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# IFRS17 – So How Exactly Will it Work for Existing UK 90/10 With-Profits Funds?

John Jenkins, Nigel Hayes and David Holliday

# Agenda

## The general measurement model

The variable fee approach

General measurement model compared to the variable fee approach

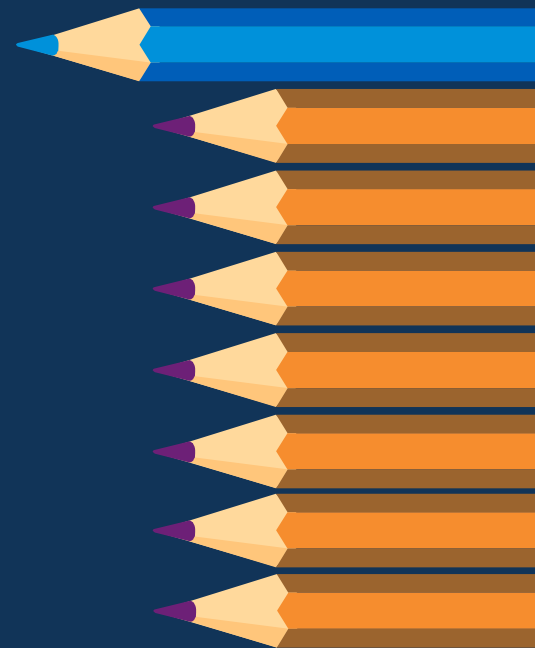
Market sensitivity

Example profit profiles

Running off the CSM

The estate and IFRS 17

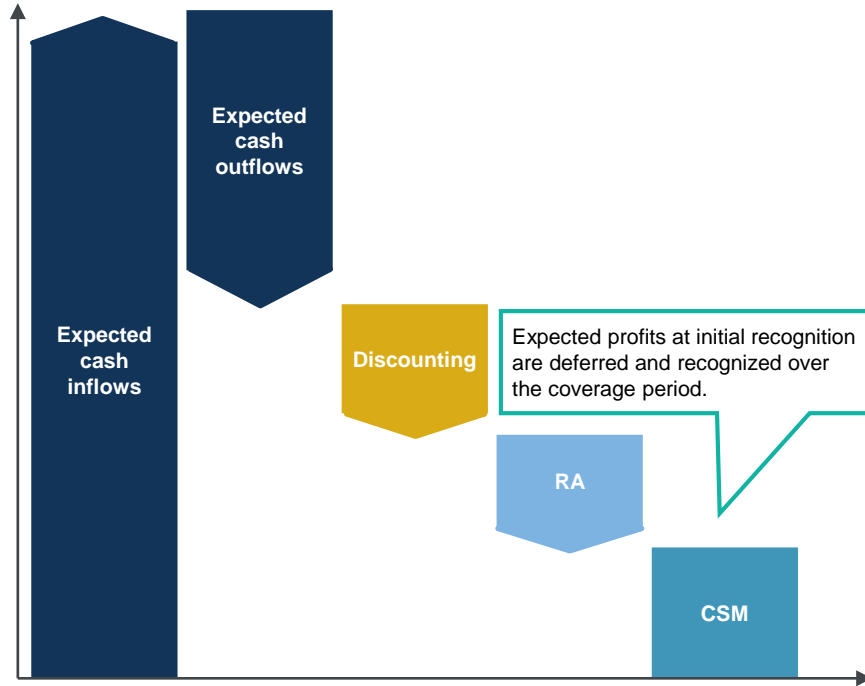
Transition



# General measurement model



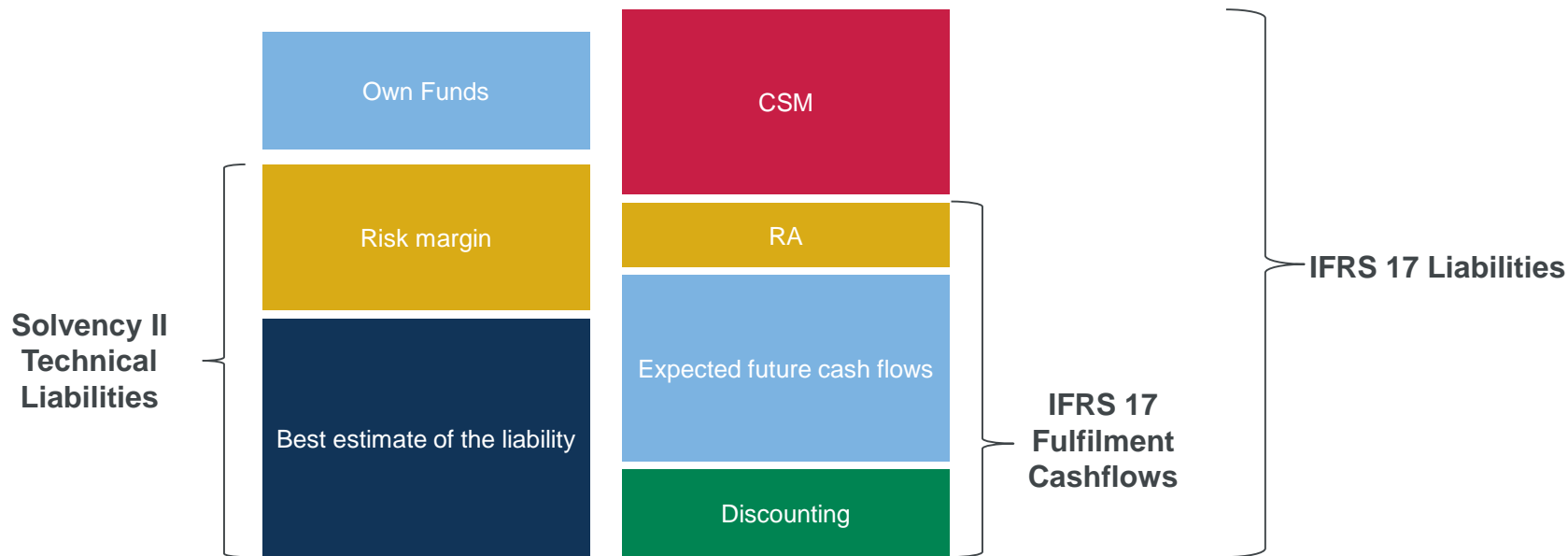
# An overview of the building block approach



