IFRS 4 Phase II: Friend or Foe?

9 November 2010
Agenda

- Introduction and scope
- Measurement models
- Profit and liability profiles
- Contrasting IFRS II and Solvency II
- Implementing the changes
Introduction and scope
The International Accounting Standards Board (IASB) has published the exposure draft Insurance Contracts: ‘to propose significant improvements to the accounting for insurance contracts. Such improvements are needed urgently. Many users of financial statements describe insurance accounting today as a ‘black box’ that does not provide them with relevant information about an insurer’s financial position and financial performance.’

The proposals in the exposure draft, if confirmed, would:

a. Provide a comprehensive framework that will require insurers to provide information that is relevant to users of financial statements for economic decision-making

b. Eliminate inconsistencies and weaknesses in existing practices, by replacing IFRS 4 *Insurance Contracts*

c. Provide comparability across entities, jurisdictions and capital markets
## Project timelines

<table>
<thead>
<tr>
<th>Phase I</th>
<th>Phase II</th>
<th>Implementation</th>
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<tbody>
<tr>
<td>IFRS 4 Insurance Contracts</td>
<td>IASB – discussion paper issued</td>
<td>End of comment period (IASB and FASB)</td>
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<td>FASB – invitation to comment</td>
<td>End of comment period (FASB)</td>
<td>IASB and FASB meetings to develop accounting standards</td>
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<tr>
<td>Oct 2008</td>
<td>Jan 2009 to Jul 2010</td>
<td>Final standard</td>
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<tr>
<td>FASB – Joined the project</td>
<td>Exposure draft</td>
<td>Jun 2010</td>
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<tr>
<td>2009</td>
<td>2010</td>
<td>Jun 2011</td>
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Project scope

- The exposure draft excludes from its scope:
  - Warranties issued by a manufacturer, dealer or retailer as part of the sale of a product (stand-alone warranties are in scope)
  - Residual value guarantees embedded in a lease or provided by a manufacturer, dealer or retailer
  - Employee benefit plans
  - Contingent consideration in a business combination
  - Excludes fixed-fee service contract

- The exposure draft includes in its scope:
  - Financial guarantee contracts stay within the scope of IFRS 4
  - Mortgage guarantee insurance contracts
  - Credit insurance contracts
Definition of insurance contract

- The ED retains the IFRS 4 definition of an insurance contract and related guidance. Specifically:
  - An insurance contract is a contract where the insurer accepts significant insurance risk from the policyholder by agreeing to compensate the policyholder if specified uncertain future events adversely affect the policyholder.
  - The guidance in IFRS 4 will be used to determine whether the insurance risk is significant. Significance of insurance risk is based on present value, rather than an absolute value.
  - Contractual terms that delay the timely reimbursement to the policyholder can significantly reduce insurance risk.
  - The definition does not capture:
    - Contracts that pay out on a change in credit rating or change in credit index, rather than on the failure of a specified debtor to make payments when due.
    - Contracts that pay out regardless of whether the counterparty holds the underlying debt instrument.
Unbundling

• Any components that are not closely related relate to the insurance coverage
  – Account balance that meets both conditions:
    – Account balance that is credited with explicit return
    – Crediting rate is based on investment performance of underlying assets
  – Embedded derivatives
  – Goods and services not closely related
• No unbundling of components closely related to the insurance coverage
Measurement models
Phase II highlights
Building block approach

IASB model:

1. Expected future cash flows
2. Discounting
3. Risk margin
4. Residual margin
5. Unallocated premium reserve for pre claims non-life short duration contracts

Present value of fulfilment cash flows

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## Phase II highlights: IASB model

