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How do you manage a with-profits firm under IFRS 4 Phase II?

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11 November 2014

Agenda

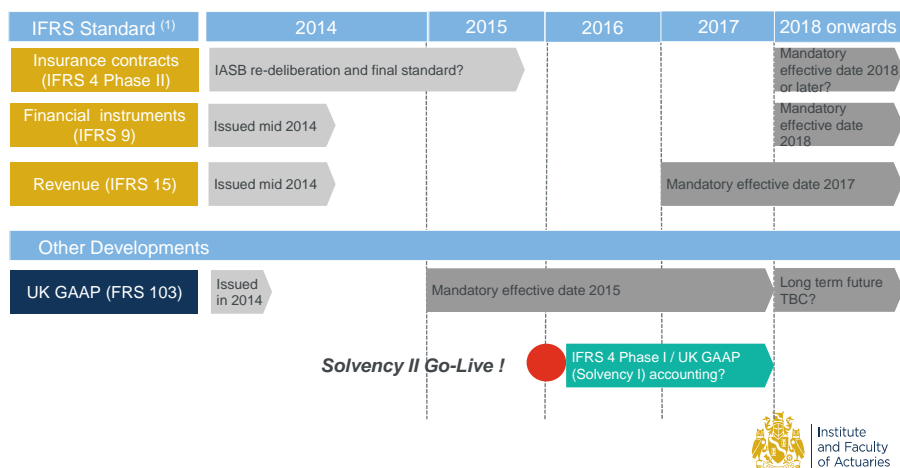
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Timeline

Interactions between IFRS and other developments (as at November 2014)



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A reminder ... the BBA approach

Current, market-consistent measurement with no "day one" profit

Contractual service margin
(Contract profit)

'Fulfilment cash flows'

Future cash flows:
expected cash flows from premiums and claims and benefits

Risk adjustment: an assessment of the uncertainty about the amount of future cash flows

Discounting: an adjustment that converts future cash flows into current amounts

Contractual service margin

A component of the measurement of the insurance contract representing the **risk-adjusted expected profit** from the contract. Created at the point of sale.

Fulfilment cash flows

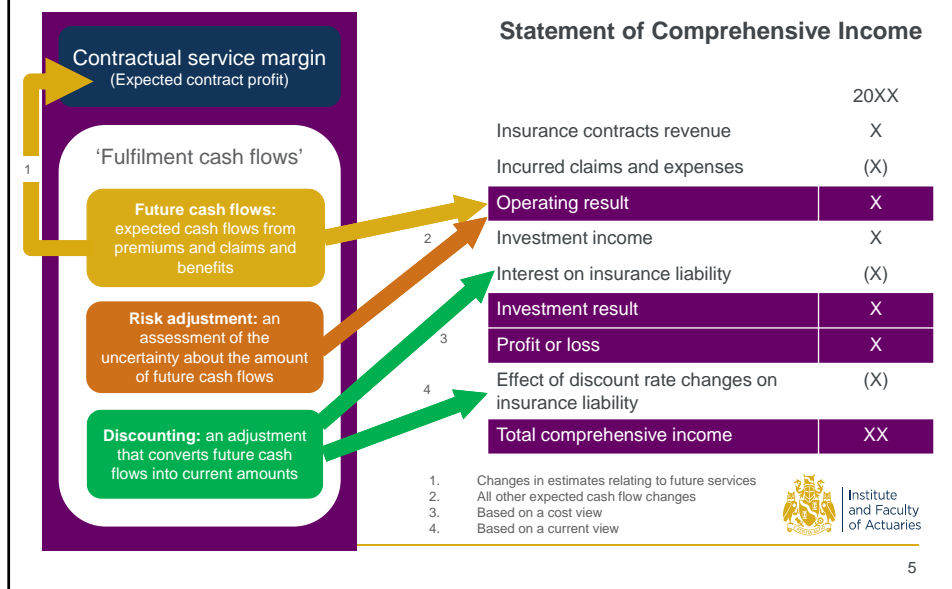
A **current**, updated **estimate** of the amounts the entity expects to **collect** from premiums and **pay out** for claims, benefits and expenses, **adjusted for risk** and the **time value** of money.



