Institute and Faculty of Actuaries

IFRS 17 – beyond implementation, towards commercial implications

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Agenda

- Overview: the changing financial reporting landscape
- IFRS 17: recap of the requirements
- Market reaction: the equity analyst's view
- Implications: understanding and preparing for change

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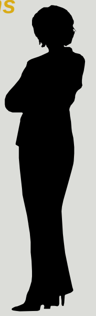
Overview: the changing financial reporting landscape

May 2017

Why is the IASB undertaking project on insurance contracts?

IFRS 4 is an interim standard

Existing policies make comparison across products, companies and jurisdictions difficult



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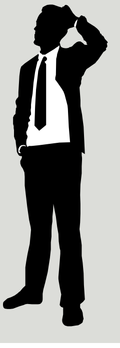


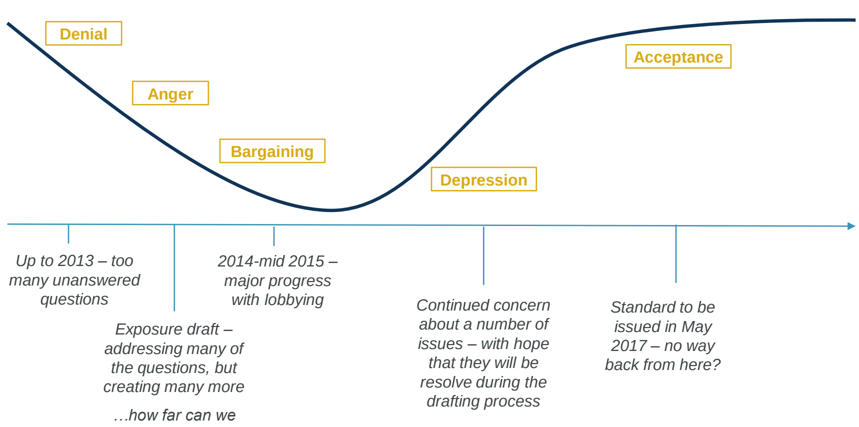
The changing financial reporting landscape

IFRS Standard	2015	2016	2017	2018 onwards
Insurance contracts (IFRS 17)	IASB re-deliberations	Drafting and final standard		Effective 1 January 2021
Financial instruments (IFRS 9)				Effective 1 January 2018, with deferral option to 2021
Revenue (IFRS 15)				Effective 1 January 2018
IAIS ICS				Effective 1 January 2018
Hong Kong RBC			QIS and publication of Pillar 1 consultation?	

'Everybody agrees it is urgent that we fix this [accounting for insurance contracts] as soon as possible. That is why the IASB is determined to publish the Standard as soon as we can.'
Hans Hoogervorst, 8 September 2016

How are you feeling now?

The Kubler-Ross model



IFRS 17: recap of the requirements

May 2017

Overview of the measurement models

	Building Block Approach	Premium Allocation Approach	Variable Fee Approach
Why is it needed?	Default model for all insurance contracts	To simplify the requirements for short term contracts with little variability	To deal with participating business where the policyholder liability is linked to underlying items
Types of contract	• Long-term and whole life insurance, protection business • Certain annuities • US style universal life • Reinsurance written • Certain general insurance contracts	• General insurance • Short-term life and certain group contracts	• Unit-linked contracts* • US variable annuities • Equity index-linked contracts • Continental European '90/10' contracts • UK style with-profits contracts

*Assuming significant insurance risk exists

Building Block Approach (“BBA”)