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<tbody>
<tr>
<td><strong>Initial</strong></td>
<td>• Recognise when ‘on risk’</td>
<td>• Reflect characteristics of contract</td>
<td>• Cost of capital, conditional tail expectation or confidence level methodology</td>
<td>• Eliminate day 1 gain</td>
<td>• Mandated for contracts less than one year coverage</td>
</tr>
<tr>
<td></td>
<td>• Unbiased probability weighted cash flows</td>
<td>• Exclude ‘own credit risk’</td>
<td>• Portfolio level</td>
<td>• Interest accretion</td>
<td>• Amortise incremental acquisition costs</td>
</tr>
<tr>
<td></td>
<td>• At contract/portfolio level</td>
<td>• Risk free rate plus allowance for illiquidity</td>
<td>• No diversification between portfolios</td>
<td>• Cohort level (date of inception and duration of policies)</td>
<td>• Onerous contract test based on fulfilment cash flows</td>
</tr>
<tr>
<td></td>
<td>• At inception includes incremental acquisition costs</td>
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<td></td>
<td>• Effectively reduced by day 1 incremental acquisition cash flows</td>
<td>• Contract level</td>
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<tr>
<td><strong>Subsequent</strong></td>
<td>• Re-measured</td>
<td>• Re-measured</td>
<td>• Re-measured</td>
<td>• Not re-measured</td>
<td>• Release over ‘coverage period’</td>
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<td>• Release over ‘coverage period’</td>
<td>• Onerous contract test</td>
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<td></td>
<td></td>
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<td></td>
<td>• Interest at inception rates</td>
<td>• Once claim incurred or accrued use fulfilment model for that part of liability</td>
</tr>
<tr>
<td><strong>Presentation</strong></td>
<td>• Reconcile opening to closing balance</td>
<td>• Need to disclose discount rate applied</td>
<td>• Reconcile opening to closing balance</td>
<td>• Reconcile opening to closing balance</td>
<td>• Reconcile opening to closing balance including premiums, claims, expenses and amortisation of acquisition expenses</td>
</tr>
<tr>
<td>and disclosures</td>
<td>• Present separately changes in experience and estimates</td>
<td>• Present changes in discount rate and interest accretion</td>
<td>• Present changes in risk adjustment</td>
<td>• Disclose the methodology basis, inputs to calculate risk margin and the equivalent confidence level</td>
<td>• Disclosure of additional liabilities for onerous contracts</td>
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<td></td>
<td>• Disclosures currently in IFRS 4 and 7</td>
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IFRS 4 Ph II Model – how does it work?

**Diagram 1: profitable contract**
- PV of future cash inflows
- PV of future cash outflows 1
- FASB: composite margin
- Nil

**Diagram 2: loss generating contract**
- PV of future cash inflows
- PV of future cash outflows 1
- FASB: composite margin
- Risk adjustment

**Cash inflows**
- Premiums, including initial premiums and instalments
- Potential recoveries (e.g., salvage and subrogation)

**Cash outflows**
- Costs of selling, underwriting, and initiating successful insurance contracts
- Transaction-based taxes and levies
- Payments to (or on behalf of) policyholders, including payments in kind
- Claim handling costs
- Cash flows that will result from options and guarantees embedded in the contract
- Policy administration and maintenance costs
- Payments to policyholders as a result of a contractual participation term
Discounting

- Reflect the characteristics of the contract, rather than the characteristics of assets backing the contract (unless the contract and asset share those characteristics):
  - Consistent with observable market prices for cash flows with same characteristics (timing, currency, liquidity)
  - Adjust observed market prices for risks and liquidity characteristics of the insurance contract
  - If the amount, timing or uncertainty of cash flows for the insurance contracts depends, wholly or partly, on the performance of specific assets, the measurement of these contracts should consider that fact
  - Not include risk that is accounted for elsewhere (expected cash flows or risk adjustment)
  - Re-measured every reporting period and changes in P&L

- Non-performance risk by the insurer
  - The measurement of an insurance liability should not be updated for changes in the risk of non-performance by the insurer
Risk adjustment

- Maximum amount the insurer would rationally pay to be released from risk
- Risk adjustment should be re-measured every reporting period (through P&L)
- Three methods allowed, depending on the circumstances:
  - Confidence level
  - Conditional tail expectation
  - Cost of capital
- Level of measurement is portfolio of insurance contracts
  - No diversification or negative correlation between portfolios
Contrasting IASB and FASB models

- The building block measurement approach for insurance contracts should ‘portray a current assessment of the insurer’s obligation’ using a framework with significant market consistent components

<table>
<thead>
<tr>
<th>IASB</th>
<th>FASB</th>
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<tr>
<td>Unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation</td>
<td>Unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation</td>
</tr>
<tr>
<td>Time value of money (discount)</td>
<td>Time value of money (discount)</td>
</tr>
<tr>
<td>Risk adjustment</td>
<td>An amount that eliminates any gain at inception of the contract (composite margin)</td>
</tr>
<tr>
<td>Residual margin</td>
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</table>

- A risk adjustment for the insurer’s view of the uncertainty (amount and timing) associated with the future cash flows to be relieved of risk (IAS 37)
- The residual margin represents an amount that eliminates any gain at inception of the contract minus an amount equal to the incremental acquisition cost

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# High level impacts IFRS 4 phase II

*Multiple dimensions affected*

## Policies
- Additional/changes to IFRS policies
- Anticipation of changes to product features due to changes in profit signatures, regulatory capital

## Governance
- Common policies and procedures over assumptions (e.g., discount rates) at geographical and line of business level
- Governance and controls frameworks updated