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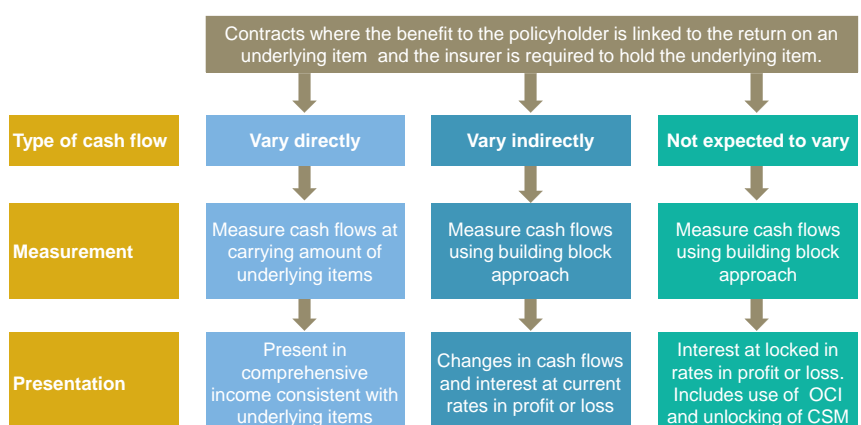
A reminder ... the BBA approach

Up-to-date information about performance



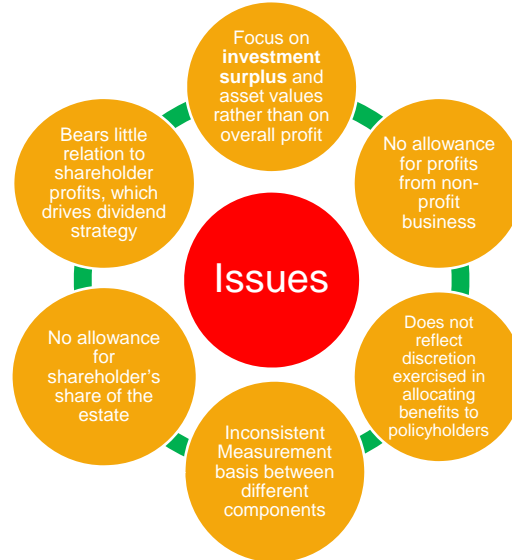
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Mirroring approach – What was it?



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Mirroring approach – What are the issues?



Mirroring approach – Industry feedback

Participants from the UK and the rest of the world responded in a similar way:

- Significant concerns about the mirroring approach, partly due to the need to bifurcate cash flows
- Decomposition of cash flows would be arbitrary, yet different decompositions would lead to different valuations of the contract
- Some suggested that a BBA approach that measures all contracts, including participating contracts, at current value would be preferable to a complex and operationally onerous exception
- Desire for consistent treatment of options and guarantees across all insurance contracts
- CFO Forum due to take its proposal through with the IASB in w/c 17 November 2014

Deloitte views (1/3)

Separate model is complex and unrepresentative of a contract as a bundle of different cash flows

- Scope is not well defined
- Analysis of cash flows into 3 types is complex and artificial resulting in different measurement and presentation for each
- Results are inconsistent with economic design and pricing of embedded derivative features
- 'Mirroring' produces misleading results if underlying items are not at FV ... potential mismatch between liability recognised for regulatory purposes and for financial reporting purposes
- No guidance how to apply 'mirroring' if underlying is a pool of insurance contracts or results of entity itself



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Deloitte views (2/3)

- Agree that economically matched asset-liability cash flows should be faithfully represented

Deloitte proposal is to modify the proposals as follows:

- Abandon the mirroring approach decomposition
- Replace it with a BBA valuation modified in two areas:
 - Discount rate should mirror the "book yield" of the underlying items; and
 - The CSM should be unlocked with inclusion of expected returns from underlying items not captured in the liability (insurer's share)



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Deloitte views (3/3)

Propose to account for all participating contracts using the same accounting model as all other insurance contracts with two key modifications

Unlocking of CSM for the returns on underlying items attributable to the insurer

- Propose to adjust the CSM for the returns on underlying items attributable to equity holders until the distribution to policyholders is made
- This would reflect the fact that insurer provides a service to current and future policyholder by allowing them participation in the underlying items
- The insurer's obligation to policyholders is not fulfilled until the distribution is made

Amendment to discount rate

- Accrete interest on directly linked cash flows using the yield generated by those underlying items limited to their expected duration.
- For cash flows beyond duration of underlying items estimate discount rate using the general provisions of the revised ED.
- The difference between the rate estimated above and the current rate in the B/S would be recognised in OCI if the entity elected to use 'OCI solution'



