



Society of Actuaries in Ireland

IFRS 4 Phase 2 Exposure Draft

15 January 2014



Agenda

- Background
- Key areas of the proposal
- Worked examples
- Comparison with Solvency II
- Questions

Disclaimer:

The material, content and views in the following presentation are those of the presenter(s).



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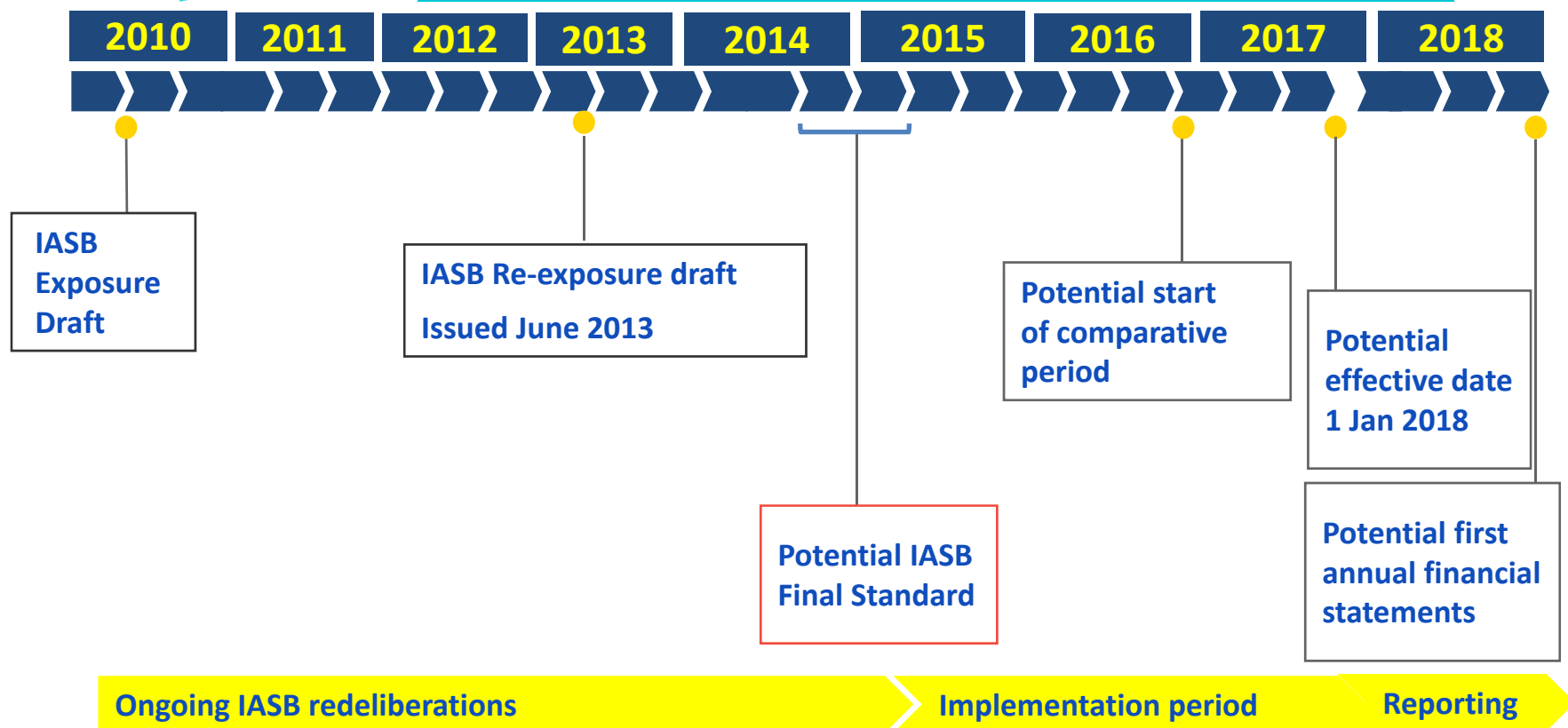
Background

Drivers for change

- Overall objective to develop current value basis for measuring insurance contract liabilities
- Improve transparency
- Improve comparability of performance
- Reduce complexity due to multiple reporting bases

