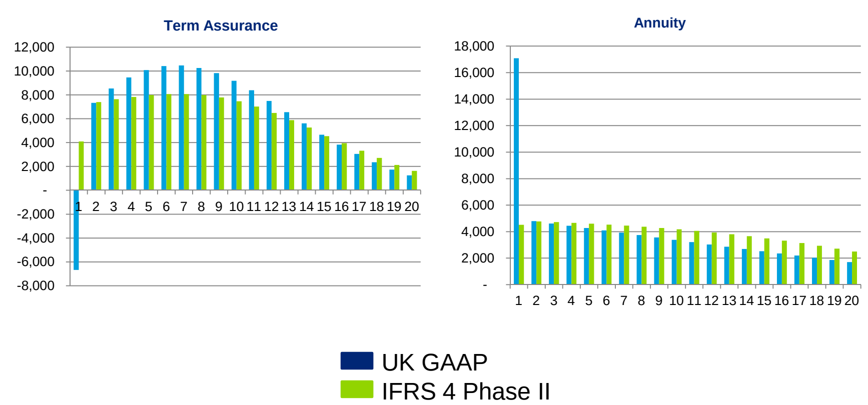
Component	Challenge	Key Areas of Impact
Scope & unit of measurement	IFRS 4 "portfolio" level measurement for certain components may require different data segmentation. Investment contracts are measured under IFRS 9.	Data and systems / Assumptions / Inputs to ICM / reporting
Best estimate cashflows	Some cash flows may differ, e.g. costs & contract boundaries.	Assumptions / Methodology
Discounting	Unlike Solvency II, discounting under IFRS 4 Phase II is governed by principles rather than rules.	Assumptions / Systems
Risk adjustment	The measurement of risk under IFRS 4 is governed by principles rather than rules. Required to disclose equivalent confidence interval.	Data and systems / Methodology / Assumptions
Contractual service margin	There is no concept of contractual service margin under Solvency II.	Data, systems / Reporting
Tax	Tax implications need to be fully understood.	Assumptions / Methodology
Reporting	Income statement attribution process needs to be developed. Balance sheet reconciliation between IFRS and SII is required.	Data and systems / Methodology / Reporting

Target Operating Model

Restatement of profit profiles

Smoothing of profit but total profit is unchanged

Under UKGAAP, there is an upfront strain or profit then profit is released over time as prudence margins unwind. Under IFRS 4 Phase II, the profit emerges in line with a pre-defined profit carrier.



Disclosure requirements

Summary of current proposals

IFRS 4 Phase II contains extensive disclosure requirements, including:

- Disaggregate insurance contract **revenue** into its main elements:
  - Probability weighted cash flows
  - Allocated acquisition costs
  - Risk adjustment for that period
  - Contractual service margin allocated for that period
- Disaggregate the following components either on the **balance sheet** or in the notes:
  - Expected future cash flows
  - Risk adjustment
  - Contractual service margin
- Disclose **judgements, methods and inputs** used, explain reasons for any changes and identify the types of contracts affected, e.g.
  - the way in which the risk adjustment has been measured
  - discount rates
- Disaggregate on an appropriate basis – e.g. type of contract, geographical area, or reportable segment. Do not obscure useful information
- Reconcile the carrying amount of insurance contract liabilities/assets from the **opening to the closing balances**, showing risk adjustment and CSM amounts separately
- Disclose the **confidence level** corresponding to the risk adjustment, if confidence level has not been used to measure the risk adjustment
- For liquidity risk, provide a **maturity analysis** on an annual basis for the first five years and in aggregate thereafter
- Disclose the **nature and extent of risks** arising from insurance contracts (e.g. insurance risk, market risk, liquidity risk and credit risk)
- Disclose the **yield curve** or range of yield curves used to discount the cash flows
- Describe how the contractual service margin was calculated on transition and how locked-in discount rates at contract inception were determined
- Insurance liabilities relating to remaining contract coverage must be shown separately from insurance liabilities relating to incurred claims

Insurance contracts project

Topics for discussion

The revised exposure draft asks questions on a limited number of topics:

