Institute and Faculty of Actuaries

# What are the challenges for valuing with-profits under IFRS17?

Jo Stansfield - Lloyds Banking Group
Shaun Gibbs - KPMG

21 November 2019

## Agenda

- A brief background to the IFRS17 measurement model
- Why is UK with-profits business troublesome?
- What are the key IFRS 17 challenges?
- Conclusions

Institute and Faculty of Actuaries

Institute and Faculty of Actuaries

# Background

IFRS17 measurement

21 November 2019

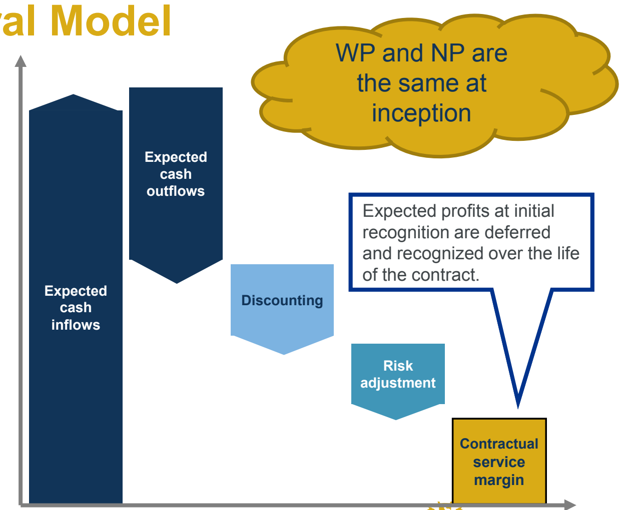
## What is IFRS17 – The General Model

**Estimates of future cash flows**

**Discounting** to reflect the time value of money

**Risk adjustment**

**CSM**
To be recognised over life of the contract

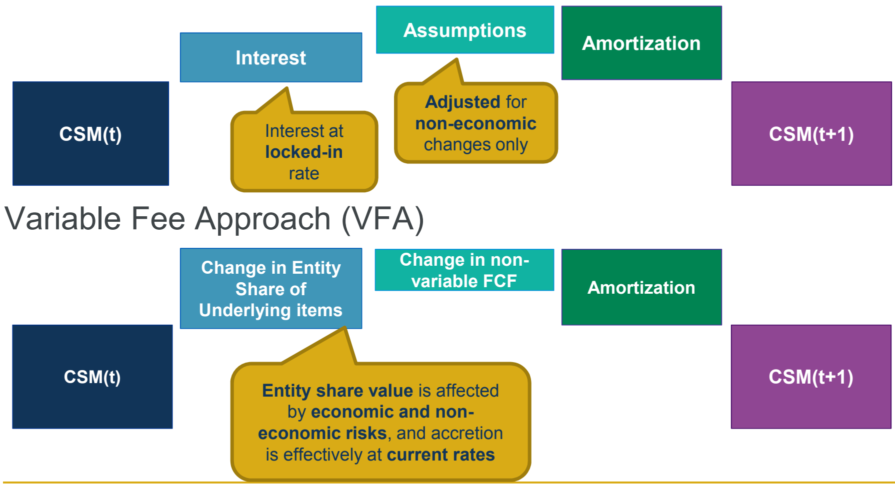



Institute and Faculty of Actuaries

21 November 2019 4

## Why a different model for WP?

General Model (GM)




WP business – value to entity is affected by past and future economic conditions.

