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IFRS 17

~~IFRS 4 Phase II~~ is happening, 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
- An analyst’s perspective on financial reporting

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Timeline & developments in current and future insurance accounting

What is happening to current and future accounting?

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Current known timeline – November 2016

IFRS standards	2016	2017	2018	2019	2020	2021
Insurance contracts (IFRS 17)	Targeted Testing	Final standard?				Effective 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?

What happens to accounting during the ‘gap period’?

Business and operational considerations

- Impact on tax
- Messaging to market (including comparability with peers)
- Operational and cost benefits (e.g. model runs, multiple restatements)
- Wider impacts such as on intangible assets (e.g. DAC, DTAs etc.)
- Impact of Solvency II ALM / capital optimisation on IFRS performance
- Solvency I still required for transitional measure reset?
- Availability of Solvency II data for restatement period
- 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 returns from these items. • Substantial portion of the expected cash flows vary with those from the underlying 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

Deferred Acquisition Cost (DAC) asset **

Invested assets

Prudent liability

Largely based on Solvency I with:

– "Contingency" reserves (e.g. closure to new business) excluded and demographic / expense assumptions may be closer to best estimate.

– DAC asset permitted provided recoverable from margins.

All changes are recognised immediately in P&L

Income statement (profit or loss)

Balance sheet

* 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. • Granular unit of account (tbc). • 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

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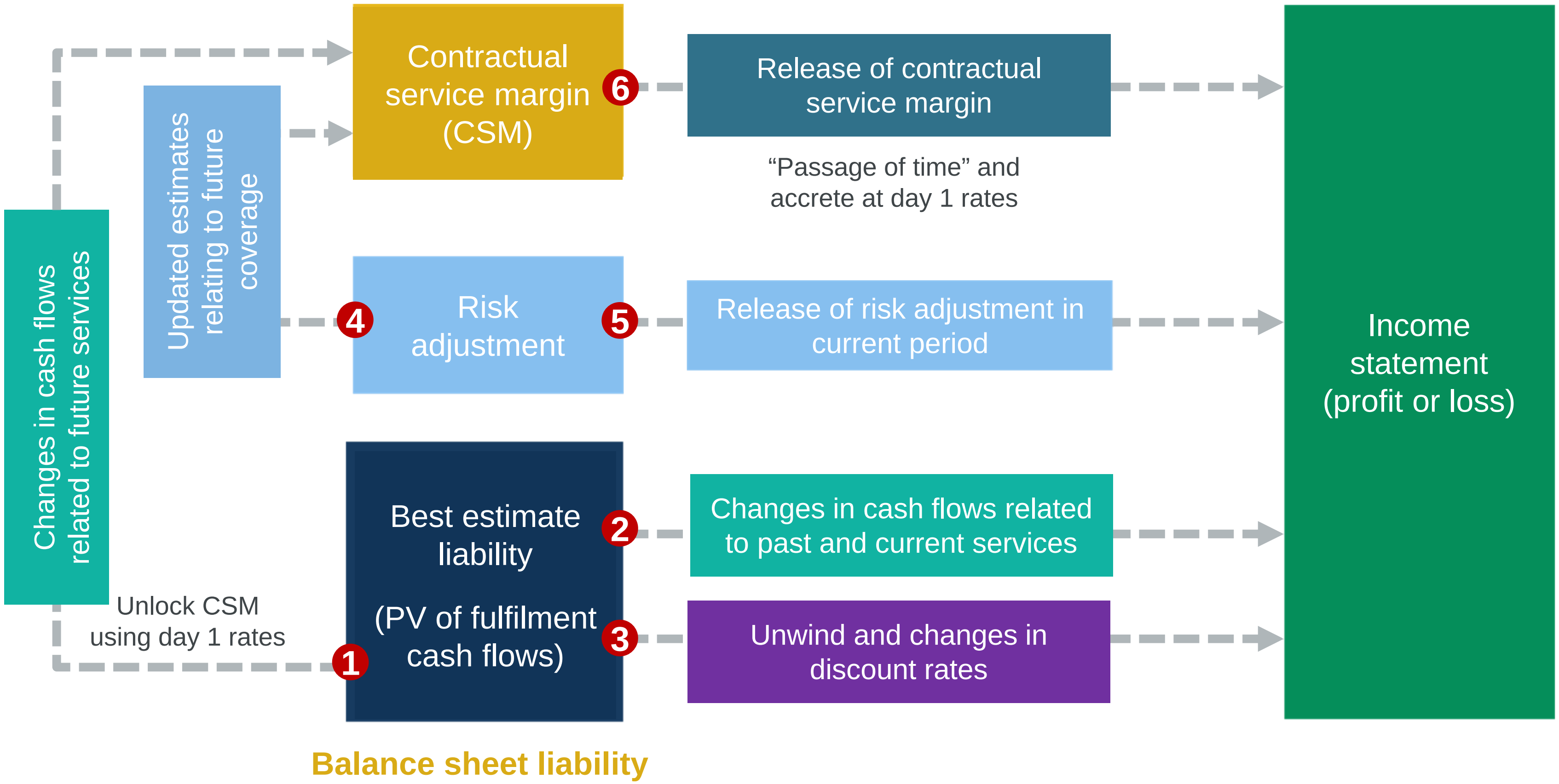
Building block approach – Flows to profit