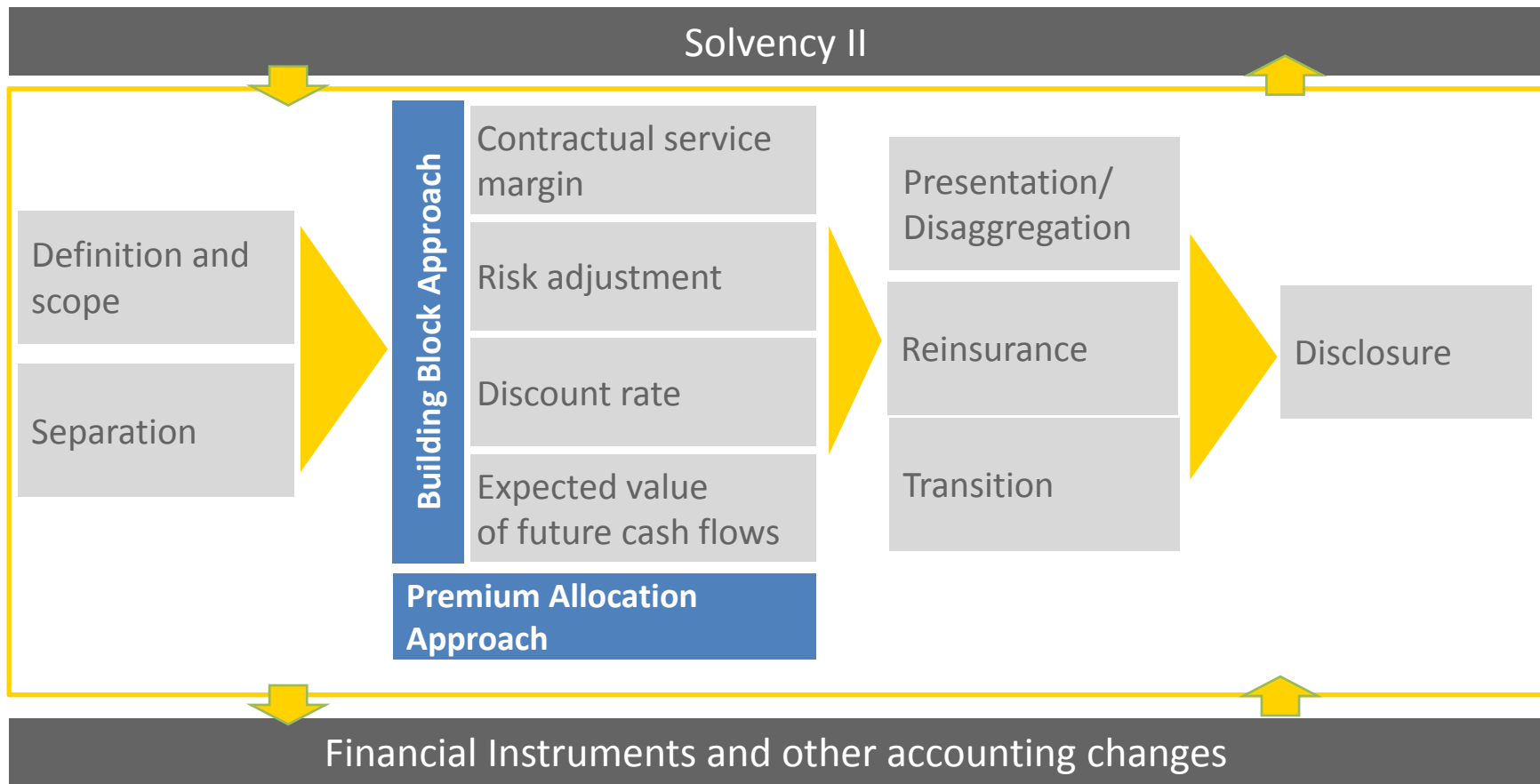


Timeline – 2018?





Elements of the ED model





Expected impacts

- Familiar accounting items go (e.g. DAC)
- Significant presentational changes
- Considerable transition effort
- Similar but different from Solvency II
- New acronyms!
- Impacts
 - Volatility in P&L or equity
 - Mismatches
 - Different performance measures
 - New systems and processes