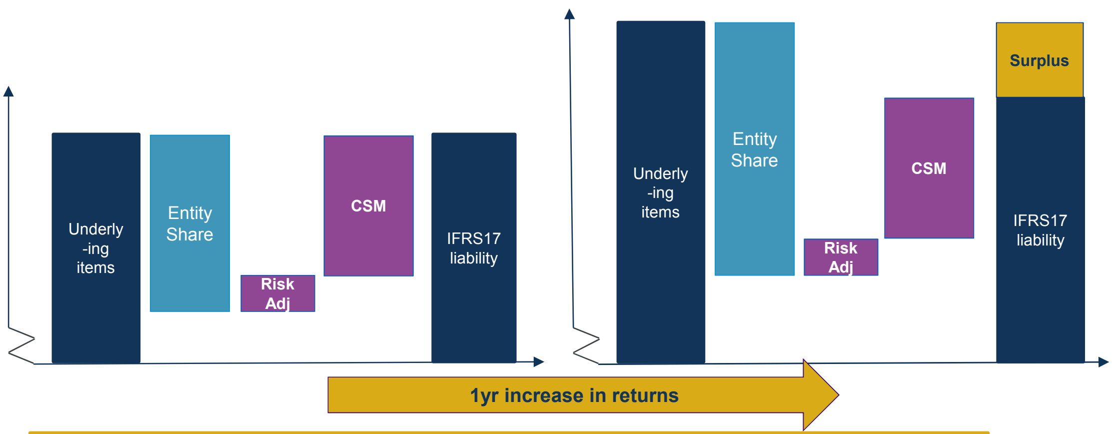
GM would not adjust CSM for economics, and any changes would be recognised in profit for the period.

Adjusted model therefore required to smooth these profits/losses

Institute and Faculty of Actuaries



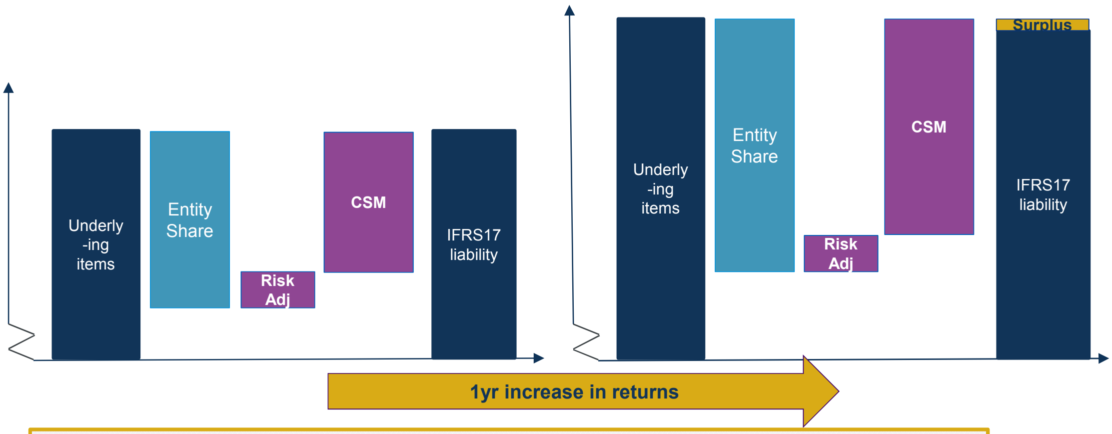
## Applying General model to WP Business




Investment returns increase the underlying items and hence Entity Share.
In the GM the CSM would not reflect this, and a surplus is generated.

Institute and Faculty of Actuaries

## WP Business with VFA model




CSM is adjusted for impact of investment returns on Entity Share.
Surplus in period only reflects release of CSM over the year.

Institute and Faculty of Actuaries



## Variable Fee Approach and Eligibility

1. The building blocks still apply
2. The approach considers the variable fee associated with direct participating contracts
3. The underlying items can be held or referenced
4. Should assist entities in reducing accounting mismatches and volatility

**Underlying items related to policyholder participation**

–

**Obligation to policyholder**

=

**Fee for service**

**Eligibility (B101)**

- Specified 'underlying items'
- Policyholder receives substantial share of returns on underlying items
- Amounts paid vary with value of underlying items

**Current draft = assessment at contract level**

The key difference is that under VFA, economic experience and assumption changes are adjusted in CSM, which means the impacts are spread over the duration of the contract.