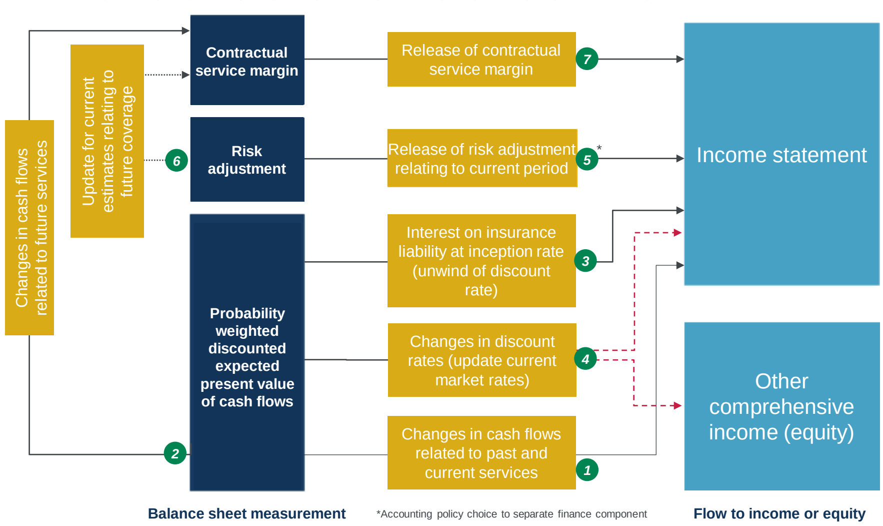
- Default model for all insurance contracts.
- Based on discounted best estimate of future cash flows (in and out).
- Explicit margins:
  - Contractual service margin to prevent gain on policy inception.
  - Risk adjustment.
- Day 1 loss recognised in income statement.
- Cash flow approach for all liabilities: past claims (including IBNR) and future cover.

Contractual service margin	Unearned profits recognised over coverage period.
Risk adjustment	Reflect compensation entity requires for uncertainty. Quantifies the value difference between certain and uncertain liability.
Discounting	Discounting future cash flows using ‘top-down’ or ‘bottom-up’ approach for discount rates to reflect characteristics of the liabilities.
Best estimate of fulfilment cash flows	Best estimate cash flows – explicit, unbiased and probability weighted estimate of fulfilment cash flows.

Expired and unexpired risk

Similar to SII but with the additional contractual service margin

Financial statements under the BBA



Balance sheet measurement   *Accounting policy choice to separate finance component   **Flow to income or equity**

Income statement presentation & drivers

Prescribed income statement presentation	20XX	20XX
Insurance contracts revenue[1]	X	X
Incurred claims and expenses[1]	(X)	(X)
Underwriting result	*X*	*X*
Investment income	X	X
Interest insurance liability	(X)	(X)
Insurance finance income or expense	*X*	*X*
Profit or loss	**X**	**X**
Gains and losses on financial assets at FVOCI	X	X
Effect of discount rate changes on insurance liability (optional)	(X)	(X)
Total comprehensive income[2]	**X**	**X**

[1] 'Deposit' elements excluded from revenue and claims
Experience variances implicitly reflected within revenue and claims
Fee income (for unbundled or investment contracts) would also be in P&L

[2] Equivalent to operating profit today

Summary of key profit drivers

- Release of the CSM
- Release of the risk adjustment
- Experience variances
- Investment margin
- Onerous contracts
- Indirect and corporate expenses

Transition under the BBA

Approach

Full retrospective
- Have to apply where not 'impracticable'
- Requires day 1 data and assumptions and full history to date of transition