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.

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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 (tbc)
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

Prescribed simplifications

Fair value of liability

Observations

- ‘Practicability’ condition for the boundary between methods.
- Risk of unintended consequences from ‘simplifications’.
- Likelihood of data at required level of granularity for full retrospective or simplified? Will the approaches be possible?
- 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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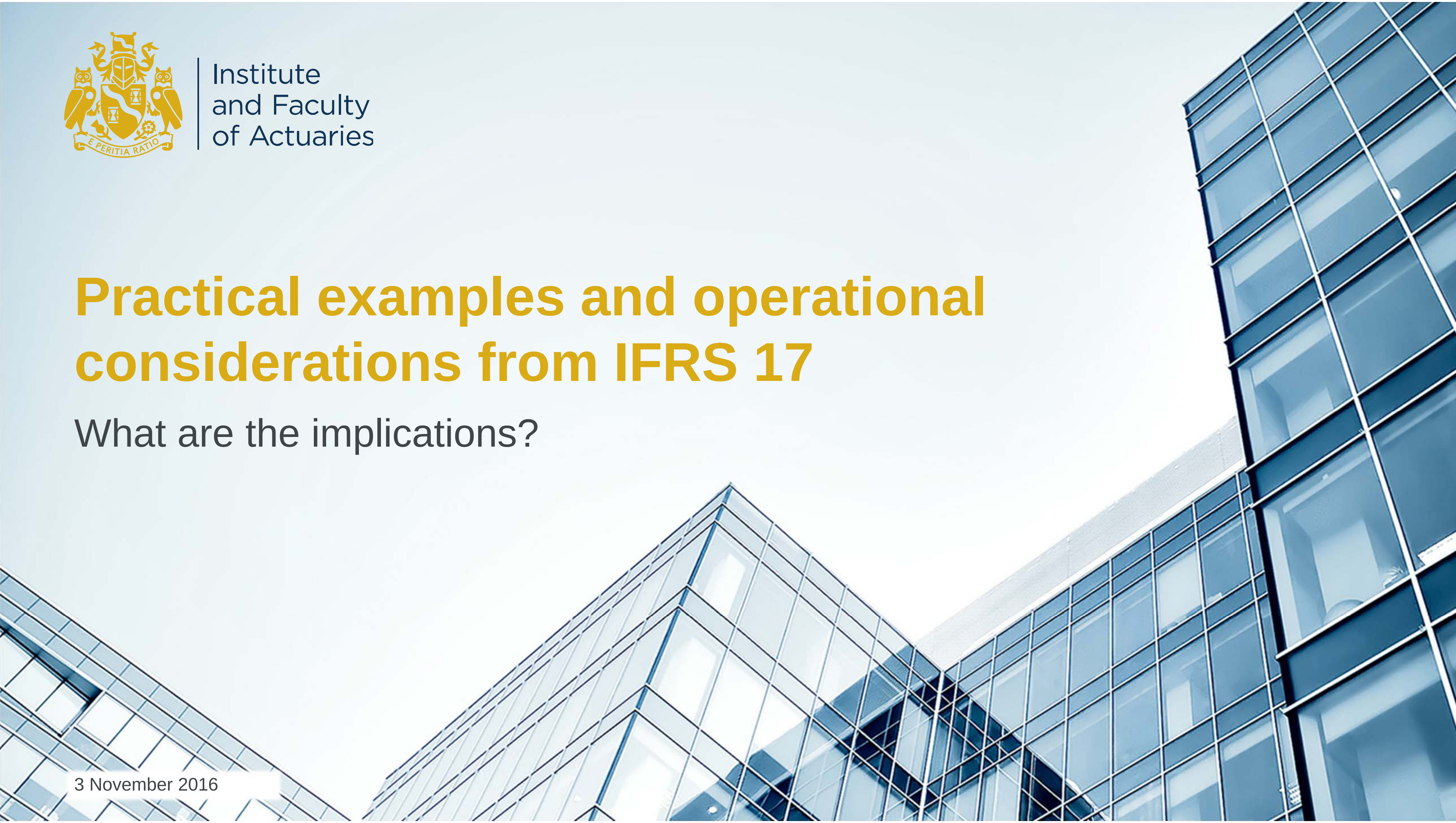
Practical examples and operational considerations from IFRS 17