Institute and Faculty of Actuaries

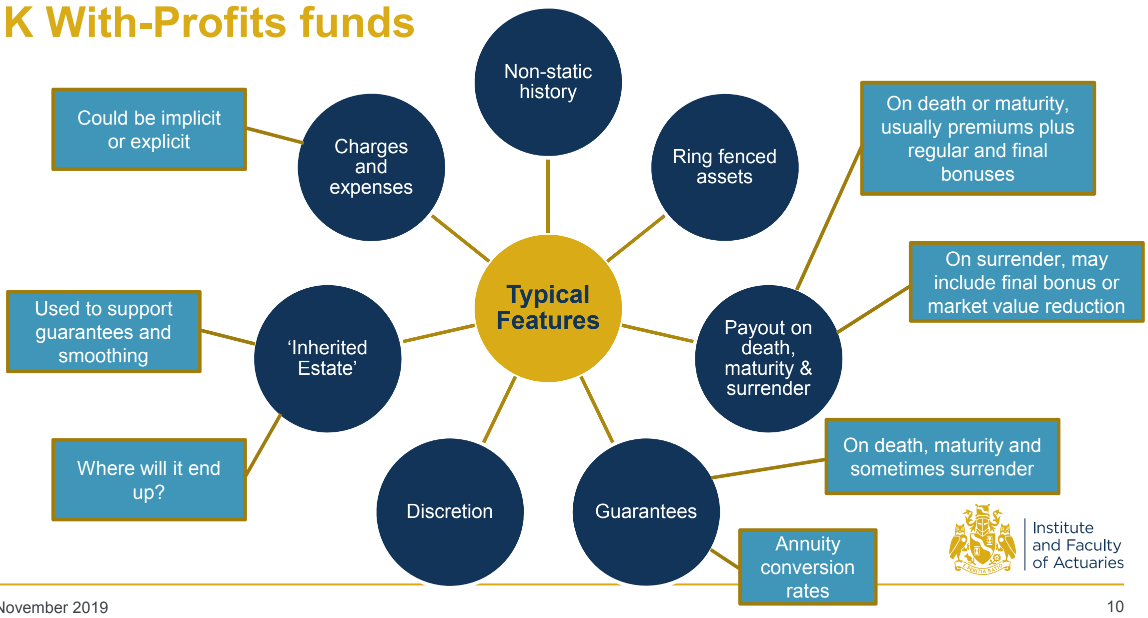
Institute and Faculty of Actuaries

# Background

Why is UK with-profits business troublesome?