Key areas of the proposal

Frank O'Callaghan

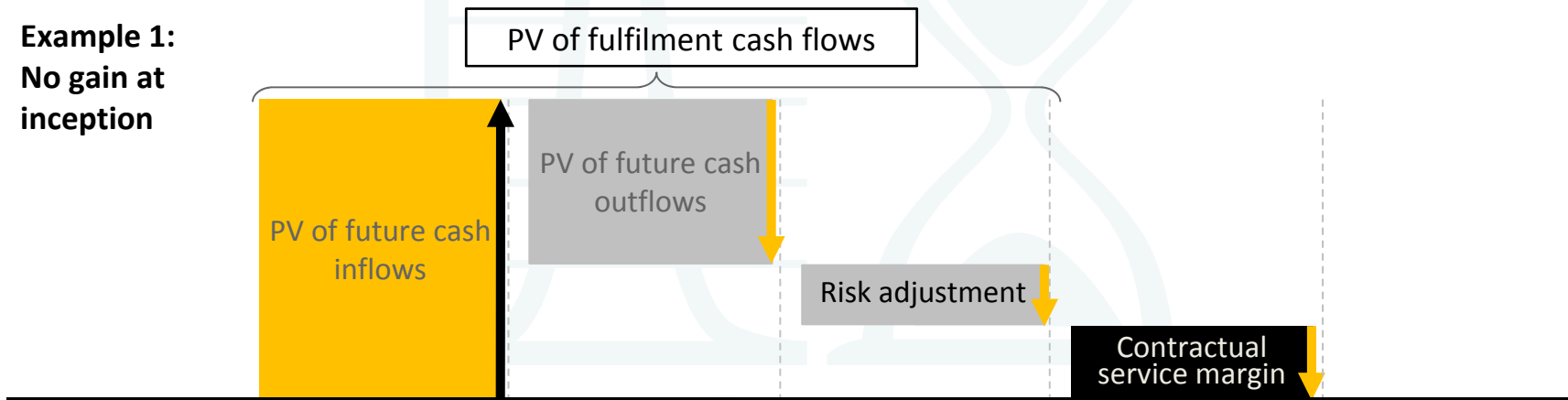


Key areas of the proposal

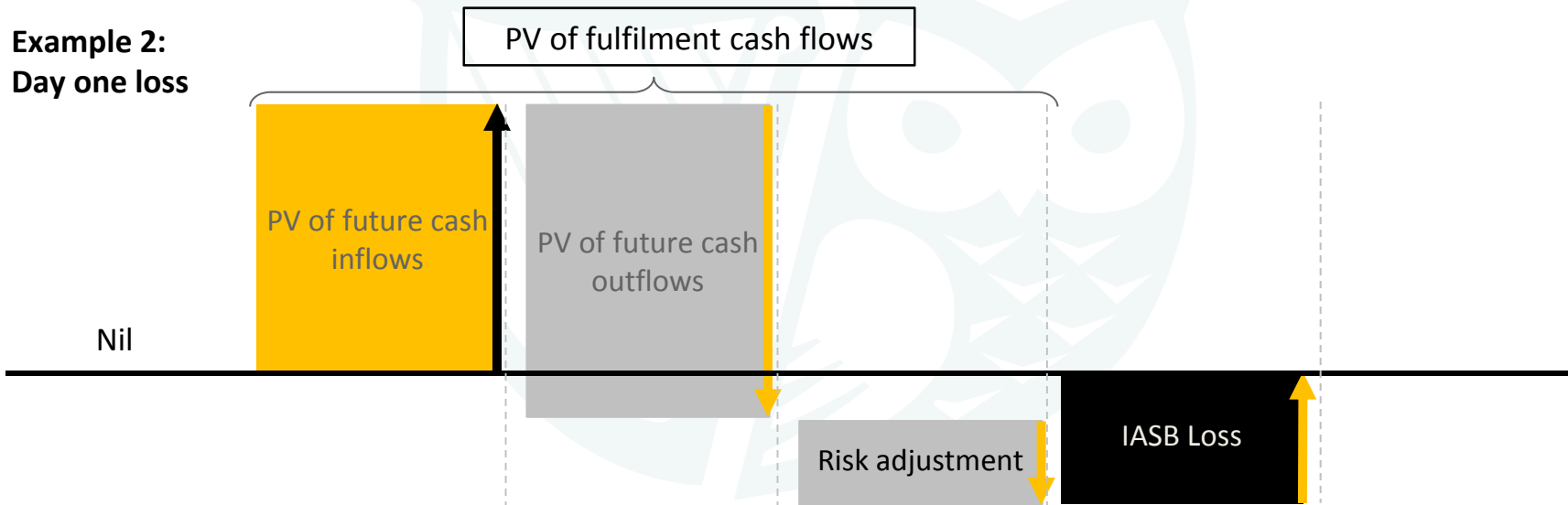
- Building block approach
- Premium allocation approach
- Other aspects
- Presentational change
- Transition
- Reaction

IFRS 4 Phase II measurement model – Building block approach(BBA)

**Example 1:
No gain at inception**



**Example 2:
Day one loss**



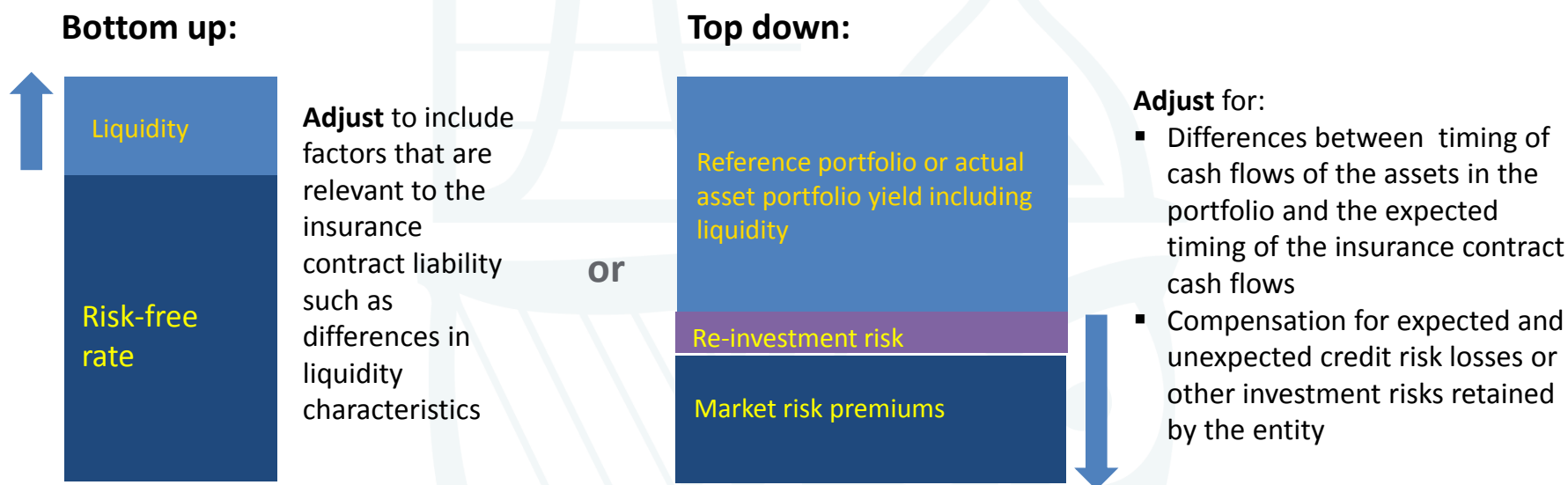
Cash flows

IASB requirement

- Current estimates of the future cash flows to fulfil the obligations of an insurance contract:
 - Explicit and current
 - Perspective of the entity
 - Unbiased, probability-weighted, relevant information
- Includes all costs that will be directly incurred in fulfilling portfolio:
 - Including an allocation of costs that are directly attributable to portfolio
 - Other costs expensed as incurred

Discount rate

- Discount rate to reflect the characteristics of the liability including timing, currency, liquidity. Two approaches allowed:



- To the extent cash flows depend wholly or partly on specific assets the discount rate should reflect that dependency
- Interest expense based on the discount rate locked in at inception. Impacts of changes in the discount rate between contract inception and the current rate recorded in OCI

Risk adjustment

IASB requirement

- Objective is to reflect the compensation an insurer requires for bearing the uncertainty in the cash flows that arise as contract is fulfilled
- Methodology for determining risk adjustment not specified – required characteristics are set out
- IASB will not specify further guidance on unit of account for risk adjustment calculation – allow for diversification consistent with compensation for bearing uncertainty
- Need to disclose confidence level to which the risk adjustment corresponds
- Re-measured every reporting period (through P&L)

