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Just when you thought you could relax, it looks like IFRS 4 Phase 2 will happen!

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20 November 2015

Agenda

- Developments in IFRS 4 Phase II
- Developments in IFRS 9 (Assets)
- What happens to IFRS / EV after 1 January 2016?
- An analyst’s perspective on financial reporting
- Concluding remarks

Current known timeline

IFRS standards	2015	2016	2017	2018	2019	2020
Insurance contracts (IFRS 4 Phase II)	Final standard late 2016 / early 2017?					Effective 2020/2021?
Financial asset and liabilities (IFRS 9)	ED to IFRS 4			Effective 1 January 2018 (for non-insurance business models?)		
Revenue (IFRS 15)	Targeted amendments to new standard			Effective 1 January 2018		
UK developments						
'New' UK GAAP (FRS 102/103)	Effective 1 January 2015					

- All IFRS standards are subject to EU endorsement.
- Future amendments to other IFRS standards may also impact insurers, for example, IAS 38 (for acquired VIF) and IAS 1 (certain disclosures).
- FASB (the US accounting standard setter) decided in 2014 to make only targeted amendments to US GAAP, so there will be no global accounting standard.

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Developments in IFRS 4 Phase II

What is the model and potential implications?

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Reminder of current accounting in UK

Insurance and with profit contract liabilities

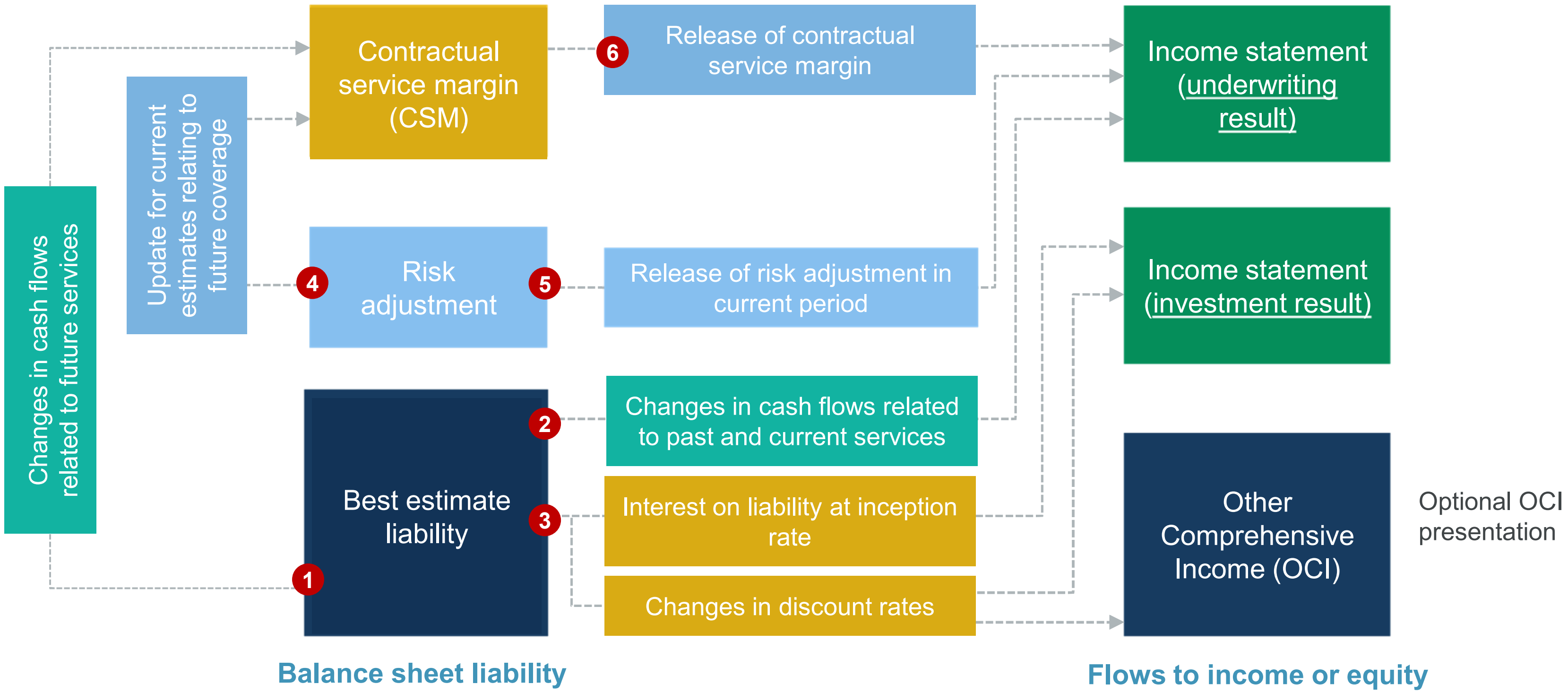
- Non-profit funds – Largely based on PRA return (Solvency I) liability with some adjustments:
  - Certain “contingency” reserves (e.g. closure to new business etc.) excluded and demographic / expense assumptions may be closer to best estimate.
  - DAC asset permitted provided recoverable from margins.
- With-profit funds –
  - Large funds: PRA realistic balance sheet with adjustments (e.g. shareholder share, non-profit VIF).
  - Small funds: PRA regulatory valuation.
  - UDS/FFA liability for unallocated surplus results in “cash” accounting (e.g. typically, profit is shareholder share of declared bonuses for proprietaries; and nil for mutual insurers).
- Notable exceptions –
  - UK-headquartered bancassurers adopt EV-accounting.
  - Some UK subsidaries of overseas companies adopt headquartered country accounting.