## Process and controls
- Significant changes to financial statement presentation and disclosures; new processes and controls
- Prior year comparison and restatement process

## Performance management and MI
- Alignment of financial and management reporting metrics and processes
- ‘Capital’ and ‘earnings/profit’ metrics will become more aligned

## People
- Multiple stakeholder management (internal and external)
- Training and communication
- Resource management (BAU vs. Project)
High level impacts IFRS 4 phase II

Key data and systems impacts

Data
- Policy data at IFRS 4 portfolio level
- Data to support unbundling of contracts
- Cash flows to model options and guarantees
- Reconciliation of data between systems (interfacing)

Modelling
- New models to calculate residual margin
- Amortisation engine to model release to income over coverage period
- Flexibility to update assumptions and to re-run cash flows
- Discounting of non-life cash flows

Reporting and disclosures
- Chart of Accounts changes to reflect the new presentation format and disclosures
- Updates to business unit reporting packs and consolidation tools
- Capability to analyse result
Profit and liability profiles
Valuation of liabilities

Liability models

- Allowance for incremental acquisition costs
- Total Premium (less allowance for acquisition costs)
- Premium

Residual margin
- Risk adjustment
- Discounted current estimate of future cash flows
- IASB liability model

Composite margin
- Discounted current estimate of future cash flows
- FASB liability model
Annuity liability

Phase 1
Phase 2 without residual margin
Phase 2 with residual margin
Annuity liability
Protection – profit profile
## Analysis of Profit – Insurance Contracts

<table>
<thead>
<tr>
<th>IFRS Phase 2</th>
<th>IFRS 4 (profit drivers)</th>
<th>MCEV</th>
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<tbody>
<tr>
<td><strong>Existing Business</strong></td>
<td><strong>Existing Business</strong></td>
<td><strong>Existing Business</strong></td>
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<tr>
<td>Change in the risk adjustment</td>
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<td>Release of residual margin</td>
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<td>(Amortisation of DAC)</td>
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<td>Expected release of margins</td>
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<td>Unwind of discount rate (VIF)</td>
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<td>Cash flow variances (v liabilities)</td>
<td>Cash flow variances (v liabilities)</td>
<td>Cash flow variances (v VIF)</td>
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<tr>
<td>Changes in estimate (liabilities)</td>
<td>Changes in estimate (liabilities)</td>
<td>Changes in estimate (liabs &amp; VIF)</td>
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<th><strong>New Business</strong></th>
<th><strong>New Business</strong></th>
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<td>Losses on initial recognition</td>
<td>New business strain / surplus</td>
<td>New business value added</td>
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<tr>
<td>Non-incremental acquisition costs</td>
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<th>+/- Investment Volatility</th>
<th>+/- Investment Volatility</th>
<th>+/- Investment Volatility</th>
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| Profit (insurance contracts) | Profit (insurance contracts) | Profit (insurance contracts) |
Contrasting IFRS II and Solvency II
IFRS 4 Phase II and Solvency II

Solvency II balance sheet

Own funds
- Net Assets at fair value
  - Best estimate liability
  - Risk margin
  - DTL
  - SCR
- Free surplus
- MCR

IFRS Balance sheet

Goodwill
- S/H equity
- DTL
- Residual margin
- Risk adj
- Best estimate liability

Phase II of insurance contracts

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Key differences between Phase II and Solvency II

**Risk margin**
IFRS permits three methods for the risk adjustment, but firms likely to use Cost of Capital approach for consistency with Solvency II. However, key differences exist regarding the level of diversification benefits, with Solvency II setting these at legal entity level, but IFRS limiting diversification to within a portfolio of contracts.

**Unbundling and contract boundary**
IFRS introduces mandatory unbundling requirements for components of the insurance contract which are not considered to be “closely related” to the insurance coverage. The recognition of regular premiums is likely to vary on some contracts, eg, Group risk and reviewable term.

**Expenses**
Phase II requires only the costs related to managing the insurance contracts to be included within the liability measurement. This would exclude overhead expenses and possibly investment expenses arising from risk contracts. Phase II would require firms to ‘look through’ to actual expenses within the Group rather use fee arrangements.