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IASB – Current alternatives

- The 2013 ED proposal to adopt a "mirroring approach" seems to have been abandoned given the extensive negative feedback received
- Alternative proposals on the table could change the accounting of CSM by including "insurer's share of underlying items" i.e. estimates of future shareholder transfers
- Three conditions could apply:
 1. the returns to be passed to the policyholder arise from the underlying items the entity holds (regardless of whether the entity is required to hold those items or whether the entity has discretion over the payments to policyholders) e.g. profits from non-profit business;
 2. there is a minimum fixed or determinable amount that the entity must retain e.g. guaranteed sum assured plus reversionary bonuses; and
 3. the policyholder will receive a substantial share of the total return on underlying items e.g. large proportion of excess of asset share over guaranteed benefits
- Conditions 1 and 2 could also apply to have an asset based unwind of discounting referred to as the "book yield approach" to accommodate business currently accounted for on book value basis



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A possible IFRS outcome

- The key measurement requirement is unchanged:
Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the portfolio of contracts and include payments arising from existing contracts that provide policyholders with a share in the returns on underlying items, regardless of whether those payments are made to current or future policyholders.
- The CSM accounting would be based on a more complex calculation with a third element being the insurer's share of the underlying items future returns aligned with the payments to current or future policyholders.
- The IASB "implicit fee" discussion suggests the CSM to be split between insurer's share associated with current and future policyholders. Only the former component could be captured in specific cohorts that follow the general principles set out for non-participating contracts.
- The CSM representing the insurer's share associated with future policyholders could give visibility to the estimate of a company's share of an inherited estate.



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A possible IFRS outcome

- The IASB is uncomfortable to use bonus declaration as the driver of CSM release to profit or loss.
- This would represent a significant change to the IFRS profit release currently used in across the UK industry.
- IFRS 9 gives companies to choose the accounting method for assets between book value and fair value. It is important that the liability accounting aligns with IFRS 9 i.e. use of market yields for fair value of assets and use of book yields for book value of assets.
- The possibility of an IFRS 15 approach to measure the profit for the services delivered in the period would produce a different profit profile and it could introduce a degree of earnings volatility.



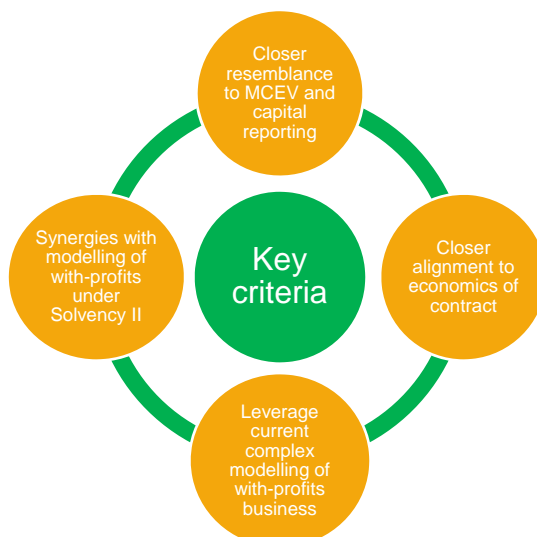
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Profits to shareholders

IFRS 4 Phase II impacts the profits distributed to shareholders for UK insurance business:

- For **non-participating business**, the transfers to shareholders are driven by IFRS profits, which IFRS 4 Phase II potentially changes; and
- For **participating business**, the transfers to shareholders are underpinned by legal restrictions on how these can be made from the fund (typically, through the “90/10 gate”). IFRS 4 Phase II profits need to be aligned to this to reflect the shareholder interest appropriately. Any participating system that involves smoothing or deferral of shareholder transfers will have this issue.

Is there a better way?



Deloitte illustration

Features

- 10 year regular premium endowment contract
- Shareholder transfers distributed through 90/10 gate
- For simplicity, assuming that smoothing reserve and cost of guarantees are zero
- Expected 4% p.a. investment return
- Expected 4% reversionary bonuses
- Terminal bonus set to pay 100% of asset share at end of 10 years
- Estate within the fund (all distributed to policyholders)
- No allowance for any discounting for simplicity
- Uniform run-off of risk margin



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Deloitte illustration

Some scenarios

We consider some economic scenarios that would lead to changes in the shareholders transfers relative to the Base case (as described on previous slide):

- Base case
- 20% fall in investment returns in Year 5
- 30% increase in investment returns in Year 7
- Increase in the reversionary bonus rate from 2% to 6% in Years 8, 9 and 10

Illustration is deliberately simple to highlight the impacts of investment returns and bonus decisions on the CSM, which is a significant area of uncertainty.