What are the implications?



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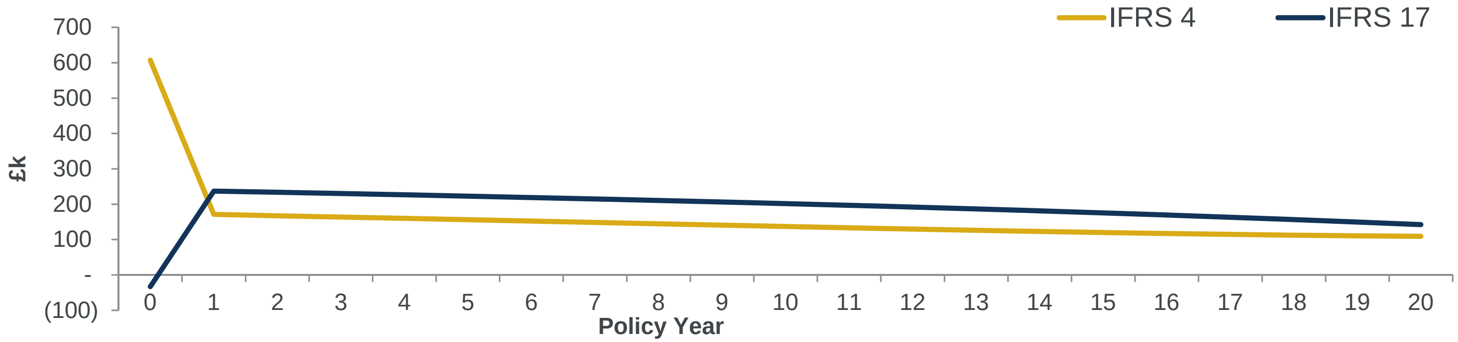
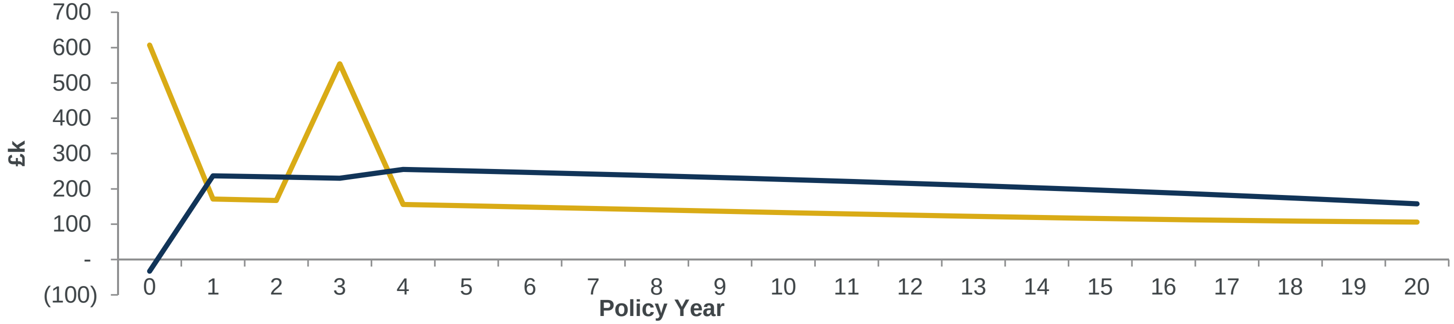
Example 1 – Portfolio of immediate annuities