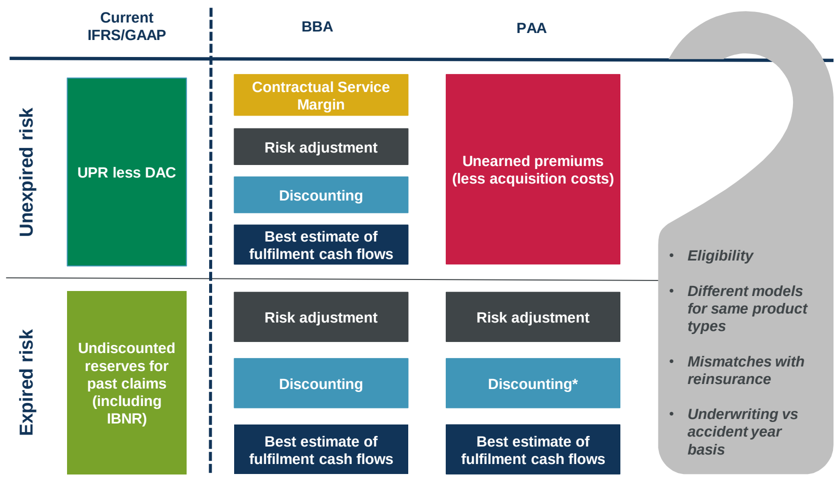
'Simplified' approach
- Retrospective with prescribed simplifications (e.g. certain interactions with contracts already terminated ignored)
- Risk of unintended consequences due to prescribed simplifications
- Not clear that it is simpler than full retrospective

Fair value
- Comparison of fulfilment value to 'fair value'
- Wide experience of fair value assessments from acquisition accounting
- Different views on the size of the CSM and hence future profits
- Given data requirements, may end up here?

Implementation considerations

Data collection	Materiality	One off calculation	Risk of 'double' transition
Recycle/lost profits	Resourcing	When to start?	Which approach to use?

Premium Allocation Approach



*Discounting is optional if the claim liability cash flows are expected to be paid or received in one year or less.

Variable Fee Approach (par contracts)

Eligibility requirements

1. *Participates in a clearly identified pool of underlying items*
2. *Pay policyholder substantial share of the returns*
3. *Substantial proportion of the cash flows vary with the underlying items*

All other participating contracts are defined as **indirect** and use the **BBA with some adjustments**.

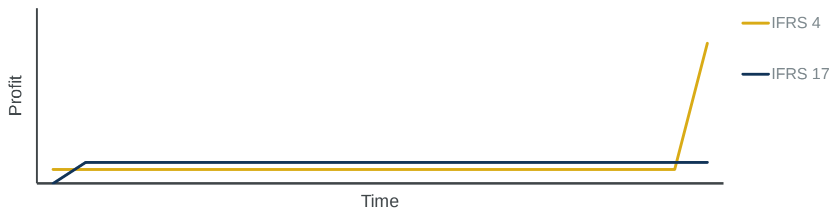
Key measurement differences between the VFA and BBA

Topic	Building Block Approach	Variable Fee Approach
Changes in amounts supporting insurer's share (variable fee)	• Not directly relevant, but likely to be recognized in P&L / OCI	• **Posted to CSM** and recognised over the **contract's lifetime**
Changes in options and guarantees	• Recognised in CSM (non financial) or P&L / OCI (accounting option)	• **Posted to CSM**, but **permitted** to put in P&L where there is **risk mitigation** to avoid an accounting mismatch
Release of CSM to P&L	• Passage of time based on coverage units • Inception rates to unlock and accrete interest	• Passage of time based on coverage units – **potential uncertainty** over application (e.g. open WP funds)? • **Current rates** (implicitly) to unlock and accrete