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Deloitte illustration

Profit & Loss

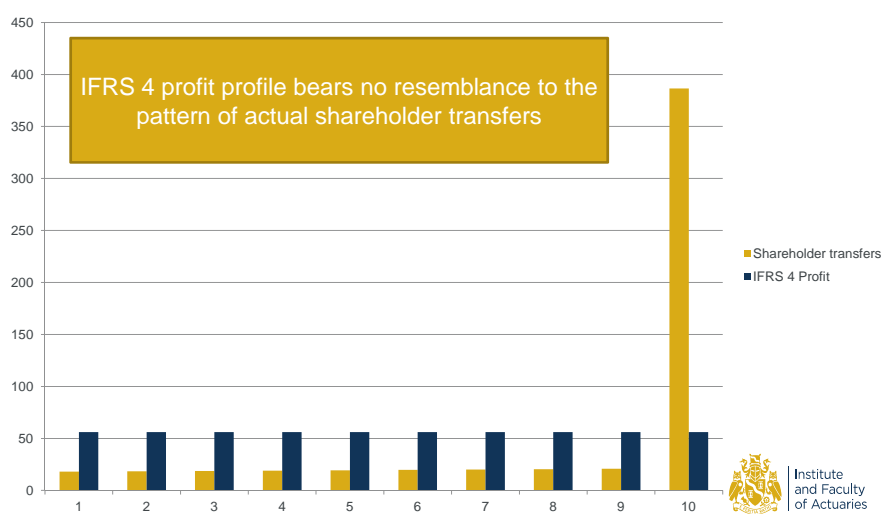
- CSM on Day 1 is intended to be the present value of future shareholder transfers
- For **non-participating business**, the CSM is the balancing item once the BEL and Risk Adjustment have been calculated, representing the present value of expected shareholder transfers
- For **UK with-profits business**, the CSM should be the shareholder transfers, and therefore, the BEL represents the balancing item between the assets in the fund (including the estate) and the shareholder transfers. The BEL is effectively the following:
 - Value of the guaranteed benefits
 - Future bonuses to current policyholders
 - Future bonuses to future policyholders (i.e. the estate)



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Deloitte illustration

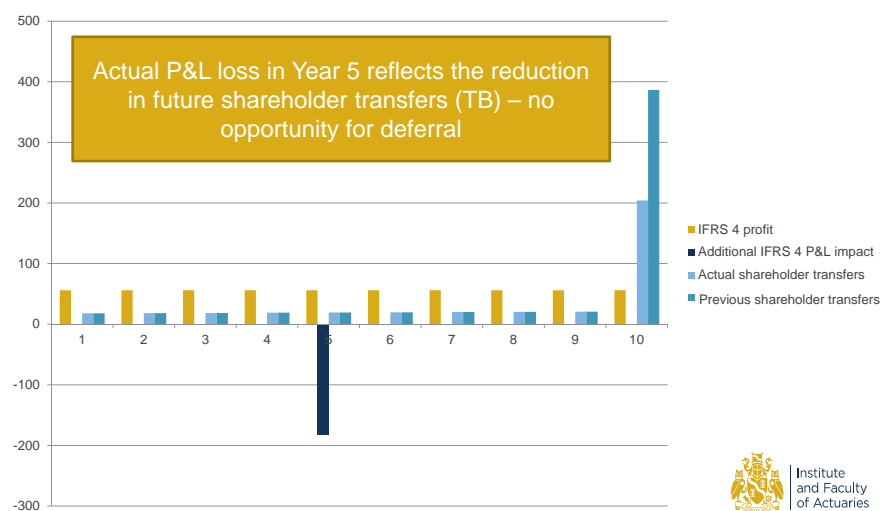
Base case



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Deloitte illustration

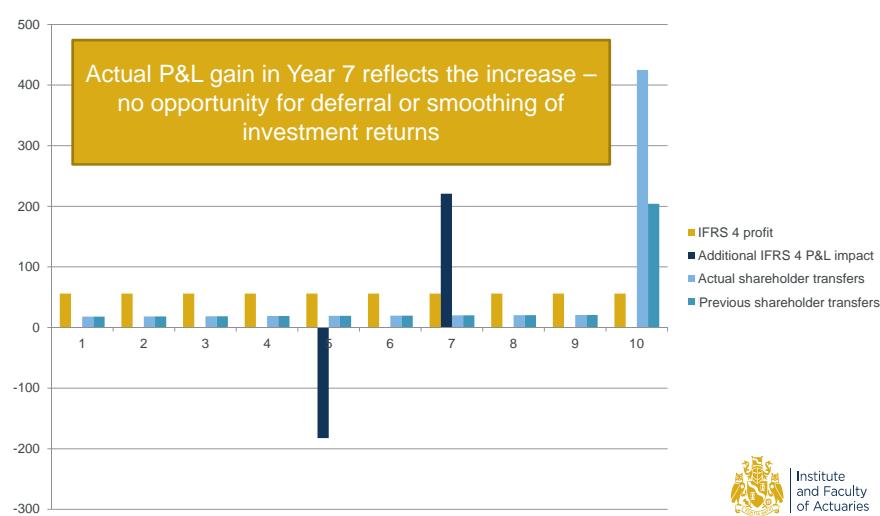
20% fall in investment returns in Year 5