- The CSM is a new liability component under IFRS 17.
- It is the difference between the discounted, risk adjusted cash inflows and cash outflows at inception of a profitable group of contracts.
- It represents the revenue the company expects to earn from the provision of the insurance coverage services before adjustment for the time value of money.
- The CSM removes any profit at inception and it is unwound over the coverage period commensurate with a reduction in “coverage units”.
- The initial CSM is the same under the general model and variable fee approach (VFA).



# Solvency II compared to IFRS 17 for a new product



Not to scale. Whether the SII or IFRS 17 components are larger or smaller will depend on the entity.



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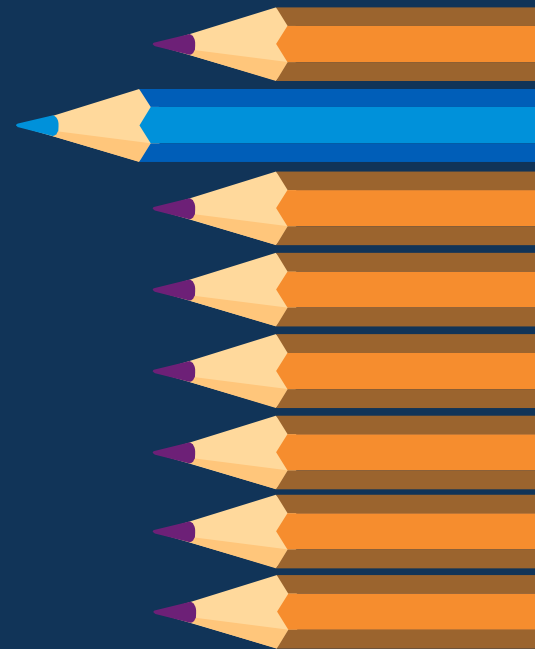
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# Variable fee approach

- The approach considers the variable fee associated with direct participating contracts.
- The building blocks still apply.
- In the UK the VFA should apply to with-profits, unit linked and index linked business (note index linked benefits like annuities are not included).
- Will reduce accounting mismatches and volatility compared to the BBA.
- Much unit-linked business will be classified as investment business hence will not be subject to IFRS 17.

Variable fee



**The obligation to pay the policyholder an amount equal to 100% of the fair value of underlying items**

**Less the entity's obligation to the policyholder**

**Note the variable fee increases the liability, hence it is earned as a profit at a later point in time.**



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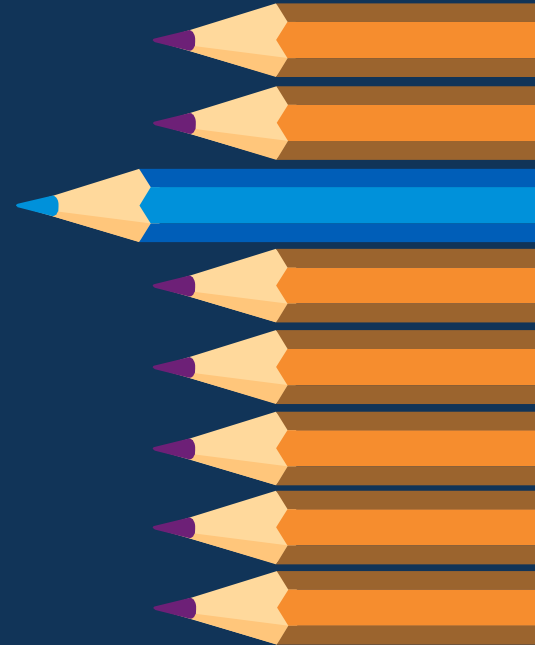
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# For which changes do you adjust the CSM?