Impact of the CSM

Base case



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



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Example 2 – Protection contracts

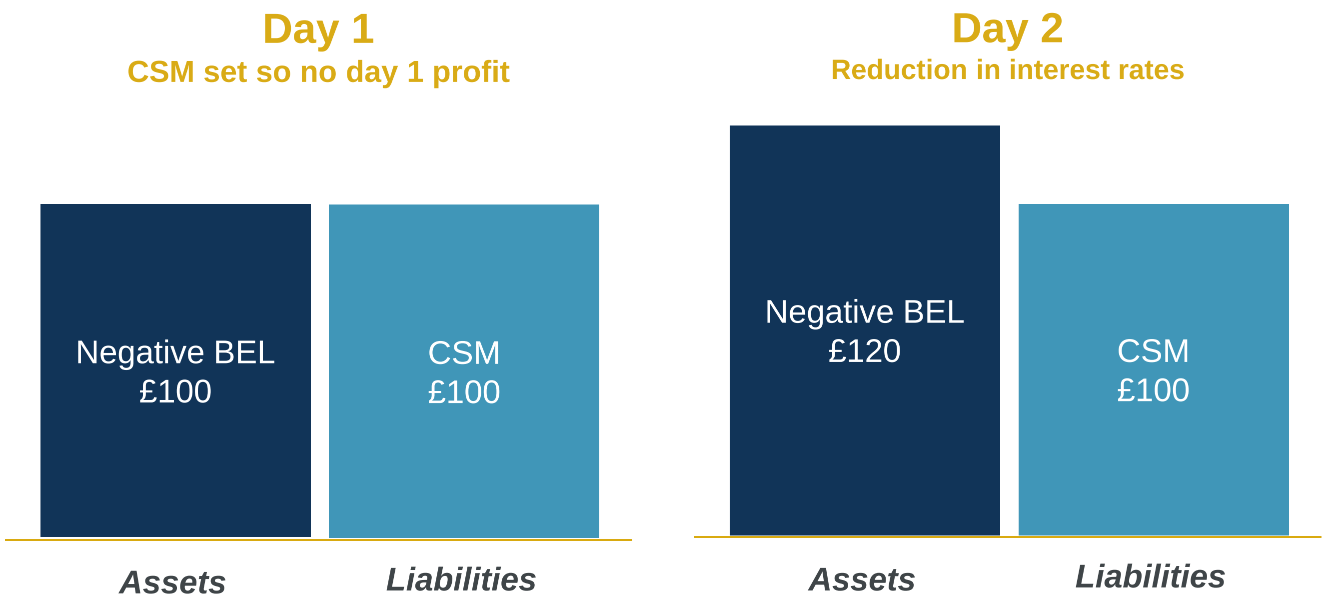
Interaction between best estimate liabilities and CSM (illustrative figures)