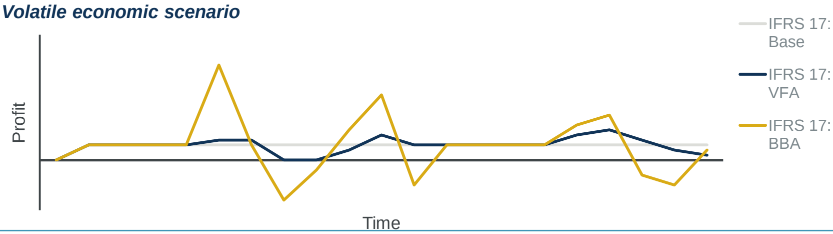
Why the VFA model matters

Profit emergence: Participating endowment

Base scenario



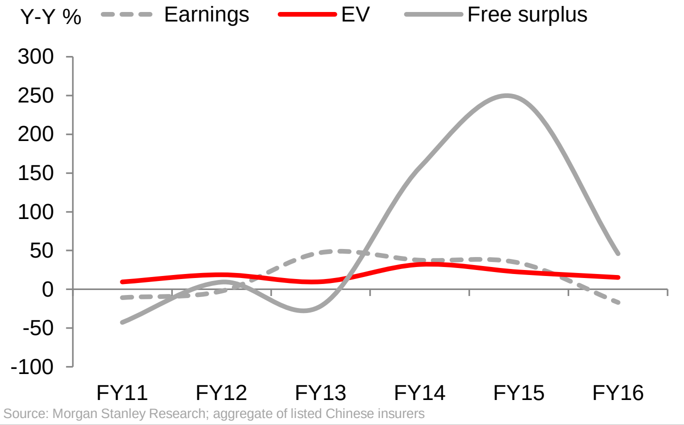
Volatile economic scenario



Market reaction: the equity analyst's view

Prefer Stable, Predictable, Sensible Disclosure

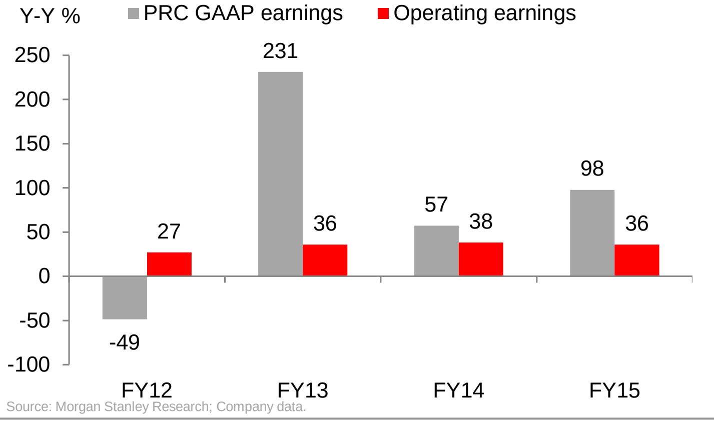
EV has been a popular valuation basis in Asia



Source: Morgan Stanley Research; aggregate of listed Chinese insurers

IFRS 17: More Complexity / Volatility or Less

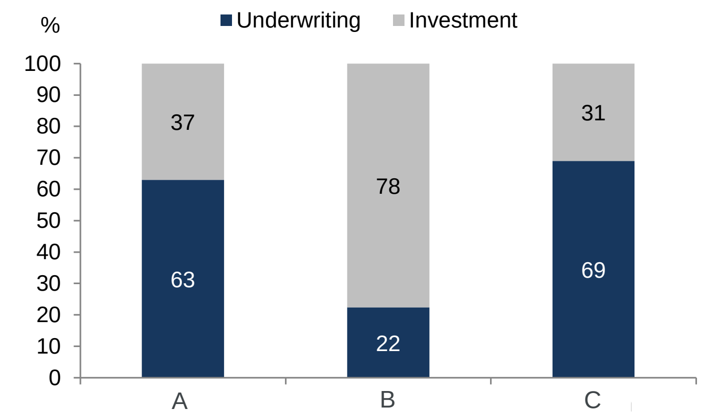
Example: IFRS earnings can be volatile and deviate from underlying trends



Source: Morgan Stanley Research; Company data.

IFRS 17: Can it Provide Additional Insight

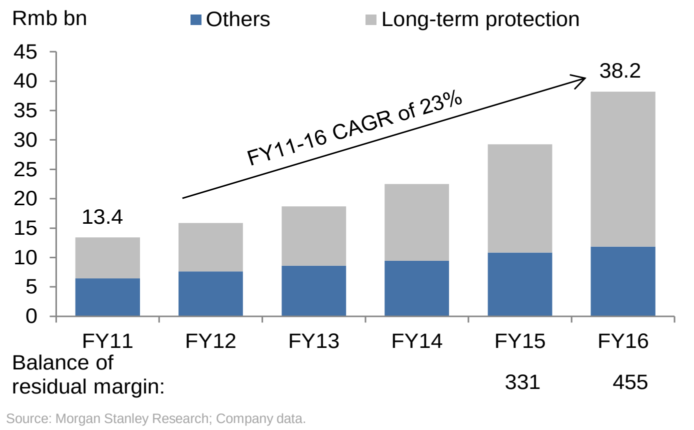
SOE is the most powerful disclose helping investors understand insurance



Source: Morgan Stanley Research; Company data.