IFRS 4 Phase II liability models

Classification	Description	Likely contracts	Model
'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
'Long term' non-participating	• No cash flows that vary with returns from underlying assets.	Immediate annuities, protection etc.	**Building block approach**
'Direct' participating	• Participate in a defined share of clearly identified 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 etc.	**Variable fee approach**
'Indirect' participating	• Where direct criteria is not met.	Certain US universal life / fixed annuities	Building block approach with adjustments (in development)

Building block approach

Immediate annuities and protection contracts



Example – Portfolio of immediate annuities (1/2)

Contract specification

- Portfolio of 1,000 policies all sold to 80 year old non-smoking males for £1,000 per annum.
- Purchase price £11,500.
- Liability assumptions: Mortality (100% of standard table); Expenses (£20 pa increasing at 0.5% pa); and Discount rate (flat 2%).
- Simplified investment strategy based on rolling 10 year annual coupon paying bonds.

Example – Portfolio of immediate annuities (2/2)

Variable fee approach

With profit and unit linked contracts

Similar principles to the BBA using a 'market consistent' view with certain technical revisions, including:

Topic	Building block approach	Variable fee approach
Changes in assets supporting insurer's share	• Not directly relevant, but would be recognised in P&L (for most UK insurers)	• **Recognise in CSM** (e.g. change in unit linked AMCs and shareholders' share of future with profit transfers / estates; even if hedged?)
Changes in value of options and guarantees	• Recognise in CSM (non-financial assumptions) or P&L / OCI (depending on option for changes in discount rate)	• In general, **recognise in CSM**, but permitted to present in P&L where there is **risk mitigation** (e.g. derivatives at FVTPL).
Level of aggregation (unit of account)	• Objective of contract level, but some aggregation likely in practice • Onerous contracts cannot be aggregated with profitable contracts	• **Higher level of aggregation** may be permitted if 'mutualisation' conditions are met? • Application to with-profit funds with estates and non-profit contracts?
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	• **No change**, although potential uncertainty over application (e.g. open with-profit funds)? • Current rates to unlock and accrete

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, Solvency II surplus funds vs. IFRS 2013 Exposure draft paragraph B66k)?
    - Different contract boundary?
    - Unbundling of components
  - 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)
  - 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).

Remarks on the model and status

- IASB status – Viewed to be a distinct number of areas to be addressed (e.g. comparison between building block and variable fee approaches)?
- Profit recognition – Significantly different to current IFRS/GAAP, notably; no day 1 profits; ‘smoothing’ effect of the CSM; and no longer ‘cash’ accounting for with profit contracts.
- Complexity – Significant increase in complexity in measurement (e.g. CSM) and presentation (flows to P&L / CSM / OCI) which will impact data and system requirements.
- Transition: Importance of getting transition ‘right’ (financial, data, systems) as CSM is a retrospective concept.
- Disclosures – Complexity and relevance of income statement ‘revenue’; and increased volume of required reconciliations / roll-forwards and narrative disclosure.
- Role of the actuary – Significant increase in actuarial involvement in financial reporting to be expected – are we ready for it?
- Market status – Limited engagement in the UK market to date – when would this be expected to change?

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Developments in IFRS 9

What is happening to the asset side of the balance sheet?