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

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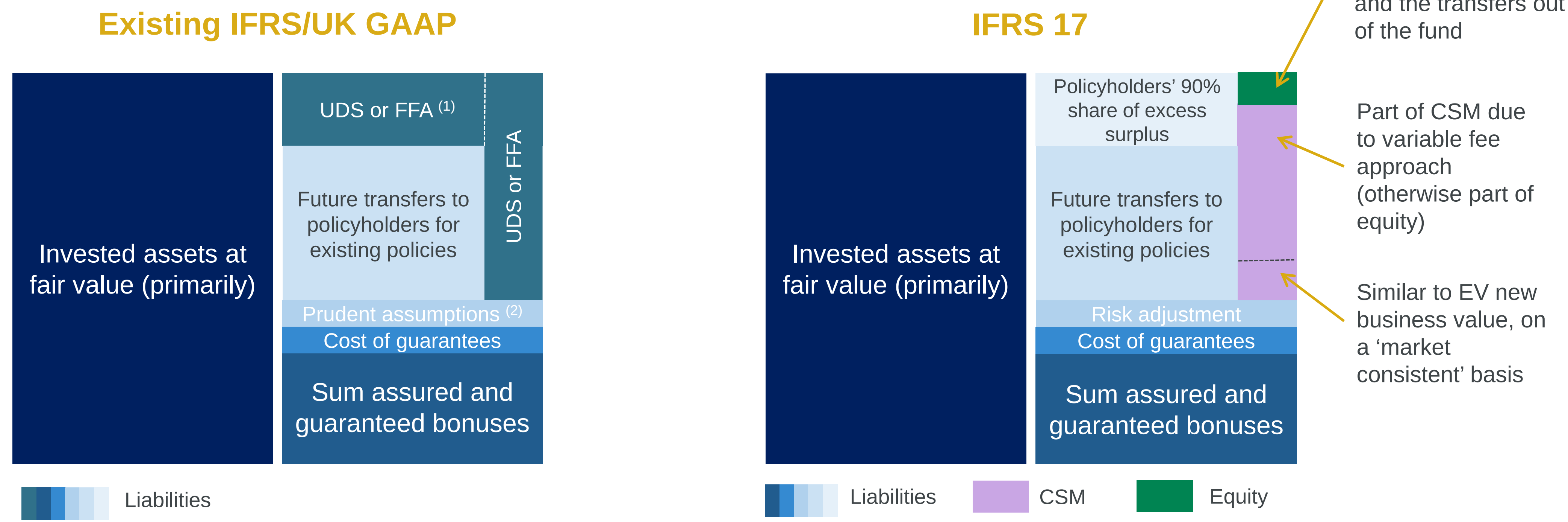
Example 3 – Variable fee approach

Illustrative impact for with-profit contracts (open fund)



- 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 Targeted Testing – September 2016

- IASB requested an assessment of the impact of the draft standard for clarity, interpretation and “operationality”.
- Assessment was restricted to 6 topics and did not consider other aspects of the draft standard.
- Process did not address whether, when taken as a whole, the proposals would lead to a true and fair view of financial position and performance and would have benefits that exceed the cost of implementation.

Topic	Summary	Preparer findings

1. Aggregation of contracts (for onerous contracts & CSM release to P&L)	• Contracts are grouped where:
	  • Future cash flows are expected to respond similarly in terms of amount and timing of changes in key assumptions.
	  • Similar profitability (CSM/premiums).
		• Drafting not clear, especially in relation to mutualisation for participating funds.
		• Excessively low level of grouping required.

2. Scope of the variable fee	• As set out earlier.	• Would UK unit linked contracts with fixed death benefits be in scope? • Interpretation of “substantial”. • Contracts with constructive rather than contractual obligation.

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IASB Targeted Testing – September 2016 (continued)

Topic	Summary	Preparer findings

3. Derivatives to mitigate financial market risk	• Option to post certain changes in the variable fee to P&L rather than CSM (where risk mitigation / hedging conditions are met).	• Limited scope of application – the following would be excluded:
		  • Hedging of AMCs / with profit shareholder share for equity risk
		  • Risk mitigation outside of VFA
		  • Macroeconomic management of economic risks
		• Prospective only basis (from point of transition).
		• Residual accounting mismatch even for those arrangements that are within scope (fair value vs. fulfilment value).

4. OCI methods	• Various accounting policy choices to allocate finance income and expense in P&L or OCI	• Limited applicability to UK insurers with P&L assets. • Complex proposals.
5. Recognition of changes in estimates	• Changes in cash flows related to future/other service recognised in CSM based on day 1 rates. • Actual vs expected experience variance in period could be in P&L or CSM.	• Uncertainty over how to interpret what constitutes “discretion” for contracts outside the VFA (drives allocation between P&L/OCI/CSM). • Does this provide meaningful information?
6. Transition	• As set out earlier	• Data gaps are likely to make the fully retrospective option, and possibly the simplified approach, not possible to apply. Simplifications to both options are needed? • Interpretation of the fair value approach? • Level of granularity for transition CSM and release to P&L thereon. • Impact of the restriction from adding new contracts to a transition portfolio (e.g. participating).