Change	General model	Variable fee
<b>Experience</b>		
Premiums received in current period relating to future service (e.g. unexpected increments or single premiums on existing business)	✓	✓
Non-financial experience adjustments relating to future service	✓	✓
Financial experience	✗	✓
Changes AvE in investment component in the period (GM: at locked-in rate, VFA: at current rate)	✓	✓
<b>Assumptions</b>		
Non-financial assumption changes (GM: at locked-in rate, VFA: at current rate)	✓	✓
Financial assumption changes	✗	✓
<b>Other</b>		
Risk adjustment relating to future period	✓	✓

- ✓ Goes through the CSM, hence there is no impact on profit in the year (for profitable groups of contracts)
- ✗ Goes through P&L, hence impacts the profit in the year

Note, this applies in general but in practice each specific change would have to be assessed against the IFRS 17 rules



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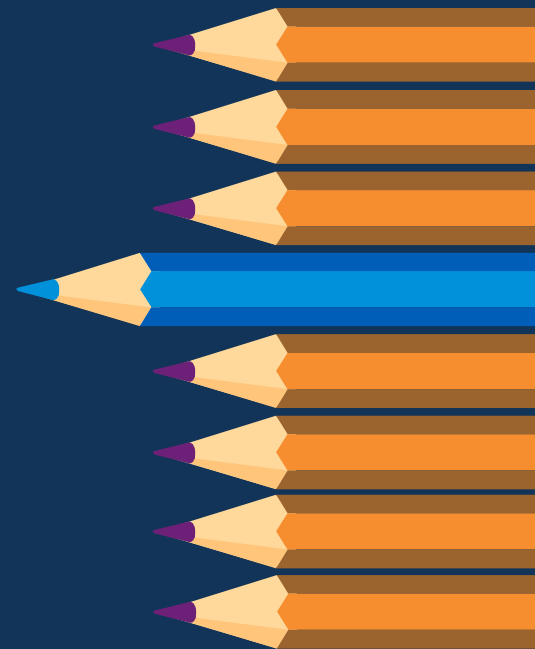
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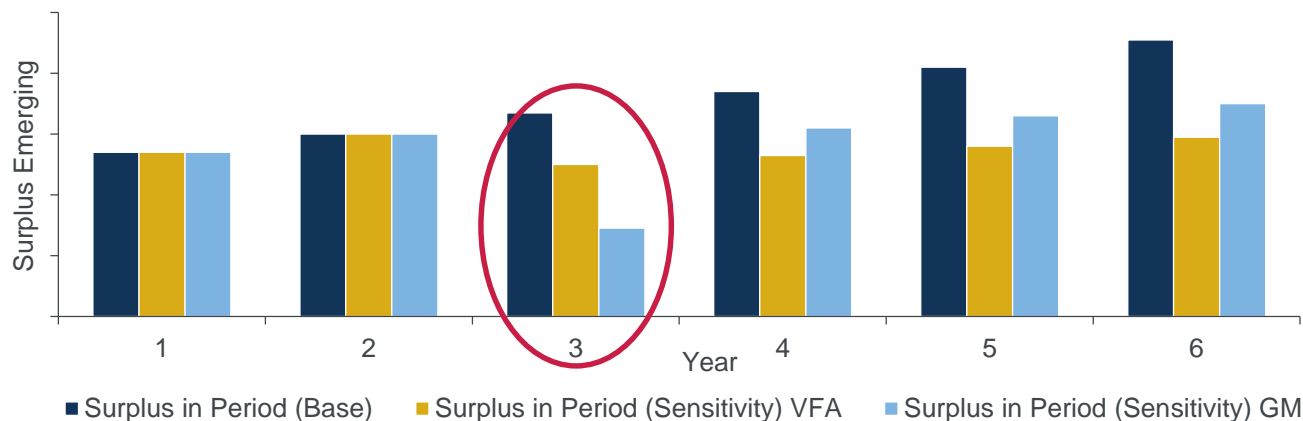


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# General Model versus VFA: Fall in investment returns in year 3

- The base case is identical under both approaches, with returns being as expected. Losses occur in year 3 and the question is how to spread them.
- General model (GM): sizeable reduction in profit in year 3 due to the economic shock. The CSM cannot be unlocked for the change in financial experience and economic assumptions.
- VFA: the entities share of the performance of the underlying funds is adjusted against the CSM. The profile is much smoother using the VFA.