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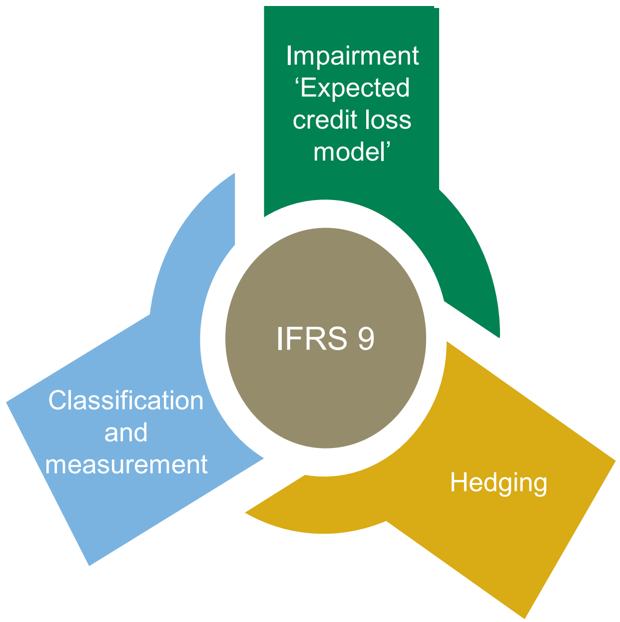
Requirements and implications

- Insurers with amortised cost assets and use ‘Available For Sale’ (AFS) will see the biggest impact
- More debt instruments will have to be measured at fair value through P&L
- New impairment model will result in earlier recognition of credit losses
- Multiple restatements in short succession?
- Need to consider assets and liabilities together to minimise accounting mismatches / volatility?



Impact is expected to be limited for many UK life insurers due to the fair value through P&L approach typically adopted in current accounting

Interactions with IFRS 4 Phase II

IASB exposure draft (ED) to amend current IFRS 4 to be issued in December 2015:

- Deferral approach –
  - Permit companies whose business model is to ‘predominantly’ issue insurance contracts the option to defer the effective date of IFRS 9 until 2021 (from 2018).
  - Assessed at (consolidated) reporting entity level.
- Overlay approach – Provides insurers who implement IFRS 9 the option to remove from profit or loss the impact of the new standard.

Potential implications:

- ‘Predominant’ condition (>75% of liabilities accounted for in IFRS 4?).
- Dual reporting for bancassurers (either owned by a bank or part of a financial conglomerate)?
- Timing of ED (60 day comment period).

FRG / IFoA will be working with IAA to develop the global professions response

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Impact of Solvency II on financial statements

What happens to IFRS / EV after 1 January 2016?

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Timeline

Standard	2015	2016	2017	2018	2019	2020
Solvency II		Effective 1 January 2016				
'New' UK GAAP	Effective 1 January 2015					Long term future unclear?
IFRS 4 Phase II (Insurance contracts)	Final standard late 2016 / early 2017?					Effective 2020/2021?
		Mind the Gap ... What could insurers adopt in the gap period?				

- Significant disconnect for the 1st time in the UK between accounting and solvency reporting from 1 January 2016

Possible options during the ‘gap period’

For insurance and with-profit contracts only

1. Maintain current approach (linked to Solvency I / PRA return)
2. Adopt elements of Solvency II or a modified version
3. Application of ‘parent’ accounting policies for subsidiaries (for multinationals)
4. Others?

Relevance and reliability

- IFRS 4 permits an insurer to change its accounting policies for insurance contracts:
  - *"if and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to these needs" .*
- IAS 8 explains that an accounting policy is reliable if *"the financial statements:*
  - *represent faithfully the financial position, financial performance and cash flows of the entity;*
  - *reflect the economic substance of transactions, other events and conditions and not merely the legal form;*
  - *are neutral, i.e. free from bias;*
  - *are prudent; and*
  - *are complete in all material respects."*

Factors to consider

Accounting considerations

- ‘Relevant / reliability’ criteria
- Prudence and risk allowance versus current accounting
- Future investment margins – use of matching & volatility adjustment
- Non-uniform accounting policies (across Groups)
- ‘Direction of travel’ to IFRS 4 Phase II
- Deferral of day 1 profits – Shareholder-owned versus mutual
- Solvency II technical provision transitional measures
- Solvency II surplus funds and inclusion of contractual cash flows

Factors to consider (continued)

Business and operational considerations

- Impact on tax and distributable reserves
- Impact of Solvency II ALM / capital optimisation on IFRS performance
- Operational and cost benefits (e.g. model runs, multiple restatements)
- 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.)
- Availability of EV profit projections for DAC/DTA recoverability
- Parent versus subsidiary accounts; or partial application

A future for supplementary / EV reporting?