21 November 2019

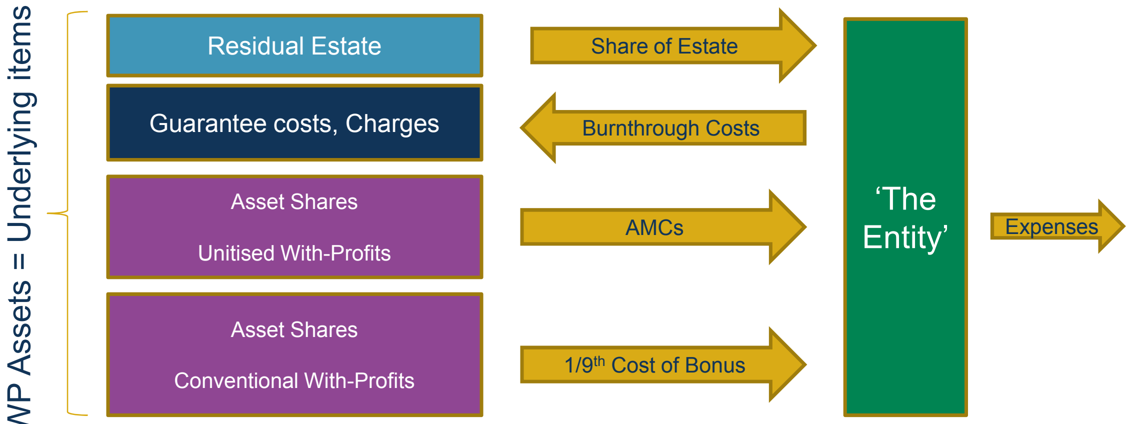
## UK With-Profits funds




Institute and Faculty of Actuaries

21 November 2019 10

## UK With Profits – Typical Proprietary Fund

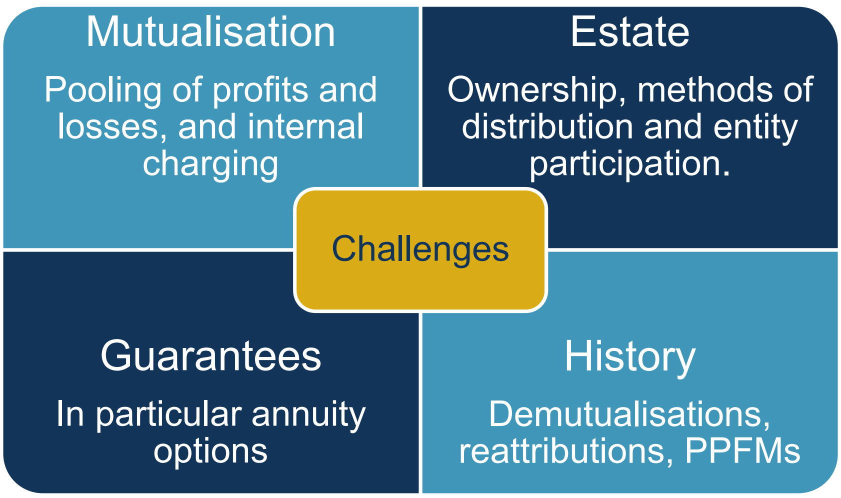



***IFRS 17 terminology:* 'Entity Share'**: The entity earns profits through the application of AMCs and bonus sharing, and through any participation in the residual estate. The entity is liable when the guaranteed benefits exceed the assets in the fund ('burnthrough').

Institute and Faculty of Actuaries



## UK With Profits – Key issues




Institute and Faculty of Actuaries

Institute and Faculty of Actuaries

# What are the key IFRS 17 challenges?

Guaranteed annuities

21 November 2019

## Guaranteed Annuities - Background

- Many with-profits pensions contracts feature guaranteed annuities e.g.:
  - Guaranteed rate of conversion (GAOs)
  - Other deferred annuities on guaranteed terms
- At retirement, there are different approaches to the annuity:
  - Write the annuity in the with-profits fund
  - Internal buy-out into annuity fund
  - External buy out to open market (clear contract boundary)
- In most cases, practically viewed as the cessation of with-profits contract and writing of new annuity contract.
- The ability to segregate the annuity has no consequence under IFRS4 or SII.

Institute and Faculty of Actuaries

21 November 2019 14

## Guaranteed Annuities – The issues

Significant issues occur if the with-profits and annuity elements cannot be separated or deemed to be modified:

**Cannot change the measurement model**

- Likely to be forced to use VFA model, which causes accounting mismatches

**Systems cannot distinguish ex-WP contracts from general annuity population**

- True inception date is likely unknown, preventing retrospective transition calculations.

**Very long coverage period**

- Savings and retirement phase, and how to determine coverage units across each phase.

**Risk adjustment**

- In WP savings phase would also need to consider future risks on the annuity

Institute and Faculty of Actuaries



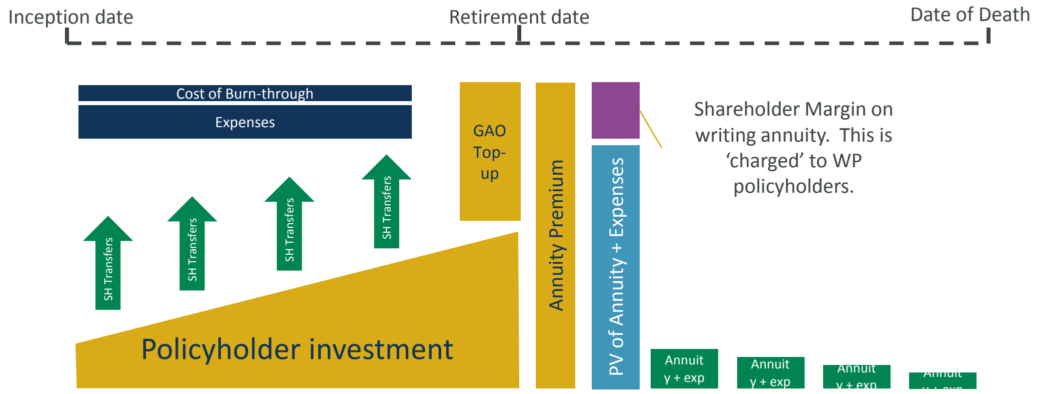
## Guaranteed Annuities – IFRS17

Can we somehow separate out the annuity under IFRS17?

