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IFRS 17 *Insurance Contracts* is coming Has the wait been worth it?

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Agenda

- Timeline & developments in current and future insurance accounting
- Practical examples and operational considerations from IFRS 17
- So has the wait been worth it?

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Timeline & developments in current and future insurance accounting

What is happening to current and future accounting?

March 2017

Current known timeline – November 2016

IFRS standards	2016	2017	2018	2019	2020	2021
Insurance contracts (IFRS 17)	Targeted Testing	Final standard				Effective 1 January 2021
Financial assets/liabilities (IFRS 9)	Revision to IFRS 4		Effective 1 January 2018 (most) & 2021 (insurers sunset clause)			
Revenue (IFRS 15)			Effective 1 January 2018			
New UK GAAP	FRS 102/103 effective since 1 January 2015					
MCEV & EEV Principles	Update published May 2016					
	Mind the Gap ... What could insurers adopt in the gap period between Solvency II and IFRS 17?					

- Investment contract accounting (e.g. unit linked savings) is **unchanged** by IFRS 17.
- **Significant disconnect** in life business for the 1st time between accounting and solvency reporting from 1 January 2016.
- All IFRS standards are subject to EU endorsement
- FASB (in US) decided in 2014 to amend US GAAP with a “targeted improvement” exposure draft issued in September 2016. So no global accounting standard for insurance.

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What happens to accounting during the 'gap period'?

For insurance contracts (including with-profits) only

- Possible options:
  - Maintain current approach typically linked to Solvency I / PRA return.
  - Adopt elements of Solvency II or a modified version.
- Permissibility or not of a change is dependent on current accounting, notably:
  - Mutual vs. proprietary; IFRS vs. UK GAAP (and "type" of reporter in these categories).
  - Current level of prudence; allowance for risk; inclusion of investment margins; and uniformity.
- Assessment required as to whether a change in estimate (impacting P&L) or a permissible change in accounting policy (restatement of prior periods).
- Likely to be "red-lines" relating to the Solvency II volatility adjustment, transitional measures on technical provisions and treatment of surplus funds in with-profit funds.
- Market experience to HY16: Limited refinements; potential for more significant changes from FY16 onwards?

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What happens to accounting during the 'gap period'?

Business and operational considerations

- Impact on tax
- Operational and cost benefits (e.g. model runs, multiple restatements)
- Impact of Solvency II ALM / capital optimisation on IFRS performance
- 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.)
- Solvency I still required for transitional measure reset?
- Parent versus subsidiary accounts; or partial application

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IFRS 17 – Several models

Classification	Description	Likely contracts	Model
'Long term' non-participating	• No cash flows that vary with returns from underlying assets.	**Immediate annuities** **Term assurance**	**Building block approach**
'Direct' participating	• Participate in a share of clearly identified pool of underlying items. • Expect to pay out a substantial share of the fair value returns from these items. • Substantial portion of the change in the amounts to be paid out vary with the change in fair value from these items.	**UK with-profits** **Unit linked insurance**	**Variable fee approach**
'Indirect' participating	• Where direct criteria are not met.	Certain US universal life & US fixed annuities	Building block approach with some adjustments
'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, certain group contracts etc.	Pre-claims liability: Premium allocation approach Claims liability: Building block approach

Note:
- There are requirements to unbundle distinct investment components and goods & services and certain embedded derivatives. These are then accounted for under other IFRS standards.
- Investment contracts (e.g. unit linked savings) will remain under IFRS 9 (currently IAS 39) and IFRS 15 (currently IAS 18).

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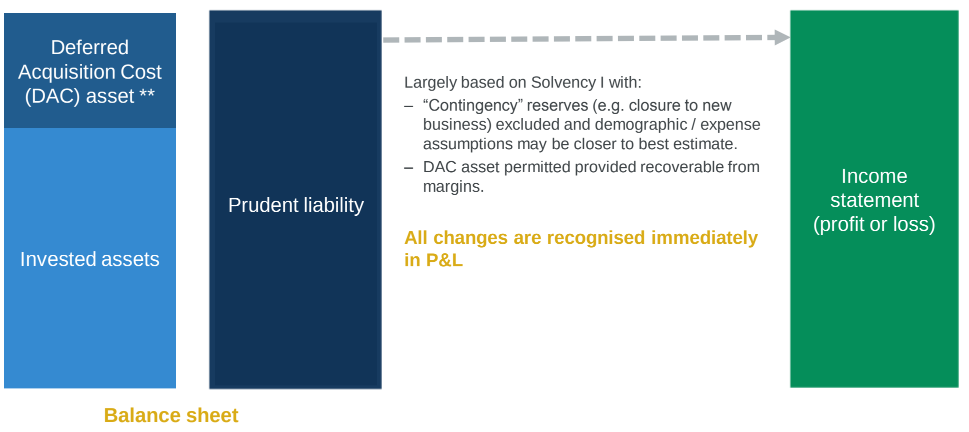
Current UK accounting *