Recall: Solvency II vs. IFRS contract liabilities

- For insurance (including with-profits), many of the building blocks are expected to be similar, however, there are likely to be a number of differences:
  - Best estimate liabilities –
    - Different cash flows (e.g. certain expense/tax cash flows, inclusion of acquisition expenses)?
    - Different contract boundary?
  - Discount rate – Restrictions in Solvency II matching adjustment versus IFRS top down approach? Applicability of the Solvency II volatility adjustment in IFRS?
  - Risk adjustment –
    - Calibration differences due to different philosophy? (e.g. fulfilment versus transfer value)
    - No transitional measure relief in IFRS
  - CSM – Not relevant in Solvency II and new modelling systems will be required for IFRS
- Non-participating investment contracts (e.g. unit linked savings) will be different to Solvency II (due to deferral / matching in IFRS).

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

Operational considerations

Best Estimate Liabilities

Process | Apps/Data | Infrastructure

- Functionality exists in Solvency II models?
- New inputs/splits to be sourced.
- Enhance model infrastructure due to extra model runs required? (e.g. from unit of account and P&L/CSM/OCI split)
- More detailed granular output.
- May need to accelerate timeline from Solvency II?

Risk Adjustment

Process | Apps/Data | Infrastructure

- Potential flexibility in requirements to leverage Solvency II processes and systems.
- New splits required (e.g. level of granularity/revenue). All produced within financial reporting timeframe.
- Is it a material risk driver of the overall result? Simplifications may be possible.

CSM

Process | Apps/Data | Infrastructure

- New processes, data and applications and systems are required.
- Level of granularity of calculation could drive significant data storage needs and overall solution complexity – may need to consider an actuarial data and results repository solution.

Transition

Process | Apps/Data | Infrastructure

- One-off exercise where significant additional historic data likely to be required for material blocks of business.
- Level of granularity and financial outcome likely to determine extent of data mining exercise.
- Opportunity to retain data now in preparation?
- Consider comparative periods.

Disclosures

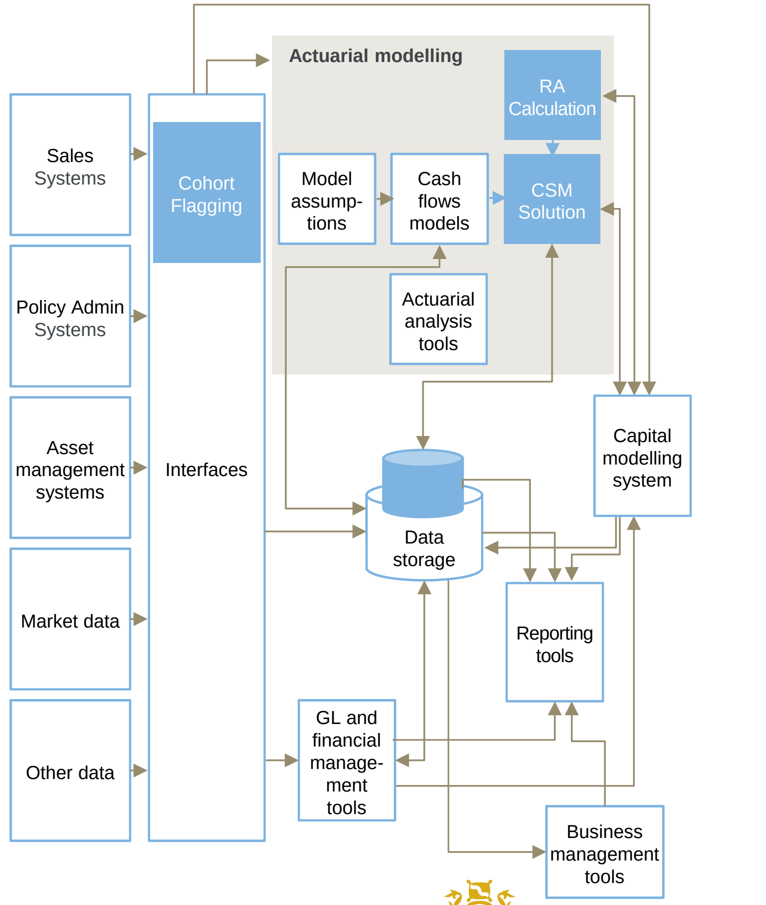
Process | Apps/Data | Infrastructure

- Aggregated accounts are to be re-defined to meet disclosure requirements which will drive re-work across aggregated reporting systems.
- New data splits/outputs will be required from actuarial models (e.g. revenue, movement analyses etc.)