Contractual service margin

IASB requirement

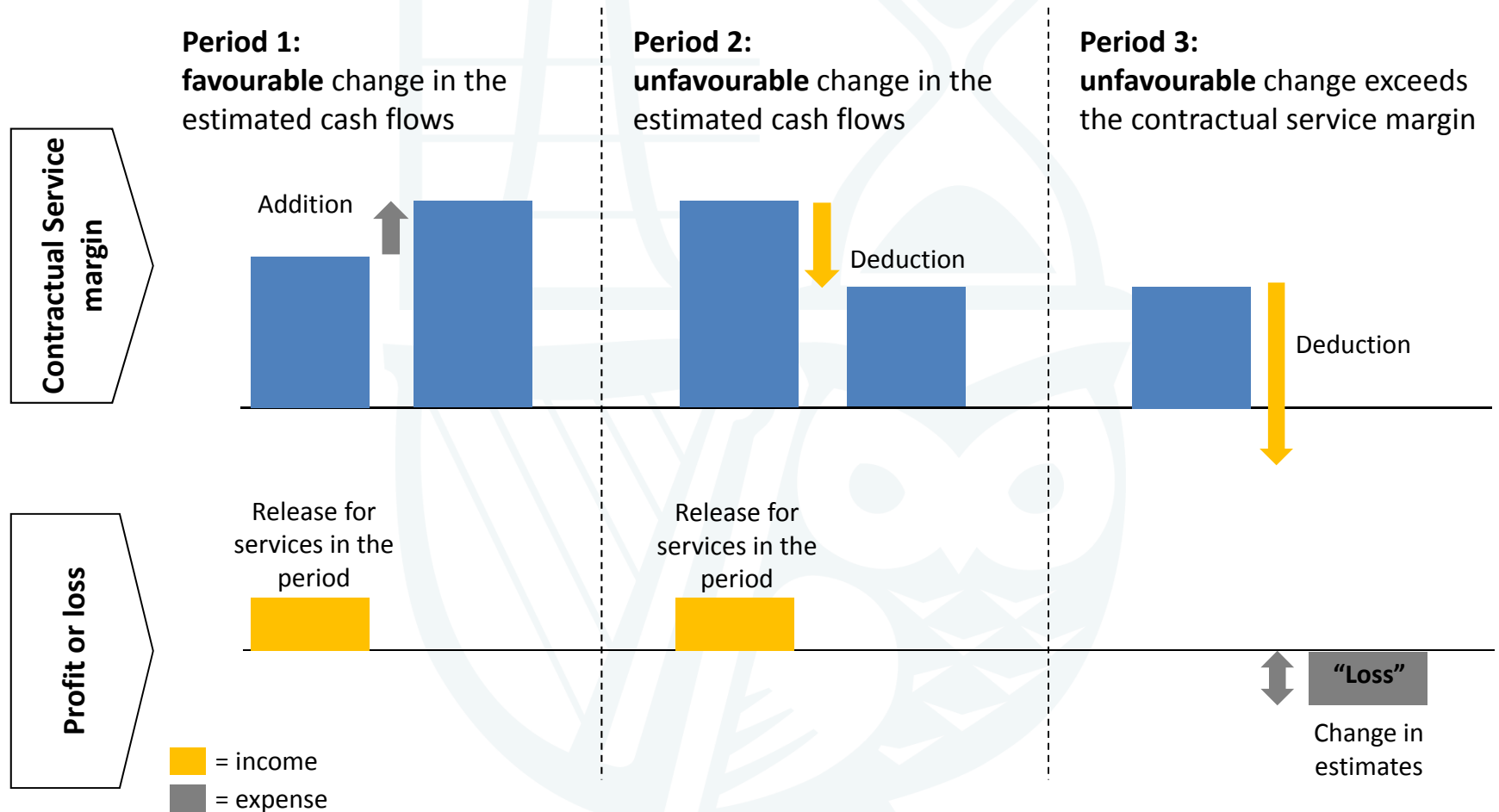
- Eliminates any gains on PV of cash flows at inception
- Deferred and released over time of the contract reflecting pattern of services provided...drives earnings
- Includes direct acquisition costs – effectively deferring these
- Subsequent ‘unlocking’:
 - Changes in estimate of PV of future cash flows, if cash flows relate to future coverage and other future services
 - Favourable and unfavourable
 - ‘Floor’ of zero
 - Applied prospectively
 - Does not apply to risk adjustment
- Determined at portfolio level
- Unit of account for release not specified

Implications

- New item on balance sheet – will require new policies, systems, processes, etc.
- Need to decide 'cohorts' for calculation (e.g. quarterly, annual; split by duration?), and define portfolios – some flexibility here.
- More cohorts/portfolios will give more granular profit recognition, but will be computationally more intensive. Impact will depend on variability of profit by 'cohort'.
- Need to decide how to amortise, manage and report CSM, including unlocking: Spreadsheet/ database/ other?
- Centralised or local tool?

Contractual service margin – cont.