Immediate annuities and protection contracts



* Notable exceptions for UK-headquartered bancassurers who adopt EV-accounting and some UK subsidiaries of overseas companies who adopt headquartered country accounting.
** Typically nil for immediate annuities.

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Building block approach – Overview

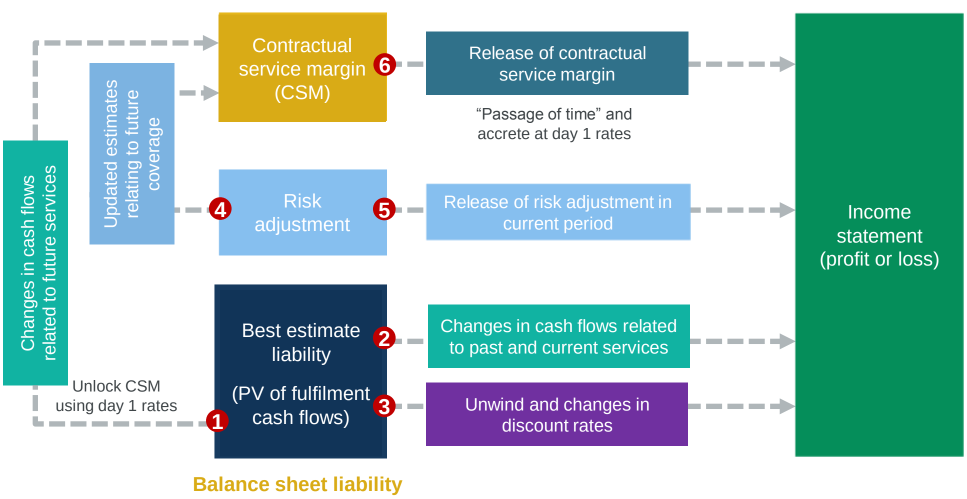
Applicable to: Immediate annuities and protection contracts

	Key features	Comparison to Solvency II
Contractual service margin (CSM)	• Deferral of day 1 profit, but day 1 losses recognised. • Unit of account: 3 groups per portfolio per annual cohort. • Assessed using day 1 ("locked-in") rates. • Not a current measure of expected future profit.	• Not applicable (Solvency vs. Profit reporting)
Risk adjustment	• *'Compensation … for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contracts.'* • No limitation on method or prescribed level of diversification • Equivalent confidence level disclosure required.	• Greater flexibility in approach and calibration in IFRS. • Different objectives (e.g. fulfilment vs. transfer value). • Net of reinsurance in Solvency II (IFRS is gross) • No transitional measure relief in IFRS. • New splits will be required in IFRS.
Best estimate liability (PV of fulfilment cash flows)	• Explicit, unbiased, probability-weighted estimate (expected value) of future cash flows. • Certain acquisition expenses are a cash flow, so deferred (no DAC) • Discount rate reflect the characteristics of the cash flows (timing, currency, liquidity). Top down or bottom up approach permitted.	Many components similar, however: • Certain different cash flows? • Potentially a different contract boundary? • Restrictions in MA vs. top down approach? • VA not applicable in IFRS. • Would UFR in Solvency II be acceptable?

Balance sheet liability

Building block approach – Flows to profit

Applicable to: Immediate annuities and protection contracts



- For UK insurers, all changes in asset likely to be in P&L.
- Option to present the impact of changes in the discount rate on BEL and Risk Adjustment in OCI (part of equity). Treatment of assets under IFRS 9 will be a key consideration in using this option.