## Participating policy with economic assumption change



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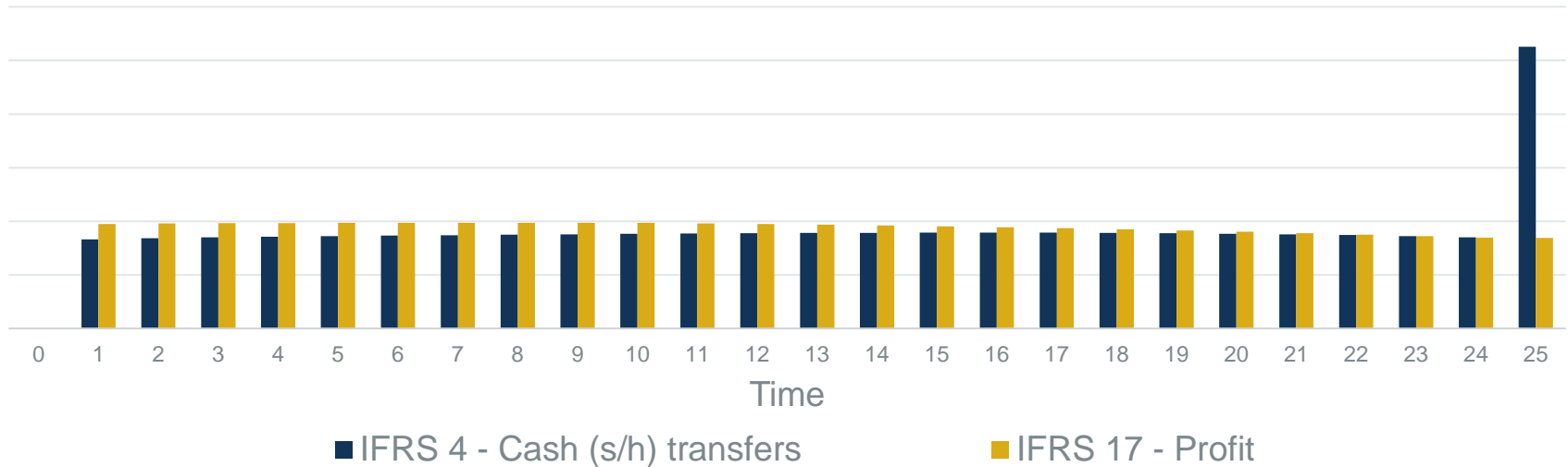
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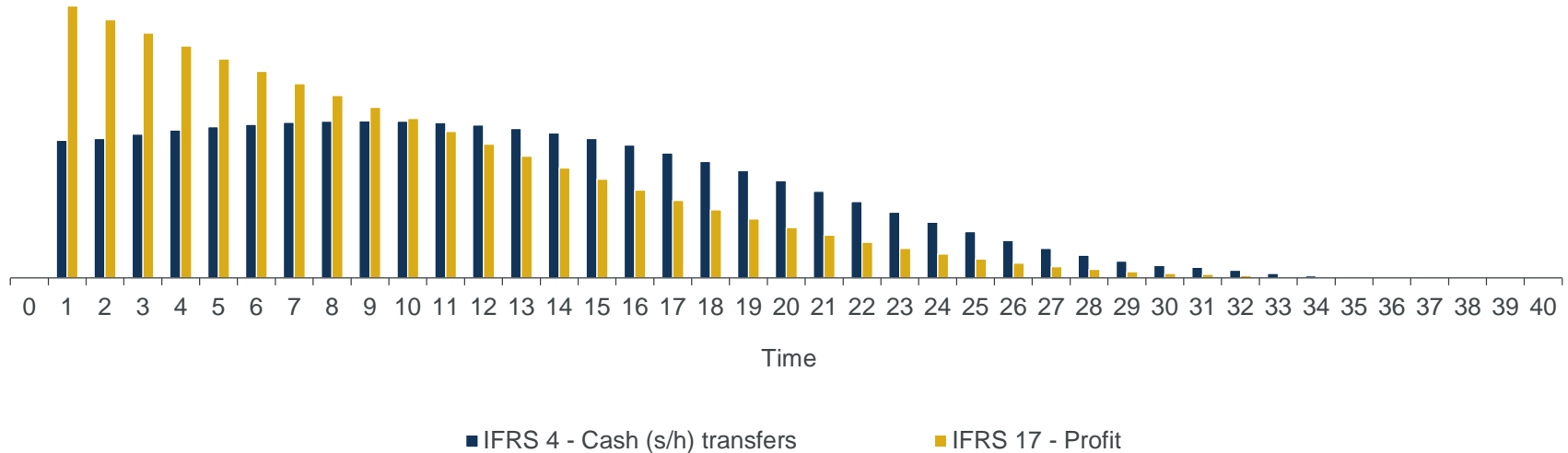
# WP modelling a 90:10 new product

- Example run off profile comparing IFRS 4 & IFRS 17.



# WP modelling a 90:10 closed fund

- Example run off profile comparing IFRS 4 & IFRS 17 assuming that the full retrospective approach was used.



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# Running off the CSM

- Coverage units are used to run off the CSM and are one of the main drivers in the profit profile.
- Coverage units are not clearly defined in the final standard. This currently leaves scope for interpretation and uncertainty:

*B119(a) identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage duration.*

- The previous slides used the remaining policy count as the coverage units. There are a number of different coverage units that could potentially be used and industry thoughts around this are still developing.





# Running off the CSM – policy count example

- The table below shows how to run off the CSM when expected policy count is used for the run off. Note, we are not suggesting that policy count is the best choice. The policy matures after year 5 in this example and we assume that exits occur at the end of the period.