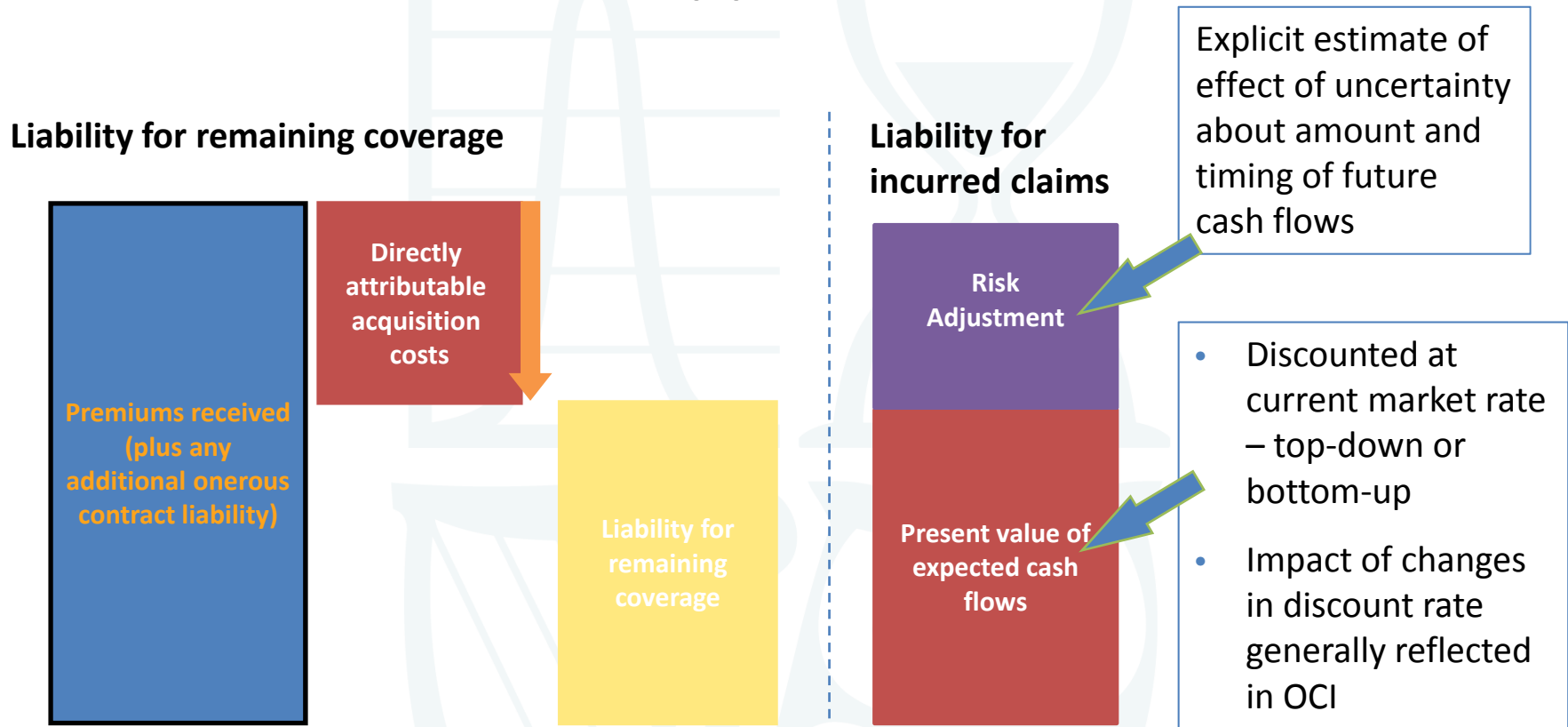
Unlocking for cash flow changes



Premium allocation approach (PAA)

- PAA is a 'simplified approach' for measuring the liability for remaining coverage
- PAA is largely anticipated to be used by non-life insurers in place of the Building Block Approach (BBA)
- Under PAA, insurance contract liability comprise (i) Liability for remaining coverage (ii) liability for claims
- Liability for remaining coverage is:
 - Premiums received less acquisition costs. Future premiums increase liability when received
 - Recognised for remaining coverage in proportion to the value of coverage based on passage of time or expected timing of incurred claims
 - Discounting required if there is a significant 'financing component' to the contract
- Liability for claims
 - Calculated consistently with BBA
 - Includes a risk adjustment but no contractual service margin
 - Is discounted, unless claims are expected to be paid within one year

Premium allocation approach (PAA) – cont.



- Recognise liability for remaining coverage in proportion to the value of coverage based on passage of time or expected timing of incurred claims
- Onerous contract test (present value of expected cash flows basis) if facts and circumstances indicate that a portfolio has become onerous in pre-claims period

Other aspects

- Scope
 - Effectively no change from IFRS 4
 - Additional guidance on : insurance contracts an entity issues/holds, investment contracts with DPF, Financial guarantee contracts
- Guidance on unbundling
- Recognition principles
 - Earlier of point where coverage period begins or payment from the policyholder is due
 - Recognise contract before the start of coverage period when the contract is onerous
- Contract modifications
 - Guidance on changes to the contract terms (“modification” and “derecognition”)
- Acquisition costs
 - Cash flows include directly attributable acquisition costs that can be allocated on a rational and consistent basis to the individual portfolios of insurance contracts
- Contract boundaries
- Reinsurance
- “Mirroring” treatment for certain types of contract which require insurers to hold underlying items (e.g. assets) and specify link between policyholder payments returns on underlying items

Presentation and disclosure

Statement of comprehensive income

(Simplified illustration)	
(A) Insurance contract revenue	100
(B) Incurred claims and expenses	(70)
Underwriting result	30
(C) Investment income	50
(D) Interest on insurance liability	(40)
Net interest and investment	10
Profit or loss	40
(E) Unrealised gains/losses on assets	10
(F) Effect of discount rate changes on insurance liability	(25)
Comprehensive income	25

Not Premium!

Contract Revenue:

- Expected claims
- Expected expenses
- CSM Recognised
- Change Risk Adjustment

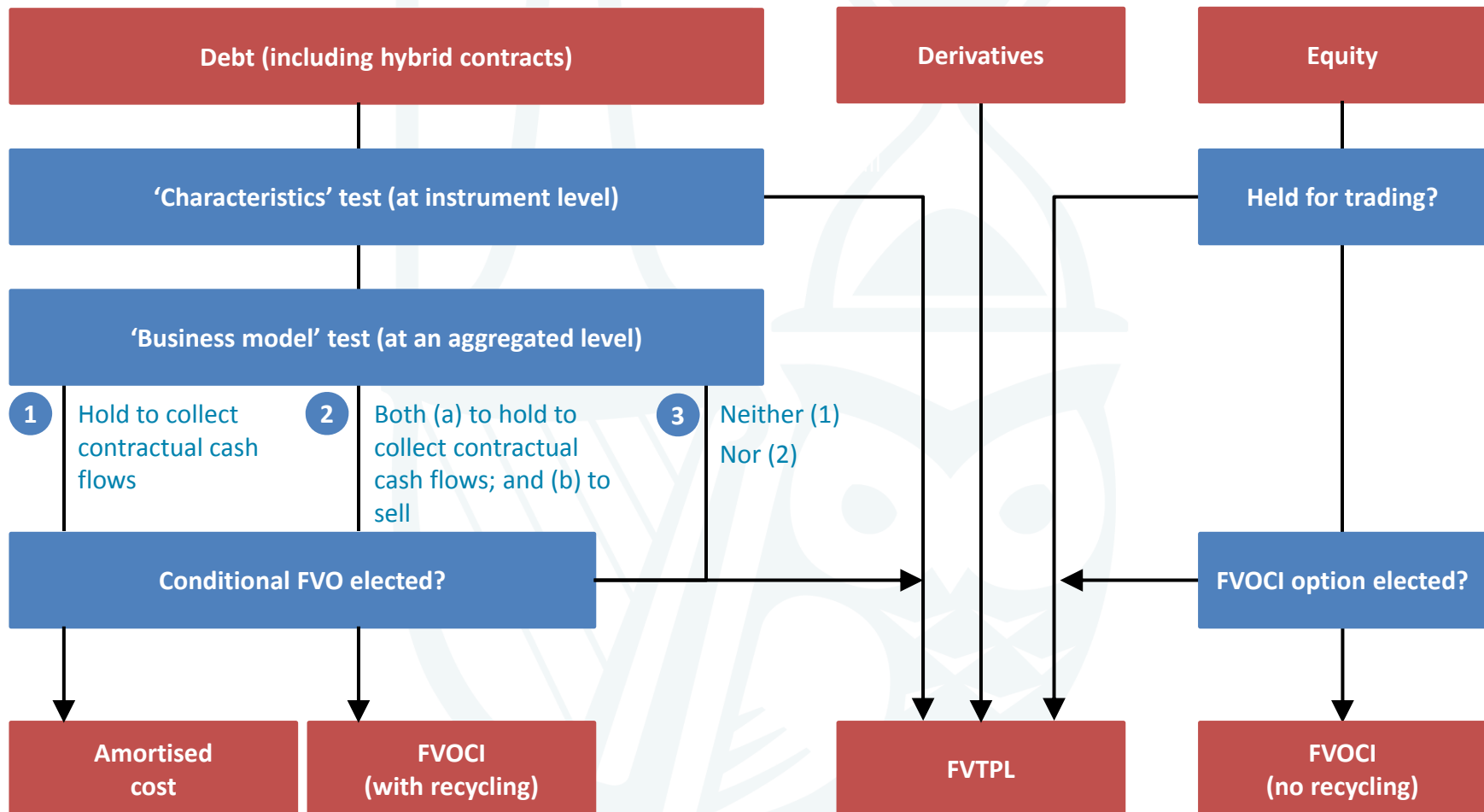
Limited detail on minimum line items:

- Revenue
 - Claims and expenses Supported by specific disclosure requirements
- Margin information in disclosures

Locked in discount rate

Potential asset mismatch - IFRS 9

Classification and Measurement



Transition

IASB requirement

- At beginning of earliest period presented:
 - Use current estimates at date of transition for PV of fulfilment cash flows
 - Determine CSM at beginning of earliest period presented:
 - » Through retrospective application to all prior periods as far back as possible
 - » If impracticable to earlier periods, using estimates taking into account all objective information that is reasonably available

Implications

- Opening CSM may require significant data gathering and computation
- Need to consider data requirements now, and ensure relevant historic (and current) data is sourced and/or retained
- Need to decide how far back historic calculations will be practicable, and consider (auditable) approximate methods where historic calculations are not practicable
- Need to consider sources of information for any approximations
- Will need to derive cumulative effect of difference between historic discount rates and discount rates determined at transition date for OCI
- Need to consider treatment of annuities that vested before transition

Reaction

IFoA welcome developments:

- The updated BBA
- The principle of unlocking of the CSM
- The PPA is no longer mandatory for short duration contracts
- The revised transition approach to apply the standard retrospectively if practicable, and with simplifications if not the case
- More expenses are allowed in the measurement of the fulfilment cash flows that IFOA believe are an integral part of insurance portfolios' cash flows
- “Top down” approach is now permitted in setting discount rate
- Change in definition of risk adjustment principle, method is no longer prescribed and diversification restrictions removed

IFoA suggested improvements due to:

- Concerns regarding the mandatory nature of the OCI approach
- Complexity of the “mirroring” approach
- Inconsistencies in the circumstances in which the CSM is unlocked
- Appropriateness of the revised revenue presentation proposals

Other concerns raised:

- Practicalities around implementation
- Complexity of transition arrangements
- Determination of risk adjustment and discount rate
- Align effective dates: IFRS 4 and IFRS 9



Worked Examples

Edward Maguire



Life Example – Term Insurance

Key Point: CSM established at outset and will be amortised in line with expected services provided i.e. expected claims pattern.

Base Case: Expected Cashflows at Initial Recognition

<i>Year</i>	<i>PV</i>	1	2	3	Total	
Premium	1,000	1,000	0	0	1,000	+FCF
Investment Income		40	31	25	95	
Claims	(342)	(200)	(150)	(12)	(362)	+FCF
Expenses - directly attributable	(30)	(10)	(11)	(12)	(33)	+FCF
Acquisition expenses - direct	(28)	(17)	(12)	(1)	(30)	+FCF
Acquisition expenses - indirect		(50)	0	0	(50)	
Cashflow totals for year		763	(143)	(0)	620	

PV FCF Initial Recognition

600



Life Example – Term Insurance

Risk Adjustment

RISK MARGIN

Assumptions

Discount Rate	4%
Margin for Risk Adjustment	10% ->claims+admin expenses

Initial Recognition

<i>Year</i>	1	2	3
Risk Adj b/f	37	17	2
RA Development in Year	(21)	(16)	(2)
Interest on RA	1	1	0
Risk Adj c/f	17	2	(0)
PV FCF Initial Recognition	600		
CSM Initial Recognition	563		



Life Example – Term Insurance

Key Point: CSM established at outset and will be amortised in line with expected services provided i.e. expected claims pattern.