Profit drivers and income statement presentation

All different to current accounting

Profit drivers
Release of day-1 profit (CSM amortisation)
Release from risk (risk adjustment)
Day-1 loss recognition
Investment margin (difference between investment return and interest expense, plus return on surplus assets)
Experience variances
Certain indirect and corporate expenses

Prescribed income statement presentation
Revenue allocated to periods using an "earned premium" model[1]
Claims and expenses incurred[1]
Underwriting result
Investment income
Interest expense
Net interest and investment
Profit or loss
Other comprehensive income (OCI)
Total comprehensive income[2]

[1] 'Deposit' elements excluded from revenue and claims.
Experience variances implicitly reflected within revenue and claims and expenses thus they are not shown separately
Fee income (for unbundled products or investment products) would also be expected to be presented in the P&L

[2] Operating profit – likely to still exist in the UK and will be determined by insurers themselves

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Variable fee approach

Applicable to: With-profit and unit linked contracts

Similar principles to the Building Block Approach with certain revisions, including:

Topic	Building block approach	Variable fee approach
Changes in amounts supporting insurer's share ('variable fee')	• Not directly relevant, but would be recognised in P&L (for most UK insurers)	• **Posted to CSM** (e.g. change in unit linked AMCs and shareholders' share of future with profit transfers) and **recognised over contract lifetime**.
Changes in (certain) cash flows due to market variables*	• Recognise in CSM or P&L / OCI (depending on option for changes in discount rate)	• **Posted to CSM**, but **permitted** to present in P&L where there is **risk mitigation** to avoid an accounting mismatch(e.g. derivatives to P&L).
Release of CSM to P&L	• 'Straight-line' (i.e. passage of time reflect the contracts remaining in force) • Inception rates to unlock and accrete	• 'Straight-line', potential uncertainty over application (e.g. open with-profit funds)? • **Current** rates to unlock and accrete

* Expected to be a 'market consistent' assessment of options & guarantees

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Transition

Assessing the 'day 1' CSM on existing business

Full retrospective

If "impracticable"

Modified retrospective

OR

Fair value

Observations

- Likelihood of data at required level of granularity for full or modified retrospective? Will the approaches be possible?
- Risk of unintended consequences from 'simplifications'.
- Fair value vs. Fulfilment value.
- Market experience of fair value assessments from acquisition accounting (wide practice).
- Overall impact of transition on future profitability of existing business and recycling of 'old' or loss of 'new' profits.
- Potential for two transitions where past acquisitions (e.g. group vs. local accounts).

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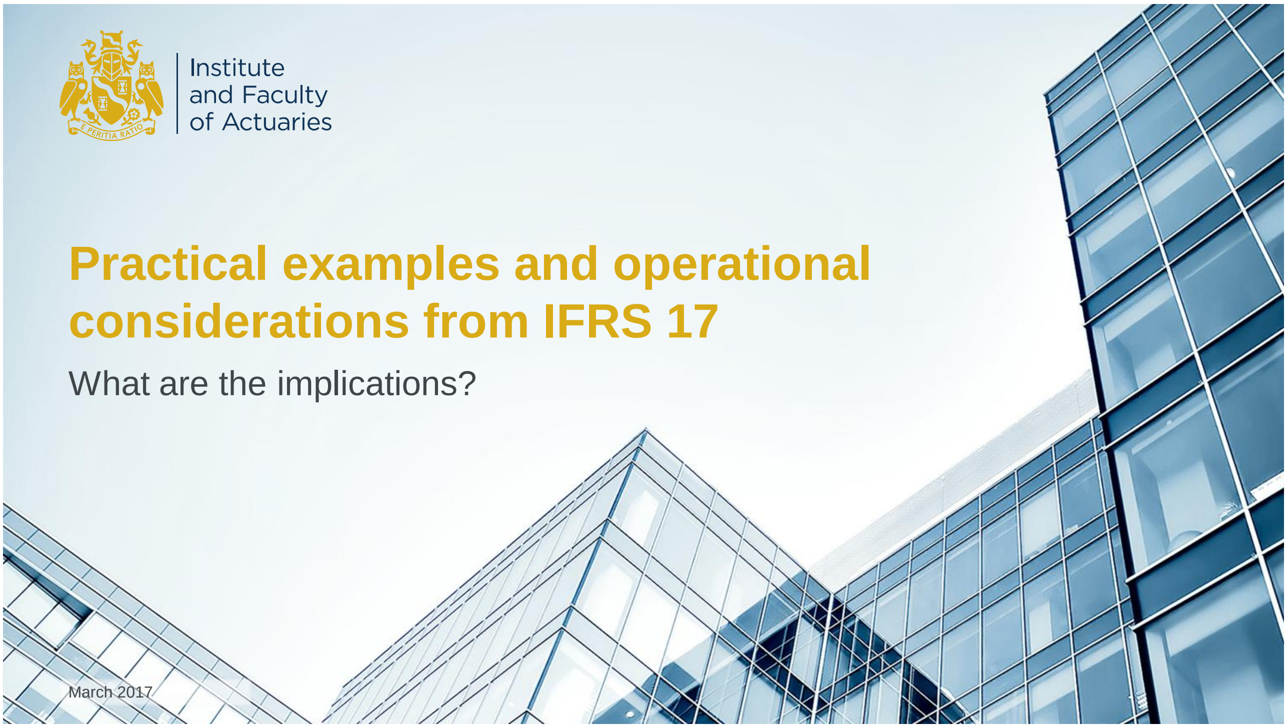
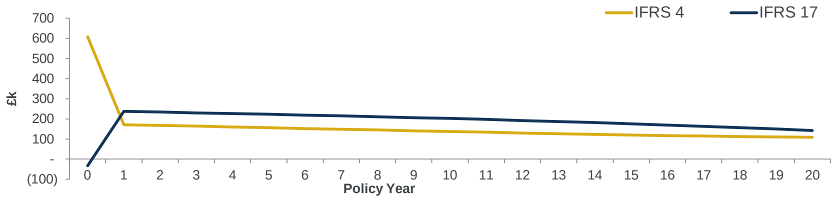