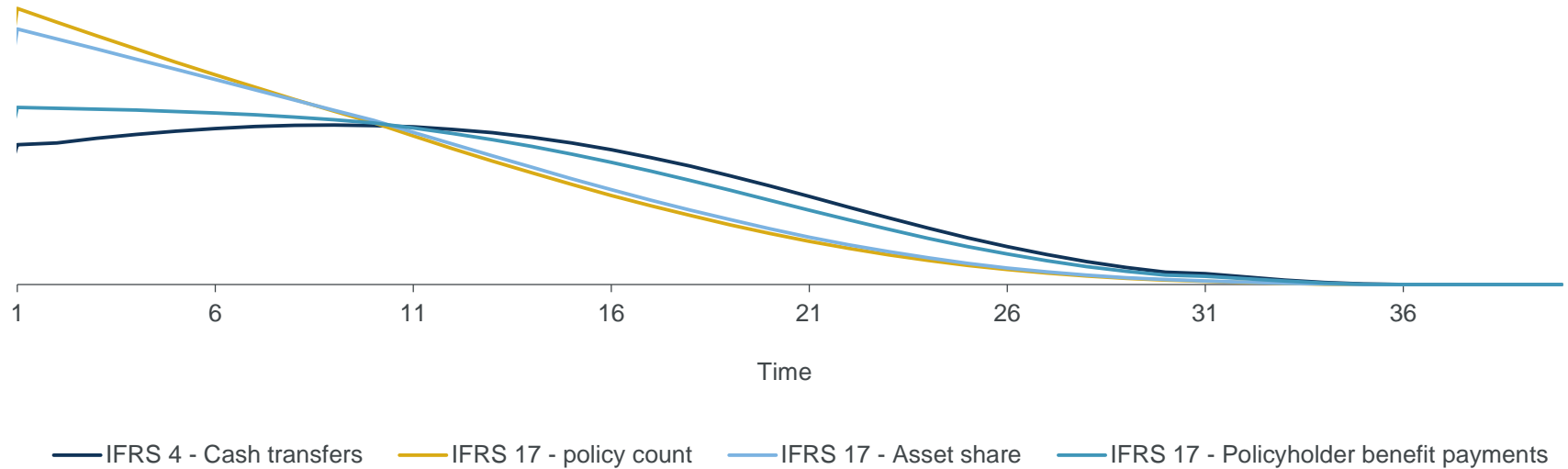
Year	1	2	3	4	5
Policy count (SoP)	100	95	90	85	80
CSM run off factor	22%	27%	35%	52%	100%
CSM SoP	100	82	63	43	21
CSM VFA	5	4	3	3	2
CSM Run off	-23	-23	-23	-24	-24
CSM EoP	82	63	43	21	0

- Note the run off factor is applied to the then CSM. Hence the run off once the policies mature has to be 100%.
- For example for the first two run offs are:

$$\text{Year 1: } \frac{100}{100+95+90+85+80} = \frac{100}{450} = 22\%; \text{ Year 2: } \frac{95}{95+90+85+80} = \frac{95}{350} = 27\%$$



# Profit profile – different coverage units



Note the coverage units are not discounted in this example. This is also based on the no estate example. At inception there is zero profit.



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# WP modelling a 90:10 closed fund – what the standard says

B68 Sometimes, such contracts will affect the cash flows to policyholders of contracts in other groups. ... Hence the fulfilment cash flows for a group:

- (a) Include payments arising from the terms of existing contracts to policyholders of contracts in other groups, regardless of whether those payments are expected to be made to current or future policyholders; and
- (b) Exclude payments to policyholders in the group that, applying (a), have been included in the fulfilment cash flows of another group.

## What it means

(a) says to allow for the estate

(b) says to avoid double counting

One interpretation is that you assume the estate is being distributed even if it isn't currently, similar to earlier embedded value approaches.



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# WP modelling a 90:10 closed fund – what the standard says

B70 Different practical approaches can be used ... In some cases, an entity might be able to identify the change in the underlying items and resulting change in the cash flows only at a higher level of aggregation than the groups. In such cases, the entity shall allocate the effect of the change in the underlying items to each group on a systematic and rational basis.

B71 After all the coverage has been provided to the contracts in a group, the fulfilment cash flows may still include payments expected to be made to current policyholders in other groups or future policyholders. An entity is not required to continue to allocate such fulfilment cash flows to specific groups but can instead recognise and measure a liability for such fulfilment cash flows arising from all groups.

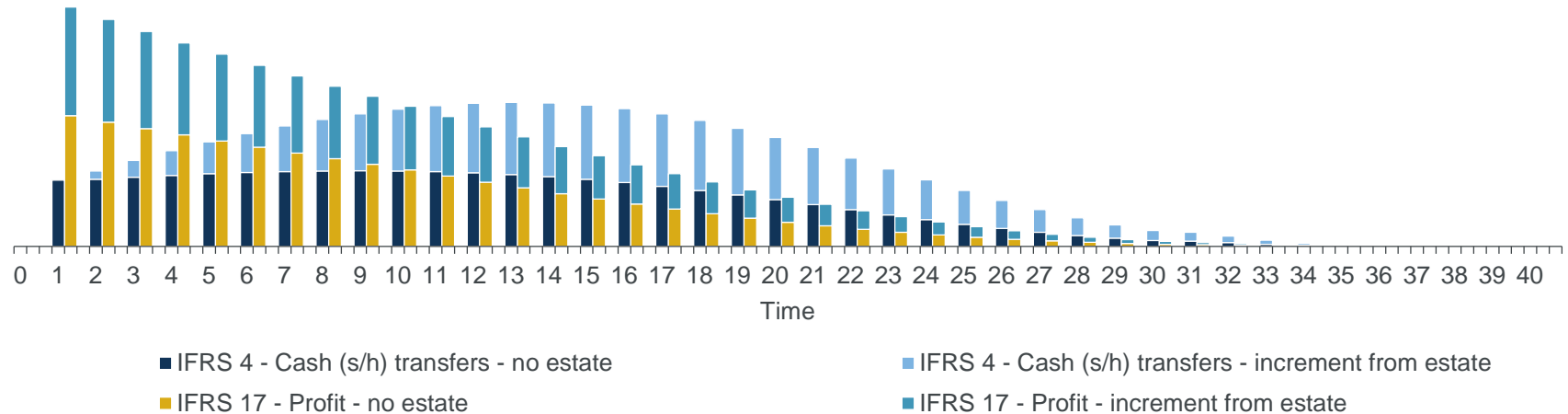
## What it means

In effect it is up to companies to implement the rules in a sensible compliant approach, as the rules do not specify the approach in complete detail.