| | IFRS17 | Conclusion |
|---|---|---|
| Separation | WP element cannot be viewed as a distinct investment component as there is clear interdependence between the cashflows on the WP contract and on the guaranteed annuity. (B31(a)). | ✘ |
| Modification | This requires that the terms of the contract have been modified, when almost certainly the guarantee existed from inception and is unchanged. The exercise of a right is not a modification (72). | ✘ |
| Contract Boundary | In some cases, the annuity is bought out:<br>- Externally – clearly there is a contract boundary, and a new contract in a new entity<br>- Internally – there is potentially a contract boundary if the annuity is bought out internally at a market price. | ? |

Institute and Faculty of Actuaries

## Guaranteed Annuities – Internal buy-out




Proposition: Underwriting the annuity internally still creates a contract boundary

Institute and Faculty of Actuaries



## Guaranteed Annuities – contract boundary

**Is there a contract boundary in an internal buy out?**

- Paragraph 34: A substantive obligation to provide services ends when:
- (a) the entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; or
- (b) both of the following criteria are satisfied:
- (i) the entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio; and
- (ii) the pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date.

**Yes**

- Premium charged by entity to WP fund to bear the risk
- Based on market annuity rates and underwriting of individual policyholder
- Premium reduces FCF on other WP contracts

**No**

- Purely internal transaction
- P34 doesn't address case where 'premium' isn't charged to that policyholder
- P34 (b) requires no premiums paid related to coverage after boundary – potentially has.

Institute and Faculty of Actuaries

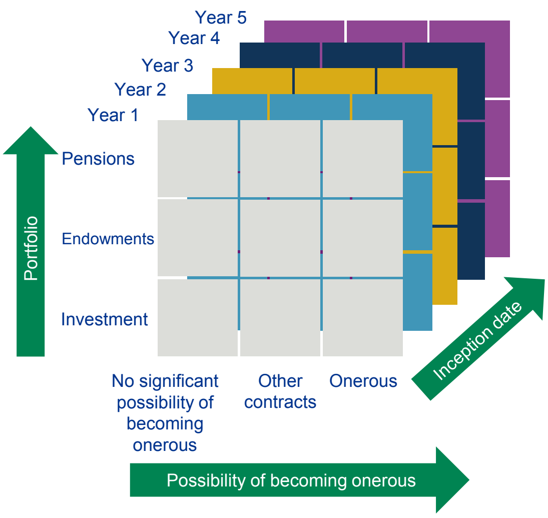
Institute and Faculty of Actuaries

# What are the key IFRS 17 challenges?

Level of Aggregation

21 November 2019

## Level of Aggregation - Requirements




**Implications for UK WP**

**Portfolios** intended to represent groups with ‘similar risks’ or ‘managed together’. **Some judgement here.**

Funds or groups may have different **profitability groups**, depending on the entity exposure e.g. extent that Estate absorbs losses.

Closed or very low new business volumes for WP – may have no need for **annual cohorts** post transition. However, for funds with NB, annual cohorting doesn’t reflect inter-generational mutualisation.

Institute and Faculty of Actuaries

21 November 2019 20

## How do we define the Portfolio?

**Similar Risks**

- Policyholder perspective? e.g. mortality, expense, market
- Entity perspective? E.g. mainly market, longevity for GAOs
- If market risk dominates for entity, should all WP be in the same portfolio?

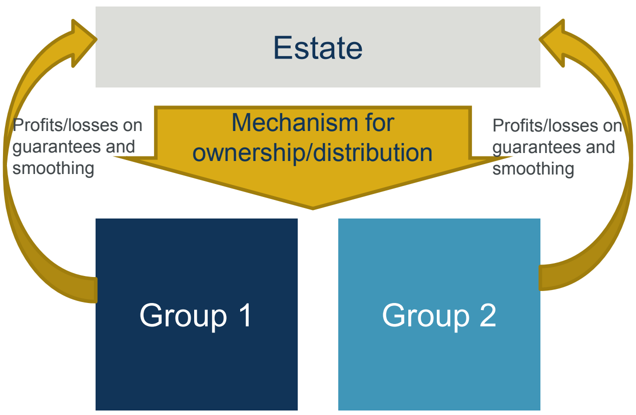
**Managed Together**

- This can mean different things
- Ring-fencing may exist e.g. for jurisdiction, tax, vintages
- Unit-linked versus conventional
- Depends on extent to which underlying items are ring-fenced
- Estate – is the segregated, or does it support all contracts indiscriminately? If the latter, risks are managed together.
- Ultimately, does the entity manage its relationship with the WP fund as a whole?