Year	1	2	3	
Amortisation Pattern based on Expected Claims	55%	41%	3%	100%
	Initial Recognition			
Year	1	2	3	
CSM b/f	563	252	19	
CSM development in year	(333)	(243)	(19)	
Int on CSM	23	10	1	
CSM c/f	252	19	0	



Life Example – Term Insurance

Liability for Fulfilment Cashflows (BEL)

Year	Initial Recognition		
	1	2	3
BEL b/f	400	190	24
Expected Claims+Expenses	(227)	(173)	(25)
Int on FCF	16	8	1
BEL c/f	190	24	0

Life Example – Continued

Key Points:

- 1) Revenue fundamentally different – **note PV of Revenue = Premium**
- 2) Statement of Financial Position has new components – FCF, CSM, Risk adj

Example Statement of Profit or Loss and OCI

Year	1	2	3	Total
Insurance Contract Revenue	581	433	47	1,061
Claims and benefits incurred	(200)	(150)	(12)	(362)
Expenses incurred	(60)	(11)	(12)	(83)
Amortization of acquisition costs	(17)	(12)	(1)	(30)
Changes in estimates of future cashflows	0	0	0	0
Unwind of previous changes in estimates	0	0	0	0
Underwriting Result (Gross Margin)	304	259	22	586
Investment Income	40	31	25	95
Interest on Insurance Liability	(40)	(18)	(2)	(61)
Profit or Loss	304	272	44	620
Other comprehensive income				
Changes in insurance liability due to changes in discount rate	0	0	0	
Fair value movements on FVOCI assets	0	0	0	
Total Comprehensive Income	304	272	44	620

Life Example – Continued

Key Points:

- 1) Revenue fundamentally different – **note PV of Revenue = Premium**
- 2) Statement of Financial Position has new components – FCF, CSM, Risk adj

Statement of Financial Position

<i>Year</i>	1	2	3
Assets			
Cash	763	621	620
Total Assets	763	621	620
Liabilities			
FCF BEL	190	24	0
CSM	252	19	0
Risk Adjustment	17	2	(0)
Equity	304	576	620
Total Liability	763	621	620

Life Example – Continued

Comparatives Against Current GAAP

Reserving Assumptions:

Discount Rate 4%
Prudence 10%

<i>Year</i>	1	2	3	Total
Premiums	1,000	0	0	1,000
Investment Income	40	31	25	95
Total Cash In	1,040	31	25	1,095
Expenses	(10)	(11)	(12)	(33)
Acquisition Costs	(80)	0	0	(80)
Claims	(200)	(150)	(12)	(362)
Total Cash Out	(290)	(161)	(24)	(475)
Cashflow	750	(130)	1	620
DAC C/F	13	1	0	
Reserves C/F	195	25	0	
<i>Change in DAC</i>	13	(12)	(1)	0
<i>Change in Reserves</i>	(195)	169	25	0
Profit (current no DIL)	569	26	25	620
Total Comprehensive Income	304	272	44	620
Δ	(264)	245	19	(0)

Life Example – Continued

Comparatives against Profit with Deferred income Liability - similar smoothness in profit emergence

Comparative against Profit (current) with Deferred Income Liability

Year	Initial Rec	1	2	3	Total
Profit before DIL		569	26	25	620
DIL amortisation pattern	591	264	20	0	
Change in DIL		264	(245)	(20)	0
Profit (current with DIL)		304	271	45	620
Total Comprehensive Income		304	272	44	620
Δ		(0)	0	(0)	(0)

Note: Deferred Income Liability based on Premium less Reserves at Initial recognition, amortized with Claims

Non Life Example

SIMPLIFIED PREMIUM ALLOCATION APPROACH

Key Accounting Changes Required:

- 1) Outstanding claims have to be discounted
- 2) Once established at outset, claims discount rate becomes locked in.
- 3) Any subsequent change in the discount rate for outstanding claims flows through “Other Comprehensive Income”.
- 4) Liability for remaining coverage needs to be calculated

GI Contract with One Year Coverage Period (written 3/4 way through year)

Year	1	2	3	Total
Premium	1,000			1,000
Total Claims (all years)	(800)			(800)
:- Incurred (undiscounted)	(200)	(600)	0	
:- Paid	(50)	(450)	(300)	(800)
Acquisition expenses - direct	(50)			(50)
<i>Acquisition expenses - direct amortised as follows:</i>	(13)	(38)		(50)
Acquisition expenses - indirect	(6)			(6)
Risk Adjustment on outstanding claims	(5)	(20)	(5)	(30)

Discount rate for claims is 10% p.a.

Non Life Example

SIMPLIFIED PREMIUM ALLOCATION APPROACH




Revised Statement of Comprehensive Income & Statement of Financial Position .

<i>Year</i>	1	2	3	Total
Insurance Contract Revenue	250	750	0	1,000
Claims and benefits incurred	(209)	(555)	5	(759)
Expenses incurred	(6)	0	0	(6)
Amortization of acquisition costs	(13)	(38)	0	(50)
Changes in estimates of future cashflows(if not c	0	0	0	0
Unwind of previous changes in estimates	0	0	0	0
Underwriting Result (Gross Margin)	22	157	5	184
Investment Income	22	78	37	137
Interest on Insurance Liability	0	(13)	(27)	(41)
Profit or Loss	45	222	15	281
Other comprehensive income				
Changes in insurance liability due to changes in discount rate	0	0	0	0
Fair value movements on FVOCI assets	0	0	0	0
Total Comprehensive Income	45	222	15	281

Non Life Example

Comparative against current Co. A/Cs

CURRENT GAAP COMPARATIVES

<i>Year</i>	1	2	3	Total
Premium Earned	250	750	0	1,000
Investment Income	22	78	37	137
Claims Incurred	(200)	(600) 	0	(800)
Expenses	(19) 	(38) 	0	(56)
Profit	54	191	37	281
INS CONTRACTS ED 2010 Total Comp Inc	45	222	15	281
Δ	(9)	31	(22)	0

Non Life Example

Scenario 1: end of year 1 claims discount rate increase from 10% to 15%.

Key Point: There is no impact on profit in any year but there are changes to other comprehensive income in years 1,2 & 3.