# WP modelling a 90:10 closed fund

- Adding an estate just increases the profit profile. This example has an estate of 10% of the initial asset share.



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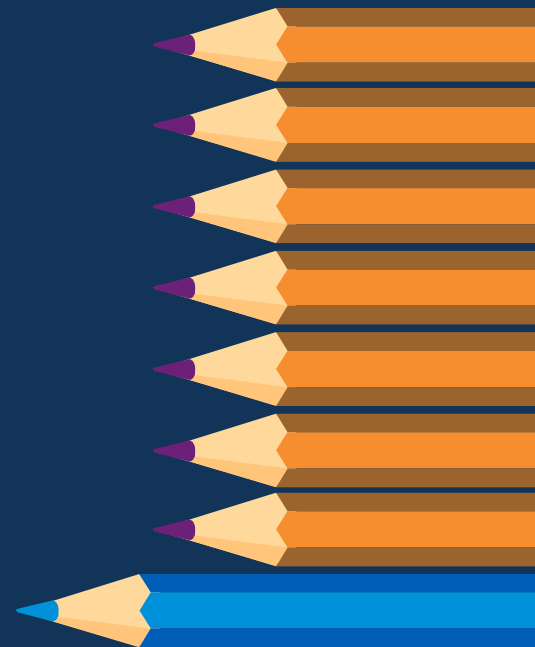
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# Transition

- The new standard is to be applied retrospectively.
- Each group of insurance contracts should be treated as if IFRS 17 had always applied.
- IASB recognises that in some cases full retrospective application will be impractical, so practical expedients are available.
- Appropriate choice must be made for each group of contracts, which may imply a mixture (e.g. full retrospective for recent years).

## Transition options for groups of contracts

### Full retrospective application

*If impracticable, choice between...*

### Modified retrospective approach

### Fair value approach

*Specified modifications are permitted, with an entity using the minimum modifications necessary.*

*Forward looking approach to transition.*

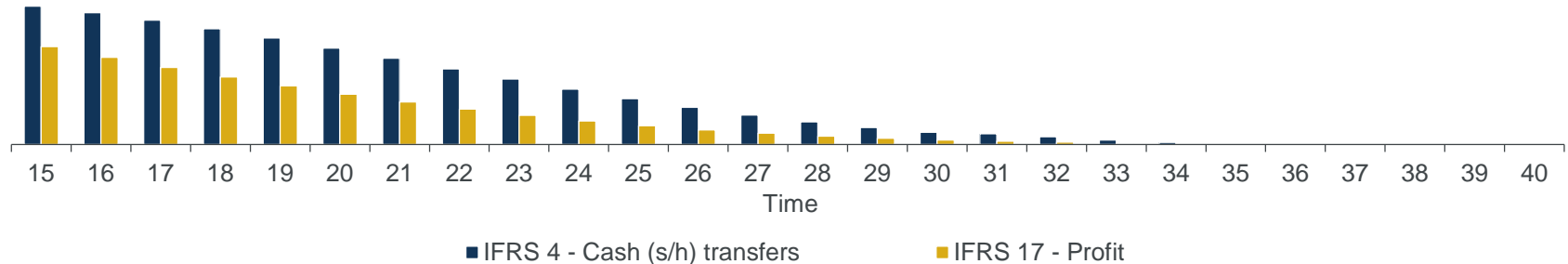


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# Transition - full retrospective approach

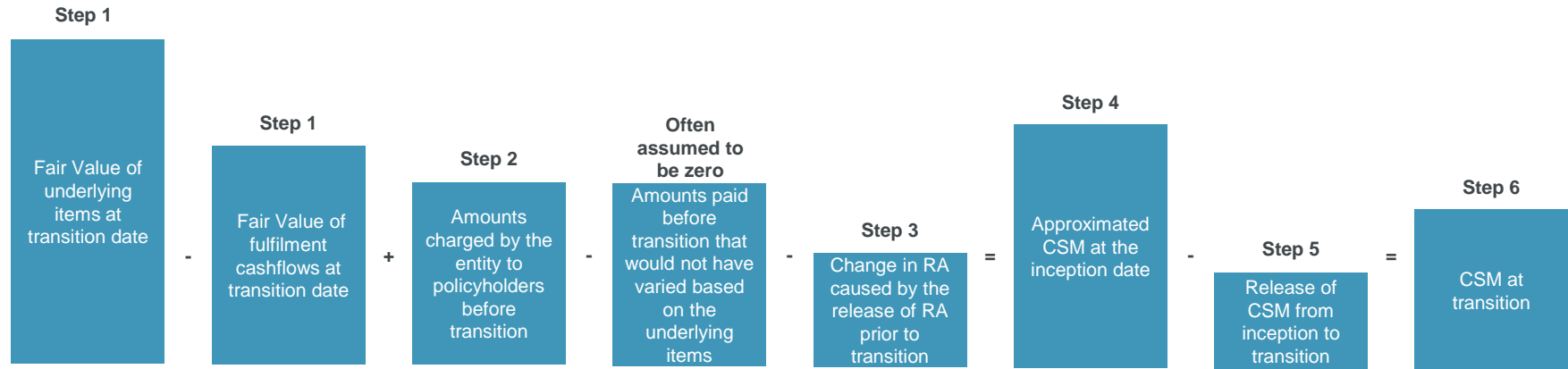
- Applying the full retrospective approach to a cohort of business would effectively give the results from our earlier profit projections, but starting at a later year.