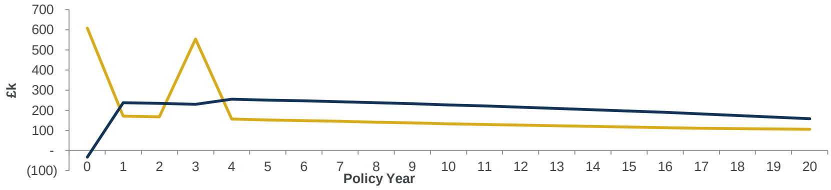
Example 1 – Portfolio of immediate annuities

Impact of the CSM

Base case



Instantaneous stress in mortality rates (increase by 10%) at the end of year 3.



Example 2 – Protection contracts

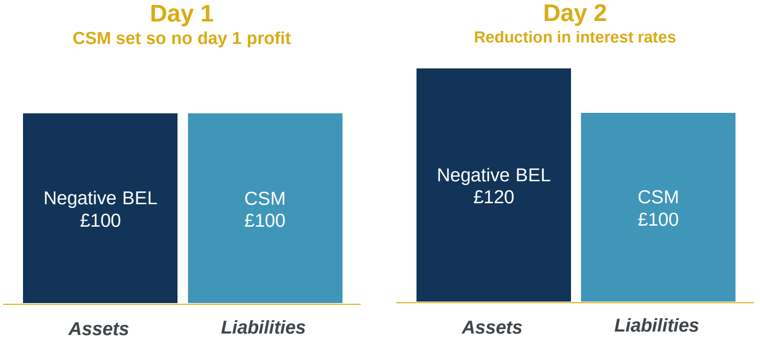
Interaction between best estimate liabilities and CSM (illustrative figures)

Specification

- Portfolio of regular premium term assurances (single unit of account).
- **Expected to be profitable** at outset.
- Ignore the risk adjustment.
- All changes in discount rates taken to P&L

Potential solutions

- Mismatch in P&L can be resolved through posting impact to OCI, but mismatch in equity will remain.
- Can the CSM be considered as a series of cash flows that are re-measured each periods (rather than a deferred balance)?