<i>Year</i>	1	2	3	Total
Insurance Contract Revenue	250	750	0	1,000
Claims and benefits incurred	(209)	(555)	5	(759)
Expenses incurred	(6)	0	0	(6)
Amortization of acquisition costs	(13)	(38)	0	(50)
Changes in estimates of future cashflows(if not c	0	0	0	0
Unwind of previous changes in estimates	0	0	0	0
Underwriting Result (Gross Margin)	22	157	5	184
Investment Income	22	78	37	137
Interest on Insurance Liability	0	(13)	(27)	(41)
Profit or Loss	45	222	15	281
Other comprehensive income				
Changes in insurance liability due to changes in discount rate	(7)	(5)	12	0
Fair value movements on FVOCI assets	0	0	0	0
Total Comprehensive Income	38	217	26	281



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IFRS Phase 2 vs. Solvency II



Scope	
IFRS Phase 2	<ul style="list-style-type: none">• Contracts with significant insurance risk, or investment contracts with Discretionary Participation Features (DPF)
Solvency II	<ul style="list-style-type: none">• All contracts written by (re)insurers in the EEA• Group supervision to all EEA insurance groups

➤ **Contract classification – different data sets**

➤ **Unbundling of investment components?**

Recognition date	
IFRS Phase 2	<ul style="list-style-type: none">• Earliest of:<ul style="list-style-type: none">• Beginning of coverage period• When premiums become due• For onerous contracts, when bound by terms of the contract
Solvency II	<ul style="list-style-type: none">• Earliest of :<ul style="list-style-type: none">• Beginning of coverage period• When the company becomes a party to the contract

➤ **Possible differences in recognition date**

Cash flows

IFRS Phase 2

- General
 - Fulfilment cash flows = Explicit, unbiased, probability-weighted estimate of cash flows
 - Segmentation required at portfolio level (i.e. Portfolio of contracts that provide coverage for similar risks and managed together as a single pool).
 - Entity specific non-economic assumptions
- Expenses
 - Related directly to fulfilment of the contract including overhead
 - Include directly attributable acquisition and overhead expenses

Cash flows	
Solvency II	<ul style="list-style-type: none">• General<ul style="list-style-type: none">• BEL = Probability-weighted average of future cash flows, discounted, realistic assumptions,• Calculate on a policy-by-policy basis• Segmentation required into homogeneous risk groups and LOB• Entity specific non-economic assumptions• Going concern basis• Expenses<ul style="list-style-type: none">• Incurred in servicing obligations including direct and overhead

➤ **Generally similar with the exception of expense cash flows**

Contract boundary	
IFRS Phase 2	<ul style="list-style-type: none"> • Can compel policyholder to pay premiums, or has a substantive obligation to provide coverage/other services • Obligation ends when the entity can amend benefits or re-price to fully reflect risk (including at portfolio level) • Ignore restrictions that have no commercial substance
Solvency II	<ul style="list-style-type: none"> • The point where the insurer can: <ul style="list-style-type: none"> • Unilaterally terminate the contract; or • Refuse to accept a premium; or • Amend the benefit or premium to fully reflect the risks (test applies at portfolio level or at policy level in some cases) • If no material insurance risk or guarantees then all future premiums are outside the contract boundary unless policyholder can be compelled to pay

➤ **Similar definitions but care needed!**

Discount rate	
IFRS Phase 2	<ul style="list-style-type: none"> • Based on market yields for similar cash flows • Can use a “top-down” or “bottom-up” approach with illiquidity premium, if applicable • Change in discount rate goes through OCI
Solvency II	<ul style="list-style-type: none"> • Risk free rate (swap curve less a deduction for default risk) • Extrapolation from last liquid point to UFR • LTGA proposals to include: <ul style="list-style-type: none"> • Matching adjustment for certain liabilities • Volatility adjustment

➤ **Possible differences in discount rates**

➤ **Historic assumptions required for IFRS**

Allowance for risk	
IFRS Phase 2	<ul style="list-style-type: none"> • Compensation the insurer requires for bearing uncertainty • No prescribed technique (examples mentioned include Cost of Capital, Tail VAR, confidence level) • Separate risk adjustments for gross of reinsurance and reinsurance • Must disclose equivalent confidence level if a different technique used
Solvency II	<ul style="list-style-type: none"> • Amount that an insurer requires to take over the insurance obligations • No risk margin if TPs calculated as a whole • Risk margin based on cost of capital approach

- **Expect companies will use similar methodology to SII**
- **IFRS more flexible**

Day 1 gains	
IFRS Phase 2	<ul style="list-style-type: none">• Expected profits are locked in at outset via the Contractual Service Margin (CSM)• Expected profits are spread via the CSM in line with future services provided
Solvency II	<ul style="list-style-type: none">• Day 1 gains allowed

- **Different pattern of profit / surplus recognition**
- **Different impact of assumption changes**

Non-life	
IFRS Phase 2	<ul style="list-style-type: none"> • Option to use Premium Allocation Approach (PAA) for short-term contracts <ul style="list-style-type: none"> • Plus onerous contract test • Liability for incurred claims similar to Solvency II <ul style="list-style-type: none"> • Discounting not necessary if < 12 months
Solvency II	<ul style="list-style-type: none"> • Probability-weighted average of future cash flows, discounted (as for life business), plus risk margin • Separate best estimate for claims outstanding and premium provisions

➤ **Potentially very different approaches**

Reinsurance	
IFRS Phase 2	<ul style="list-style-type: none">• Calculated and presented as a separate contract• No day 1 gains• Separate CSM and risk adjustment• Changes in expected credit losses go straight to P&L
Solvency II	<ul style="list-style-type: none">• Future reinsurance recoveries recognised as an asset• Include allowance for PD and LGD• Single net of reinsurance risk margin

- **Reinsurance recoveries separately recognised**
- **Separate risk adjustments**

Conclusions

Comments / Questions?