- IFRS 17 profit is generally more 'front-ended' than the shareholder transfers used for IFRS 4.
- Hence for existing cohorts, future profits under IFRS 17 are generally lower.
- Future IFRS 17 profits are 'stored' in the CSM and RA to be released over time.
- The excess value of future shareholder transfers is recognised as equity (but remains locked within the with profits fund).

# Transition – modified retrospective approach

- Aim of modified retrospective approach is to achieve closest outcome to full retrospective while using available information.
- The standard describes the following approach for determining the CSM for groups of insurance contracts with direct participation features at the transition date.



- Step 1 gives PV of future shareholder transfers (PVSHT) at transition date less RA (which is included in fulfilment cashflows).
- Step 2 adds back shareholder transfers between inception date and transition date.
- Step 3 adjusts RA to level it would have been at inception date, delivering estimate of CSM at Step 4.
- Step 5 then releases the CSM in the normal way from inception date to transition date.



# Transition - fair value approach

- In fair value approach, CSM at initial recognition is equal to the **fair value of liabilities** less the IFRS 17 **fulfilment cashflows**,
- The fair value (FV) is the price that would be received to transfer the insurance contracts in an orderly transaction between market participants. It must be calculated in line with IFRS 13 excluding paragraph 47 (deposit floor).
- Fulfilment cashflows = BEL + RA
- Hence under the fair value approach: 
$$\text{CSM} = \text{FV} - \text{BEL} - \text{RA}$$
- Starting point to assess FV should be the IFRS 17 valuation of the liabilities = BEL.
- Adjustments could then be made for various items:
  - profit compensation on purchase of portfolio (i.e. the discount that a purchaser might require below the PV of shareholder transfers)
  - non-allocated expenses
  - allowance for risks that are not included in the above

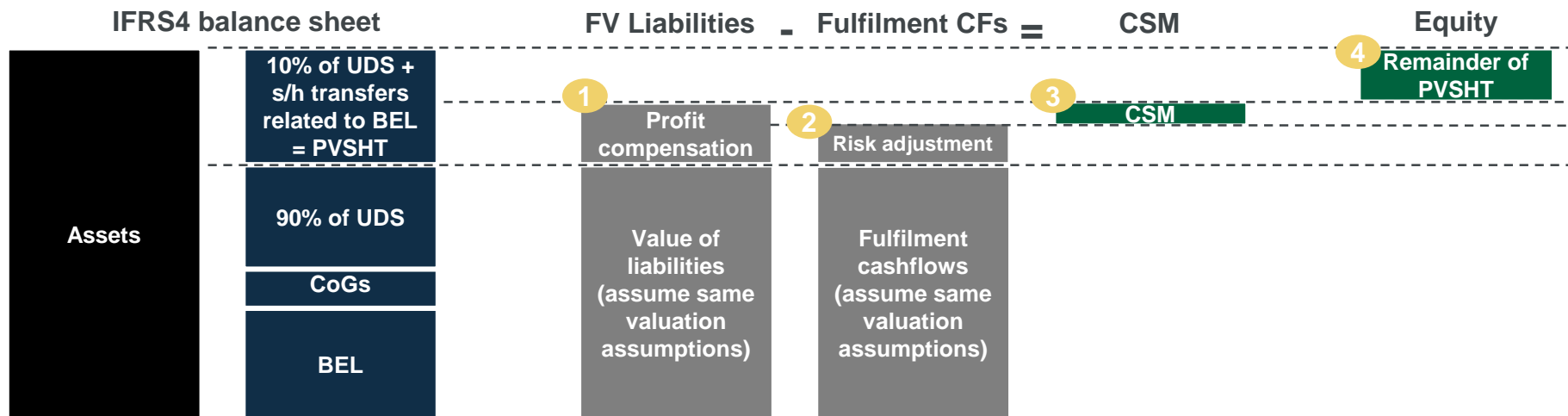
There will be a positive CSM if adjustments exceed RA; likely to be small though



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# Transition - fair value approach illustration

- Derivation of CSM in fair value approach is illustrated below (not to scale):



- Profit compensation will be a margin for profit, the risk of not getting the PVSHT, and the risk of burn-through. Typical transactions take place at 70-90% of MCEV implying a margin of 10-30% of PVSHT.
- Risk adjustment will be small as it is only the shareholder part and is after allowing for management actions.
- CSM is then the profit compensation less the risk adjustment; this is likely be small.
- Remainder of the PVSHT is recognised immediately in equity – this part is the ‘arms-length’ price of the PVSHT.