Other impacts

Process | Apps/Data | Infrastructure

- No anticipated impact on policy administration systems, however, the unit of account assumption drives the granularity and quantity of data required, which will likely lead to solutions such as cohort flagging being implemented.
- Revisions to general ledger and chart of accounts may be required.



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An Analyst's Perspective on IFRS Phase 2

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Balance Sheet, which one?

- Solvency II (SII) now plays significant role in external reporting – will evolve
- SII discount rate produces reasonable results only alongside ‘fixes’ including VA, MA, DVA, UFR, transitionals, definition of fundamental spread. IFRS any better?
- ‘Cash and capital’ generation
  - Can include capital in unit-linked - not normally cash, and may not be capital under IFRS phase 2
- SII risk margin has become contentious

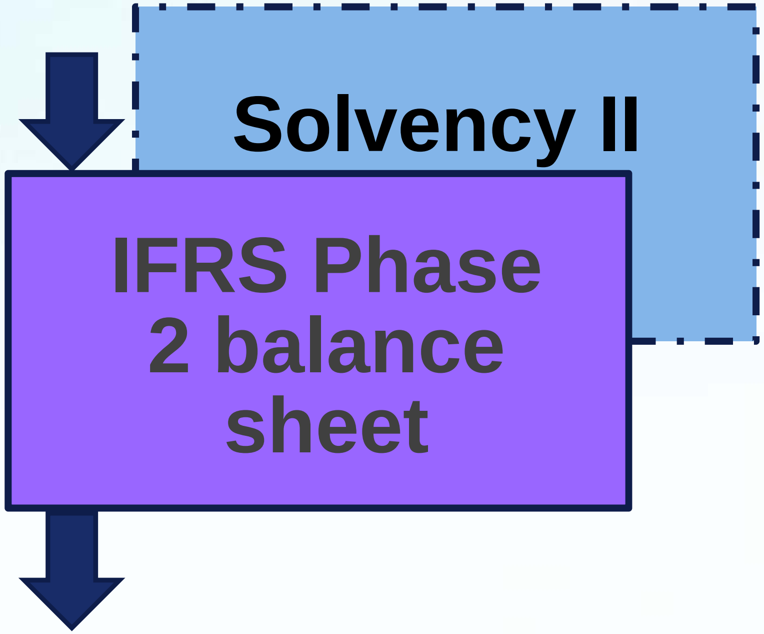
Solvency II own funds

IFRS Phase 2 balance sheet

Balance Sheet, IFRS

- More flexibility on discount rate, likely closer to expected return
- Reserves more clearly represent expected cost, add risk adjustment for a market value
- Market value/amortised cost choices for liabilities should be well flagged
- Loss of link to regulatory reporting. But was unclear and complex.
- IFRS phase 2 includes profit/performance measure

Introduction of IFRS phase 2 would likely act to diminish the role of SII



Profit, a new measure

- Solvency II has movements only.
- Profit ≠ cash IS like other industries
- CSM, ‘ons’ and offs’ likely to be a focus, may extend to risk margin
- Investment ‘variances’ go to CSM for participating and insured U-L only. Investment contracts separate.
- Narrow unit of account unattractive as CSM then becomes ‘only the good news’
- CSM can help reinstate profit as significant metric. Amortisation of CSM (and risk adjustment) looks like an ‘underlying’ measure.

CSM was ‘plug’ to avoid year one profit

Becomes estimate of per annum profitability

To consider …

- Implementation still not clear, but IFRS phase 2 will have central role for users of financial reporting
    - IFRS will be (more) global, will be data input for rating agencies
    - By default, IFRS will be capital measure for many important stakeholders, including investors
    - Profit/performance measure will be IFRS
    - But, IFRS does not provide a required capital measure
- CSM and risk adjustment – part of capital?
- Revenue presentation a challenge – it has become another estimate
- Bridge between SII and IFRS will be desirable
- A wider view than the SII lens probably helpful for line-of-sight to broader stakeholder/commercial objectives

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So has the wait been worth it?

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Questions

Comments

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