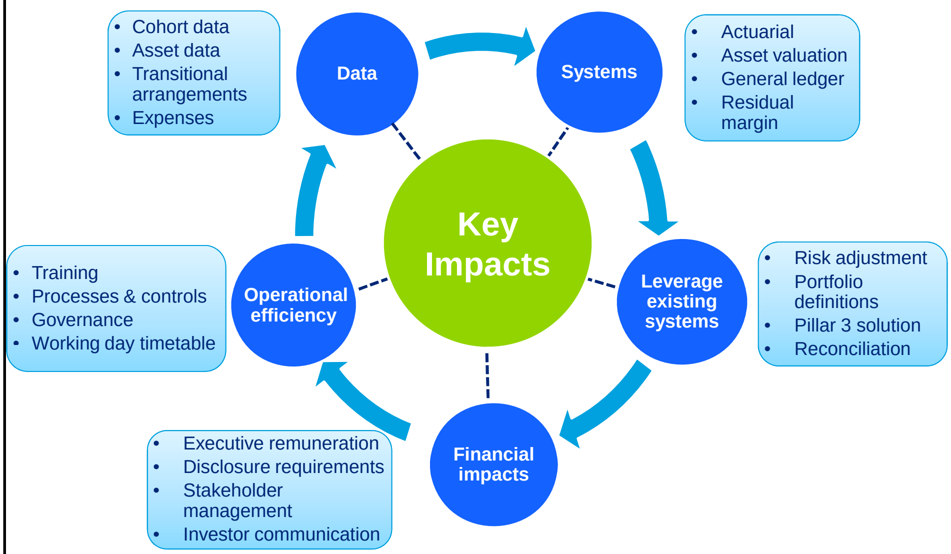
1. the “unlocking” of the contractual service margin (i.e. the unearned profit in an insurance contract)
2. the proposed transitional arrangements
3. the measurement of participating insurance contracts on the same basis as the underlying assets (‘mirroring approach’)
4. presenting the effect of changes in the discount rate in Other Comprehensive Income (‘OCI solution’)
5. the presentation of insurance contract revenue and expenses in the statement of comprehensive income (‘earned premium’ approach)

The IASB does not intend to revisit other aspects of the proposed standard.

Practical implications

What are the significant impacts of IFRS 4 Phase II?

Wide ranging impacts with varying degrees of complexity and lead time



Data segmentation

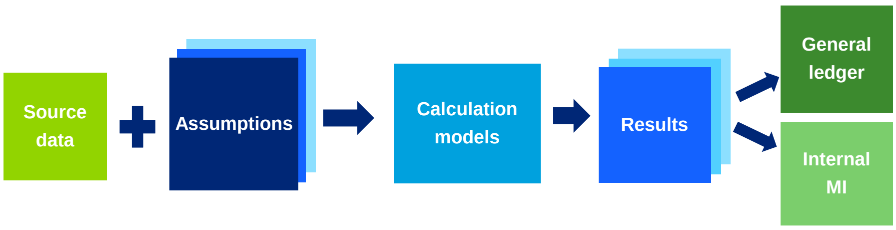
Challenges of varying degrees of difficulty

Increasing difficulty →

	Aggregation	New data	Separation
Asset data	• Grouping of assets by portfolio	• New asset data information required for book value of assets	• Unbundling?
Policyholder/ cohort data	• Cohorts within portfolios		• Unbundling of premiums & benefits (e.g. riders)
Transitional arrangements		• Paid-up/alterations history • RDR at inception • Single premium at inception • Initial expenses/commission	• Unbundling of premiums & benefits (e.g. riders)
Expenses	• New split of expenses		

Systems

Impacts across all systems in the reporting process



- Asset data for assets other than those at market value
- Policyholder cohort data
- Transitional data

- Multiple bases required (e.g. Solvency I & II, IFRS, MCEV, Economic Capital, etc)
- Multiple assumptions bases, including expense bases, for IFRS 4 Phase II

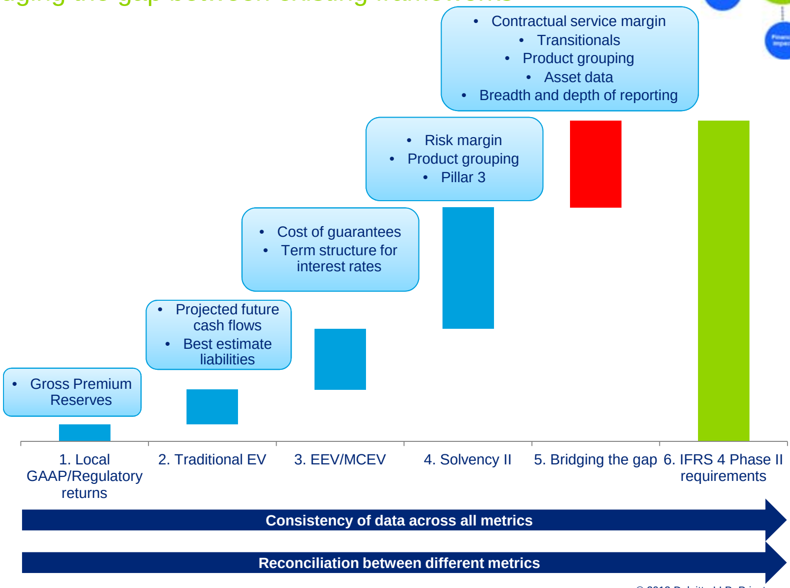
- Best-estimate liability
- Cost of guarantees
- Risk adjustment
- Contractual Service Margin
- Contract boundaries
- Investment business reserves under IFRS 9