# Fair value approach - example

£m	IFRS 4	IFRS 17
Assets	100	100
BEL	60	90
FFA	40	-
Risk Adjustment	-	1
CSM	-	?
Total Liabilities	100	?

The difference between the Assets and BEL is the present value of the shareholder transfers = 10.

The IFRS 17 BEL includes planned estate distributions, but excludes shareholder transfers. Hence it is less than IFRS 4 insurance liabilities + FFA.

The FFA is removed under IFRS 17.

For most firms the risk adjustment will be new under IFRS 17. Its size will depend on how healthy the with-profit fund is.

The CSM should be set such that the total liabilities equal the fair value of the liabilities. But what is the fair value of the liabilities?

The total liabilities under IFRS 17 is value is not expected to equal 100.



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# Possible outcomes

- Under 'fair value 1' market price for PVSHT of 10 is assumed to be 9
- Under 'fair value 2' it is assumed to be 7

£m	IFRS 4	IFRS 17 (full retrospective)	IFRS 17 (modified retrospective)	IFRS 17 (fair value 1)	IFRS 17 (fair value 2)
Assets	100	100	100	100	100
Insurance liabilities	60	90	90	90	90
FFA	40	-	-	-	-
Risk Adjustment	-	1	1	1	1
CSM	-	5	5	0	2
Total Liabilities	0	96	96	91	93
Increase in equity on transition to IFRS 17	N/A	4	4	9	7

The modified retrospective approach is intended to give a reasonable approximation to the full retrospective approach

Note that sum of CSM and equity is the same for each

The modified retrospective approach can give a higher or lower CSM compared to the fair value approach, but is most likely higher.



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# Practical considerations

## Which approach to apply

- Option to use modified retrospective or fair value approach applies if and only if it is impractical to apply full retrospective approach to a group of contracts.
- Potentially significant practical difficulties for historic business:
  - identifying original assumptions and reproducing original cashflow projections and risk adjustment
  - tracking subsequent experience variances and assumption changes
- For with profits business, additional complexity is introduced by:
  - notional allocation of estate to current customers
  - mutuality, leading to contracts affecting cashflows of contracts in other groups
- Harder to demonstrate impracticality for recent cohorts, in particular post-2017 new business

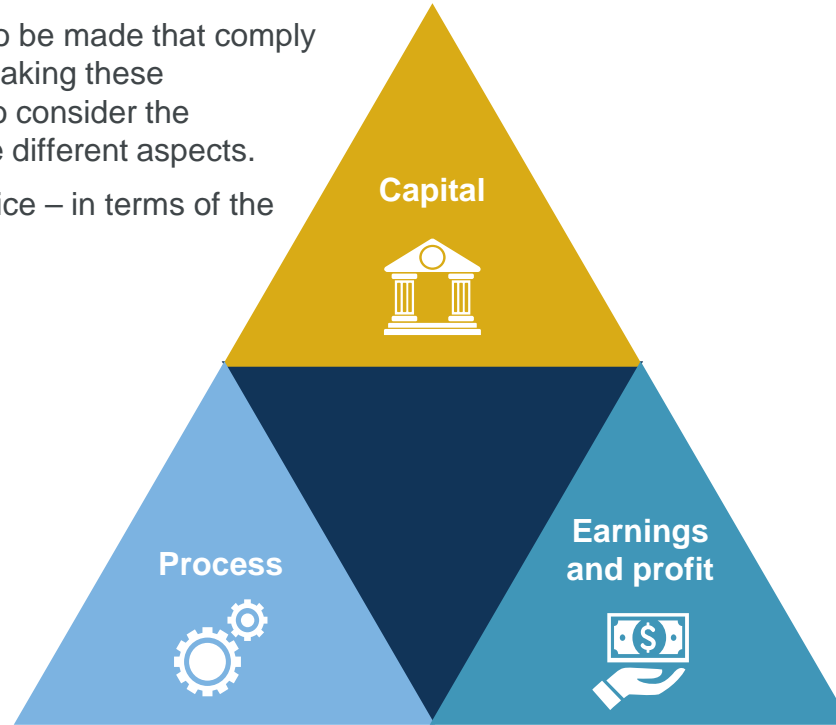
## Extent of retrospection

- For business combinations or transfers, proceed as if the entity had entered into the contracts at date of the transaction
- Use the consideration received or paid as a proxy for the premiums received
- This gets close to the fair value approach for recent transactions



# Transition – balancing the impact of influences

- Judgements will be need to be made that comply with the standard, whilst making these judgements it is sensible to consider the interactions between these different aspects.
- This is an area of free-choice – in terms of the IFRS17 standard.



**Potential dividend issues if IFRS17 profit is higher than actual cash transfers.**



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# Future challenges and uncertainty

- 1 Risk adjustment for with-profits
- 2 Non-profit business in the with-profits fund
- 3 Transition requirements – proving impracticability
- 4 Level of aggregation
- 5 Distributing the estate whilst writing new business

Transition  
resource  
group?



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# Questions

# Comments

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