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Deloitte illustration

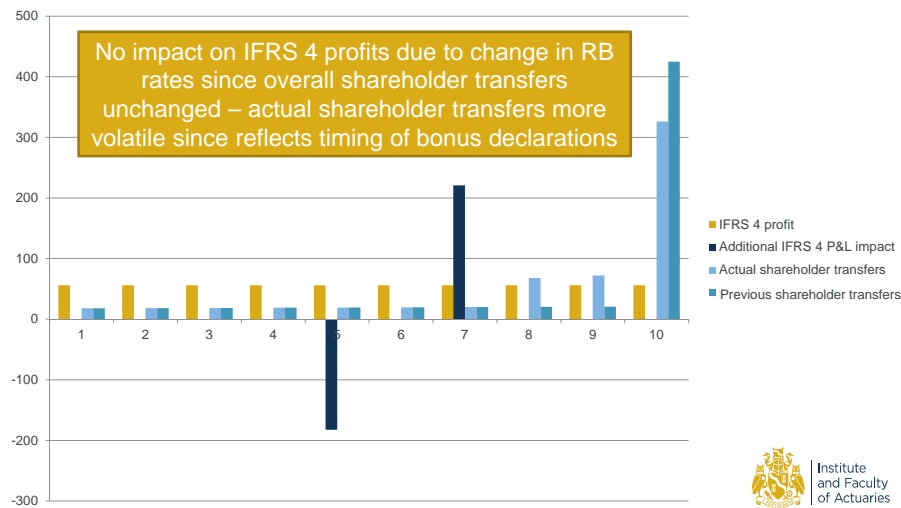
30% increase in investment returns in Year 7



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Deloitte illustration

Increase in RB rate to 6% in Years 8 to 10



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Deloitte illustration

Summary

- Under the IASB proposal, any changes in investment returns during the duration of the contract would flow through P&L rather than through the CSM, and therefore, would lead to significant volatility in profits for a with-profits contract.
- Unless IFRS 4 profits are aligned to shareholder transfers, there will be significant volatility in the P&L account and a mismatch between reality, which will require further explanation / clarification for key stakeholders.
- CSM releases need to reflect actual distribution of shareholder transfers if they are to be representative of the way a with-profits contracts works.

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Practical implications

Feature	IASB mirroring approach	Deloitte proposal	
Practical modelling of with-profits	Difficult given the need to bifurcate cash flows	In line with existing modelling of with-profits	↑
Shareholder transfer vs. emergence of IFRS profit	Quite different as per previous slide	Similar to current profit profile	↑
Day 1 profits	PVFST at outset	PVFST at outset	↔
Transition	Difficult given the need to bifurcate cash flows	In line with existing modelling of with-profits	↑
Unlocking the CSM – changing the bonus rates	Uniformly over the duration of the contract	In line with the actual bonus declarations	↑
Calculating the risk adjustment	Leverage from risk margin calculation under Solvency II	Leverage from risk margin calculation under Solvency II	↔
Management actions	Internal driven decisions, so flow through the CSM	Internal driven decisions, so flow through the CSM	↔
Policyholder behaviour	Internal driven decisions, so flow through the CSM	Internal driven decisions, so flow through the CSM	↑
Economic changes	P&L	CSM	↑
Non-economic changes	CSM	CSM	↑

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IASB next steps (1/2)

Remaining issues to be discussed

- On participating contracts the IASB will decide on:
 - Measurement of fulfilment cash flow
 - Where changes in estimates are presented
 - The identification of underlying items, specifically *the insurer's share, the book yield approach and what amounts should adjust the CSM?*
 - Presentation
- The final targeted topic is the transition requirements for the first time adoption for participating business including the new IFRS effective date

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IASB next steps (2/2)

Likely effective date

- The drifting of the re-deliberations to 2015 will put pressure on the choice of 1/1/2018 as the effective date and 1/1/2019 is now an equally possible choice for the IASB.
- Publication of a final standard is expected towards end of 2015 but feasibly early 2016.
- Effective date of the standard will be “approximately three years from date of publication of the final IFRS”.
- It is desirable for Insurers to apply IFRS 4 Phase II at the same time as IFRS 9 *Financial Instruments*. If the IASB completes its deliberations in Q2 2015 the most likely effective date is unlikely to be before 1 January 2019 - but companies can early adopt.



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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 presenters.



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