IFRS 17: Can it Provide Additional Insight

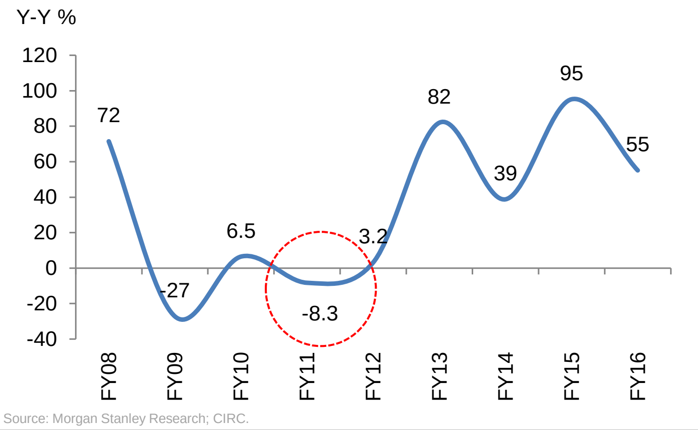
Chinese insurers start to disclose residual margin to help crystalize its future earnings



Source: Morgan Stanley Research; Company data.

IFRS 17: Will it Impact Strategy

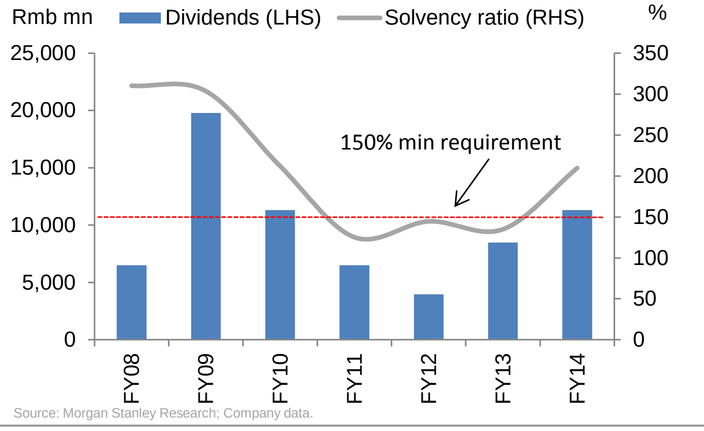
Case 1: UL sales shrank when China initially adopted IFRS principles in 2011



Source: Morgan Stanley Research; CIRC.

IFRS 17: Will it Impact Strategy

Case 2: Maintaining IFRS based payout can lead to capital shortage



Source: Morgan Stanley Research; Company data.

Final thoughts

- A step forward to help investors track expected earnings…
- …but still not sufficient to perform true source of earnings analysis.
- Volatility and complexity could increase cost of capital if the results are not well understood by investors.
- Supplementary disclosures might continue to help guide the market.
- Need to keep an eye out for unintended consequences on product strategy, asset allocation and dividend policy.