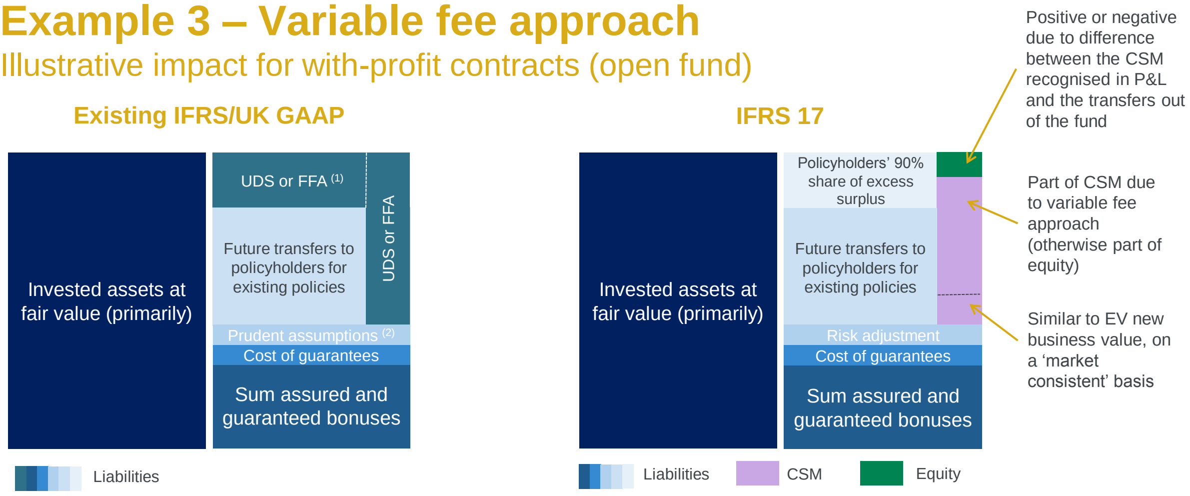


Profit of 20 to P&L on Day 2

Example 3 – Variable fee approach

Illustrative impact for with-profit contracts (open fund)

Existing IFRS/UK GAAP | **IFRS 17**



- Based on Solvency I with adjustments (e.g. shareholder share, non-profit VIF).
- UDS/FFA results in "cash" accounting (e.g. profit is shareholder share of bonuses or nil for a mutual).

- Acceleration of profit compared to today as not linked to bonus declaration.
- No concept of 'surplus funds' as in Solvency II

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(1) For a closed with-profit fund the policyholders' 90% share of excess surplus is in the policyholder liabilities rather than UDS (or FFA)
(2) Where applicable, some insurers adopt a best estimate

IASB decisions in November 2016 and February 2017

- Unit of account:
  - Simplified to require only 3 groups per annual cohort per portfolio.
  - Can group contracts where ability to set a different price is restricted by regulation.
- Transition: Simplifications allowed through the modified retrospective and fair value approaches.
- Experience adjustments: The impact on past and current periods is taken to P&L while the impact on future periods is taken to CSM
- Hedging: Hedging exception extended under the VFA so that changes in the variable fee can be treated consistently with changes in hedging instruments.

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Potential remaining concerns

- Testing: The standard, when taken as a whole, has not been fully tried and tested to ensure that it passes the cost/benefit test.
- Unit of account / granularity:
  - Operationally complex, in particular separate annual groups requirement
  - Does not reflect insurance business model
- Scope of VFA: May result in economically similar products being treated in an inconsistent manner.
- Hedging: Restriction of the hedging adjustment to the VFA and to be prospective at transition will lead to accounting mismatches.
- Locked-in rate: The use of a locked rate to accrete interest on the CSM for non-VFA business will lead to accounting mismatches.

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Potential key impact on operating model: High Medium Low No Impact

Operational considerations

Best Estimate Liabilities		
Process	Apps/Data	Infrastructure

- Cash flows similar to Solvency II
- Differences in discount rate, contract boundary, expenses ?
- Enhance infrastructure due to extra model runs being required
- More detailed granular output
- May need to accelerate timeline

Risk Adjustment		
Process	Apps/Data	Infrastructure

- Flexibility in approach
- Different calibration to Solvency II ?
- More granular analysis required
- Accelerate reporting requirement
- Materiality may allow simplifications

CSM		
Process	Apps/Data	Infrastructure

- Not part of Solvency II requirements
- New processes, data and systems required.
- Granularity drives data storage needs and solution complexity

Transition		
Process	Apps/Data	Infrastructure

- One-off exercise
- Significant historic data required
- Opportunity to retain data now
- Consider comparative periods

Disclosures		
Process	Apps/Data	Infrastructure

- Accounts re-defined to meet disclosure requirements
- Impacts reporting and consolidation systems
- New data splits/outputs will be required from actuarial models

Other impacts		
Process	Apps/Data	Infrastructure

- No anticipated impact on policy administration systems
- Cohort flagging needed
- Revisions to general ledger and chart of accounts may be required

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Questions Comments

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