Institute and Faculty of Actuaries



## Risk Sharing – argument for single group




- Risk sharing exists through the Estate.
- Profits and losses incurred by each group initially adjust the Estate.
- Ownership or distribution of the Estate is likely to be a independent of where these profits/losses arise.
- Therefore, there is sharing across all groups via the Estate.
- Absent any ring-fencing of the Estate, this means risk sharing across portfolio, annual cohorts and profitability groups.

BC138 acknowledged that with full risk sharing, any aggregation of more granular portfolios would give the same result as a single portfolio. IASB did not change requirements in these cases to avoid complexity
However, if it achieves the same outcome for amounts reported, it is allowable to avoid lower portfolios.

Institute and Faculty of Actuaries

## Measuring The Estate

Ultimately, the Estate cannot be shown as undistributed surplus. It must be included in the FCF.

**IFRS17**

- IFRS17 (2): "*An entity shall consider its substantive rights and obligations, whether they arise from a contract, law or regulation, when applying IFRS 17*"
- IFRS17 (B71): "*After all the coverage has been provided to the contracts in a group, the fulfilment cash flows may still include payments expected to be made to current policyholders in other groups or future policyholders*"
- IFRS17 (BC265): *When applying IFRS 17, payments to policyholders form part of the fulfilment cash flows regardless of whether those payments are expected to be made to current or future policyholders*

**Implications**

- 'Regulation' – e.g. what does PPFM say about management of the Estate?
- BC265: Effectively the Estate must be translated to future cash flows, so that there is exhaustion at the end. This is true whether fund is open or closed:
- B71: Applies if there is no 'systematic or rational' way of allocating these cash flows. In this case can have Estate as a separate group.
- But would expect some method to allocate the Estate to groups.
- Equally applies to Burn-through costs



Institute and Faculty of Actuaries

## What are the key IFRS 17 challenges?

Non-Profits contracts in with-profits funds

# Non-Profit business

- Economically, the profits earned on these contracts are distributed wholly or partially to with-profits policyholders. The Entity may share in these profits.
- However:
  - NP policies need to be grouped separately
  - Measurement of the group in isolation would lead to a CSM (assuming profitable)
- This is confirmed in an IASB paper on mutuals:
- *"Mutual entities may issue conventional insurance contracts that do not provide policyholders with a residual interest in the mutual entity, for example non-participating insurance contracts…..* The requirements of IFRS 17 apply to these contracts regardless of the fact that they: have been issued by a mutual entity; and are underlying items for other contracts. **Consequently, groups of such contracts are expected to have a CSM**"
- Implications:
  - Entity disclosing profits that are actually allocated to policyholders.
  - Value of NP business is valued at Fair Value when assessing with-profits contracts, whereas IFRS17 is used for the NP contracts, creating an accounting mismatch.

Institute and Faculty of Actuaries

21 November 2019 25

Institute and Faculty of Actuaries

# What are the key IFRS 17 challenges?

Other issues

21 November 2019

## Other With-Profits issues

- VFA eligibility: Latest draft suggests assessment at individual contract level
- Risk Adjustment: how we get from ‘entity view’ to ‘shareholder view’
- Transition:
  - What is the recognition date – usually multiple transactions, demutualisation, creation of PPFM
  - Methods – Very hard to apply any retrospective methods (no recent NB). What could a fair value for WP funds be?
- Reinsurance: VFA/GMM mismatch (how can this be resolved by risk mitigation option)
- Treatment of hybrid contracts