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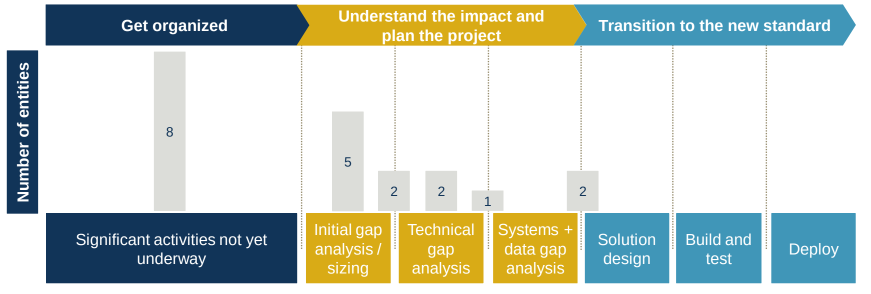
Implications: understanding and preparing for change

Implementation status of key players

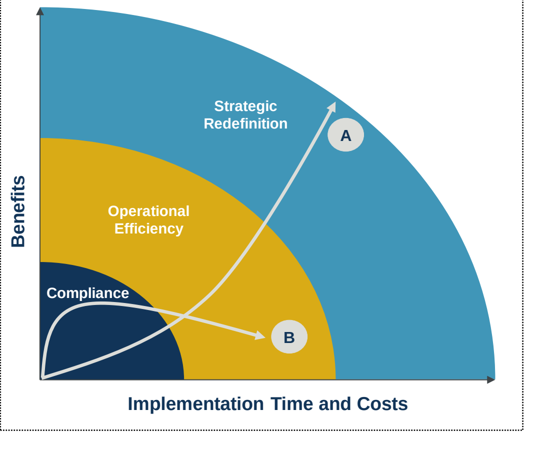
IFRS – Major insurers' positions (source: PwC analysis)



Key observations

- **Capacity** – Finance and actuarial resources will be kept busy by other existing projects during 2017 and beyond, e.g. RBC implementation.
- **IT complexity** – Significant lead times required to implement an automated solution by the 2021 expected go-live date.
- Need to focus on designing the end-state solution, but **don't overlook transition**. One-off tools may be required.
- Early identification of the potential impacts of IFRS 17 allows improved management of the **interactions with other projects**.
- IFRS 17 creates opportunity to **optimise the operating models** for the finance, actuarial and potentially risk functions.
- Limitations in **IFRS capability and insight** can exist, particularly in Asia where financial reporting can be less advanced.
- Some clients are already **locking up third-party support** for the long term due to concerns over **resource shortages**.

Market ambition?



Path A – Strategic Path

Some firms are taking this opportunity to **transform their finance function** - re-defining finance, actuarial and risk functions, establishing the operating model, tools and capabilities to support the business use the new metrics that are emerging.

Path B – Compliance Path

Some firms may seek to address the requirements in a **low-cost compliance manner,** either through workaround solutions or by increasing resources.

Strategic implications: business

Business

- Product design
- Generating value
- Operating model
- Acquisitions & disposals

"We need to change our product design to include more explicit participating mechanisms to ensure our products qualify for the VFA model"

"The guarantees on my variable annuity portfolio are going to severely damage my balance sheet - I need to find a solution, quickly".

"We need to rethink our actuarial and finance operating model to get a joined up view of the balance sheet and income statement"

"Transition is going to cause significant problems for our Korean business. It doesn't make sense to stay in this market – we are looking for a buyer"

Strategic implications: investment

Investment

- Investment strategy
- Hedging strategy
- Volatility management

"We need to investigate the duration gap under IFRS 17. I am concerned about market consistent discount rates and the impact of contract boundaries."

"The CSM under the VFA helps address accounting volatility concerns – do I still need hedging assets?"

"The BBA is going to create volatility in my P&L for protection business because the CSM is not unlocked for changes in discount rates."

Strategic implications: market reporting

Market reporting

- Explaining value
- Suite of reporting bases
- Stakeholder understanding

"At transition I need to decided whether I want higher day 1 equity, or higher ongoing profits – which is more suitable to my business model?"

"Does IFRS 17, and its volatility smoothing options such as the use of OCI, remove the need for a separate operating profit definition?"

"Profit emergence under IFRS 17 is going to be completely different from what I currently report – I need to help my investors understand and buy into the new emergence pattern."

Recap

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Questions Comments

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