**Discount rate and liquidity premium**
Solvency II QIS5 has used a risk free rate based on Swaps - 10bps, with a prescribed liquidity premium. For Phase II the liquidity premium will be justified relative to the characteristics of the liabilities. Whilst the relative positions are still under debate it is likely the final positions will differ.
Overlaps between Solvency II and IFRS

- **Pillar 1**: Capital requirement
  - Solvency II: P&L attribution
  - IFRS: Residual margin and short duration contracts
- **Pillar 2**: Governance, processes and controls
- **Pillar 3**: ORSA and Internal model disclosures
  - Balance sheet Representation
  - Risk margin
  - Financial and Insurance risk Disclosure
Implementing the changes
# Insurers face multiple other challenges

## Significant overlaps in timetables

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<thead>
<tr>
<th>Phase II</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
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<tbody>
<tr>
<td>Exposure Draft (Q3/Q4)</td>
<td></td>
<td>Final Standard published (June)?</td>
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<td>Effective date to potentially commence 1.1.2014 from 1.1.2013</td>
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<tr>
<td>Solvency II</td>
<td></td>
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<td></td>
<td>Opening balance sheet</td>
<td>Phase II regime commences</td>
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<tr>
<td>Finalise L3 guidance</td>
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<td>Level 3 Implementing measures published and adopted by member states</td>
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<td>Adoption of L2</td>
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<td>2013 Comparatives required</td>
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<td>QIS 5</td>
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<td>IFRS 9: Financial Instruments</td>
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<tr>
<td>Classification and measurement of assets standard</td>
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<td>Hedge accounting standard (Q4/Q1)</td>
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<td>IFRS 9 regime commences</td>
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<tr>
<td>Financial liabilities classification and measurement standard (Q3/Q4)</td>
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<td>Impairment standard (Q4/Q1)</td>
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<td>EU endorsement expected</td>
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<td>Derecognition standard(Q1)</td>
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<td>Other IFRS</td>
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<td>2012 Comparatives required</td>
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<td>Revenue recognition ED (Q2)</td>
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<td>Revenue recognition standard (Q2)</td>
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<tr>
<td>IAS 37 Liabilities standard (Q3/Q4)</td>
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<td>Fair Value measurement standard (Q4/Q1)</td>
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### Finance transformation projects
The incremental challenge
Moving to SII and then to IFRS 4 Phase 2

Incremental project view

Statutory financial statements

Development of robust SII reporting processes, reconcilable to underlying statutory accounts

Solvency II

Incremental development and build off SII work to meet new IFRS reporting requirements

IFRS 9 and Phase II

Target reporting process view

Statutory financial statements

IFRS 9 and Phase II become the new basis

IFRS 9 and Phase II

Robust and reconcilable IFRS and SII Quarterly reporting process

Solvency II
Managing synergies and interdependencies

*Indicative program structures*

<table>
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<th>Portfolio and program management</th>
<th>Change management</th>
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<tr>
<td>(Steerage and inter-dependency management)</td>
<td>(Organisational preparation and resource management)</td>
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<tr>
<th>Solvency II</th>
<th>IFRS 4 Phase II</th>
<th>Transformation projects</th>
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<tbody>
<tr>
<td>Project management</td>
<td>Project management</td>
<td>Project management</td>
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<tr>
<td>Define business requirements</td>
<td>Define business requirements</td>
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<td>Data and systems interface</td>
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<tr>
<th>Data and systems</th>
<th>Financial controls framework</th>
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<tbody>
<tr>
<td>(Systems architecture and IT implementation)</td>
<td>(Standards and documentation)</td>
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## Indicative integrated roadmap

### Leveraging synergies and inter-dependencies

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<th>2010</th>
<th>2011</th>
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<tr>
<td>Q3</td>
<td>Q4</td>
<td>Q1</td>
<td>Q2</td>
<td>Q3</td>
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<tr>
<td>BAU quarterly/half yearly reporting</td>
<td>BAU quarterly/half yearly reporting</td>
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#### Development of Internal Model
- **Impact assessment:**
  - Pillar 2/3 requirements
  - Processes, data systems impacts
- **Data quality and preparation**
- **Design options**

#### Solvency II requirements
- **Set up and scoping**
- **Impact assessment:**
  - Accounting differences
  - Business processes, data systems impacts
  - Design options

#### IFRS requirements
- **Set up and scoping**

#### In-flight finance transformation
- **Optimise capital and model approval**
- **Dry runs and embed**
- **Solution development:**
  - Development of strategic options
  - Aligned with other Finance projects
  - Solvency II specific solutions
- **Restatement strategy**
- **IFRS 9 restatement and comparatives**
- **Financial statement optimisation**

#### Other projects
- **IFRS 4 Phase II milestones**
- **OBS for Phase II**
- **Solvency II Regime begins**
- **Solvency II reporting:**
  - Go live SII Qtrly/Annual reporting
  - Reconciled to Financial/statutory reporting
  - Ongoing reporting process improvement
- **Cut over:**
  - Embed new reporting solutions
  - Go live

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Questions or comments?
Thank you

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