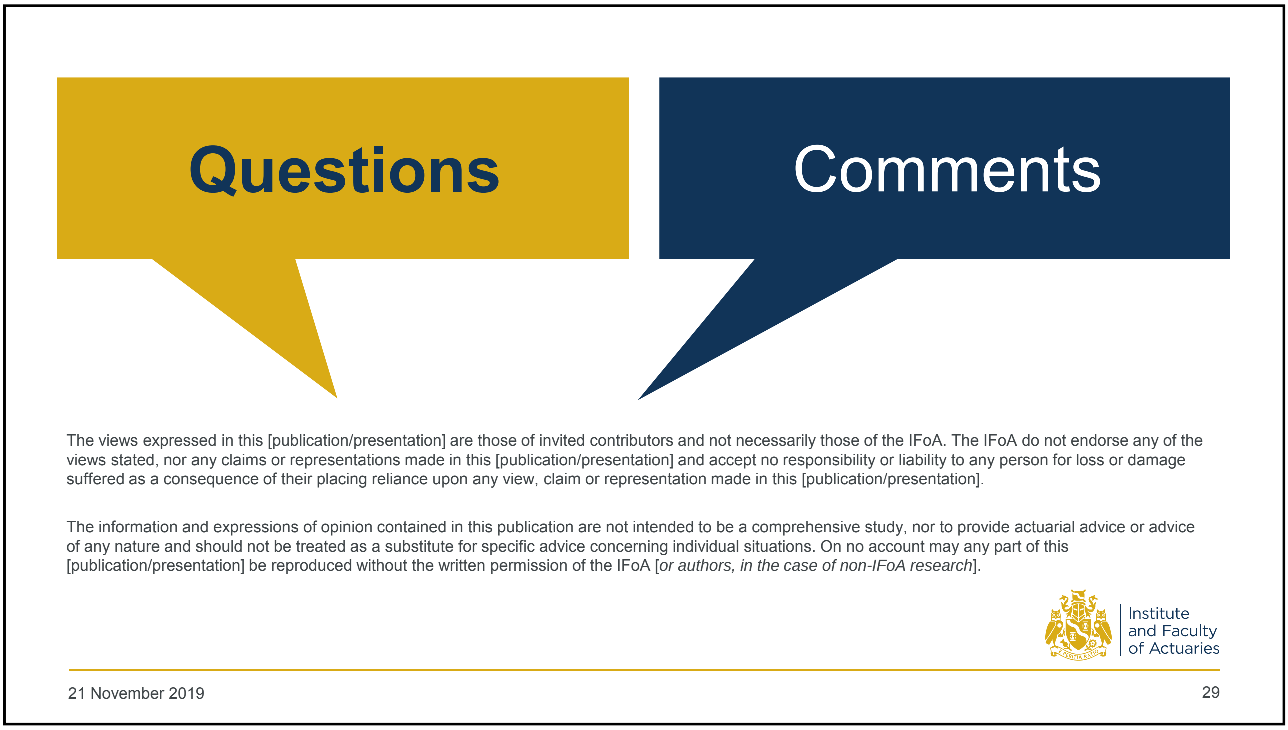
Institute and Faculty of Actuaries



## Conclusions

- The standard as written presents commercial and operational issues
- Little appetite for IASB to address UK specific issues (e.g. Estate, GAOs)
- But there is ongoing lobbying on mutualisation and GAOs
- Ultimately, IFRS17 profit recognition will be smoothed vis a vis recognition of cash, which mainly occurs when final bonuses paid.
- Much of pain is operational – actuarial modelling and data availability
- Need to balance policyholder interests if adjusting scheme in any way in reaction to IFRS17 e.g. changing writing of guaranteed annuities.

Institute and Faculty of Actuaries


Questions
Comments
The views expressed in this [publication/presentation] are those of invited contributors and not necessarily those of the IFoA. The IFoA do not endorse any of the views stated, nor any claims or representations made in this [publication/presentation] and accept no responsibility or liability to any person for loss or damage suffered as a consequence of their placing reliance upon any view, claim or representation made in this [publication/presentation].
The information and expressions of opinion contained in this publication are not intended to be a comprehensive study, nor to provide actuarial advice or advice of any nature and should not be treated as a substitute for specific advice concerning individual situations. On no account may any part of this [publication/presentation] be reproduced without the written permission of the IFoA [or authors, in the case of non-IFoA research].
Institute and Faculty of Actuaries
21 November 2019
29