- New output requirements
- Reconciliation
- Validation analysis
- OCI impact of assumption changes
- P&L impacts
- Data storage requirements for CSM calculations

- General ledger system will need to be updated for actuarial and accounting data flows

Leverage existing systems

Bridging the gap between existing frameworks



Financial impacts

Three key areas for consideration

Financial impacts	**High-level financial impacts analysis on the balance sheet and profit & loss account to help focus the efforts on the significant areas and also to influence the precise methodology to be followed.**
Executive remuneration	**Both the annual bonus and LTIP schemes will need to be re-calibrated on the new metrics.**
Investor communication	**The investor community will need to be educated on the financial impacts. It is likely that this journey will need to begin on the back of Solvency II.**

Operational efficiency

Three key areas for consideration

Processes & controls	**Auditable standards required across all processes**
Governance	**Embedded into existing infrastructure**
Training	**Training required across the following areas:** • **Methodology** • **New systems** • **Governance**

Industry challenges

Unprecedented level of challenges

Competing challenges are facing the industry

Regulatory	**Implementation of multiple mandatory regulatory requirements:** • Solvency II • Economic capital • IFRS 4 Phase 2 • Local GAAP • US GAAP • Regulatory returns
Market	**Market pressure to present more information within shorter timescales:** • Regulatory capital • Economic capital
Economic	**Better quality MI required on a timely basis for improved decision making in the management of scarce economic resources**

Requirement for more reporting, in faster timescales, in a more controlled and auditable way – **Working Day Timetable**

Next steps

Next steps
Areas for consideration

- Clear understanding of future reporting requirements including systems requirements (e.g. Local GAAP, US GAAP, MCEV, IFRS 4 Phase 2, Economic Capital and Local Regulatory Returns)
- Working group established to perform a more detailed assessment of the impact of IFRS 4 Phase II on data, calculations, models, systems and processes
- Non-functional requirements (e.g. speed of use) are just as important as functional requirements
- Compare to current reporting requirements (functional and non-functional)
- Benchmark the current reporting working day timetable against the vision for the close process (25 days?, 30 days?)
- This should highlight the critical areas that cause delays to meeting the end state timetable

Next steps
Areas for consideration

- Consider which systems, controls and processes are planned to be or are already being worked on:

  - Ensure that no “fatal flaws” are being built in that will make future reporting more challenging - these cost considerably more to undo
- Decide when to begin the implementation process for IFRS 4 Phase II so as to allow a smooth and efficient transition to take place, building on existing knowledge, systems and processes.
- Build a “right to left” project plan – ensure that you will finish by the implementation date
- Pay particular attention to systems that take time to alter or are more costly to change and therefore need to go through a more rigorous budget approval process
- Planning should reflect the uncertainty associated with specific areas within the current ED i.e. “lighter touch” for those areas that are have the greatest potential to change in the final standard.
- Make the optimal use of own resources to keep costs down and retain knowledge within the organisation.

The earlier planning is begun, the more cost effective it is ultimately likely to be

Key Performance Metrics – Life KPIs

Life KPIs

Annual premium equivalent	*Internal rate of return*	*Value of new business*	*Embedded Value*	*Present value of new business premiums*
Free Surplus	*New business strain*	*Available shareholder cash*	*Market Consistent Embedded Value*	*New business margin*

Impact on KPIs

- A number of factors will influence the way in which the key KPIs will change under IFRS 4 Phase II
- Many of these factors will be at the discretion of the Company given that IFRS 4 Phase II is not too prescriptive
- The precise way in which the key KPIs change will depend on the particular combination of the factors chosen and the way this interacts with the risk profile of the particular product
- Therefore, in making methodology choices under IFRS 4 Phase II, Companies should be mindful of the way in which these choices could impact the key KPIs, so as to mitigate the risk of (unexpected) adverse changes in key KPIs

Conclusions

- Main impacts are actuarial and systems – we should be well placed to support these changes.
- Think and plan, don't build anything big yet.
- There are some big systems potentially involved – make sure they will be ready for the implementation date.
- Think about both internal and external stakeholders.
- The accountants need our support!

Questions?

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