- Do users need a ‘third view’ of the business or will Solvency II own funds and IFRS CSM be sufficient?
- Preparers are already showing appetite to streamline (stop?) their embedded value disclosures with greater focus on economic capital / Solvency II and cash generation metrics
- Where might supplementary reporting be useful?
  - Existing business profitability – a more ‘economic’ view than Solvency II Pillar 1 or IFRS.
  - New business reporting – volume and profitability measures.
  - Economic earnings recognition patterns – key drivers, timing, volatility etc.
- Don’t forget where embedded value is used in current IFRS reporting!

To what extent will insurers allow for Solvency II in the embedded value reporting at 31 December 2015?

European Insurance CFO Forum public statement

October 2015

"In October 2015, the European Insurance CFO Forum ('CFO Forum') announced additional guidance for embedded value reporting in advance of the effective date of Solvency II. The additional guidance replaces the previous interim guidance announced in September 2012.

The additional guidance states:

- *The Solvency II regulatory regime is effective from 1 January 2016. The Solvency II requirements will not be finalised until late in 2015 for a number of insurers, consequently, the CFO Forum* ***do not view*** *an allowance for Solvency II and its associated consequences to be required when complying with the European Insurance CFO Forum Market Consistent Embedded Value Principles (MCEV Principles)© or the European Embedded Value (EEV) Principles for reporting periods ending before 30 June 2016.*
- *It is recognised that* ***some members*** *of the CFO Forum are expected* ***to move towards Solvency II*** *methods in embedded value reporting for example, in relation to the reference rate. The CFO Forum* ***will revisit*** *the MCEV and EEV Principles for reporting periods ending in 2016 and subsequently."*

An Analyst's Perspective on IFRS 4 Phase 2 disclosure

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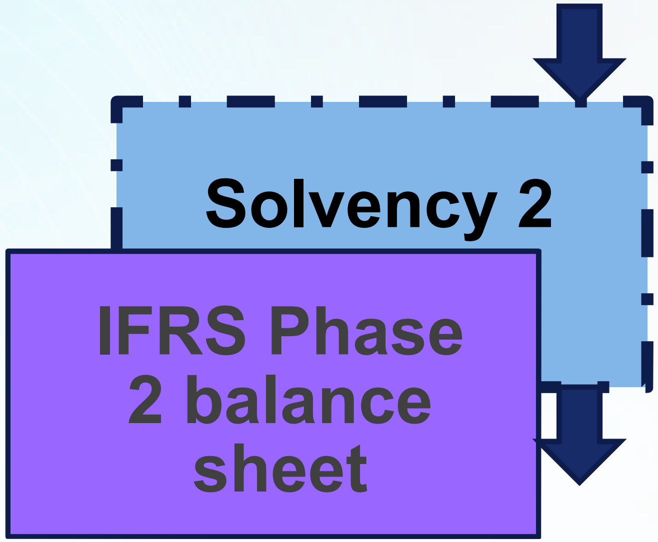
Overview

- Contractual Service Margin (CSM) potentially a valuable piece of reporting
  - But no required capital in IFRS reporting
- Revenue disclosure a considerable challenge for analysts
- Investment
- Balance sheet and capital - higher profile for Solvency II disclosure in the meantime, but might change as phase 2 introduced

Balance Sheet, which one?

- Solvency II own funds expected to play significant role for users before phase 2 is introduced. Yet it is likely to be an idiosyncratic result in some respects.
- Identifying and valuing cash flow net of required capital will remain a challenge
- If EV not reported, then would be missed for NAV, and as basis of ‘cash’ in ‘cash and growth’ stories
- Can IFRS supersede when it arrives?



Profit, a new measure

- In principle an improvement, particularly the CSM
- Potential to reinstate profit as a more significant metric
- CSM, ‘ons’ and offs’ could become area of enquiry, which then may extend to risk margin
- Do investment ‘variances’ go to CSM for participating business only?
- New business metrics, relationship to other disclosure?

To avoid year one profit

Best estimate of per annum profitability

To consider …

- Discount rate – more realistic than Solvency II?
- Investment reporting – what gets measured gets managed?
- Treatment of risk margin?
- Transition, initial communication will be an uncomfortable challenge
- If S2 own funds used for NAV, can this be paired with the CSM?
- IFRS will be data input for rating agencies – plus adjustments
- By default, IFRS will be capital measure for some important investors

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Concluding remarks

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Questions

Comments

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