IFRS4 Phase 2
OVERVIEW AND IMPLEMENTATION CHALLENGES

23RD ANNUAL CONFERENCE OF THE CARIBBEAN ACTUARIAL ASSOCIATION
SECRETS WILD ORCHID – MONTEGO BAY, JAMAICA
DECEMBER 5, 2013

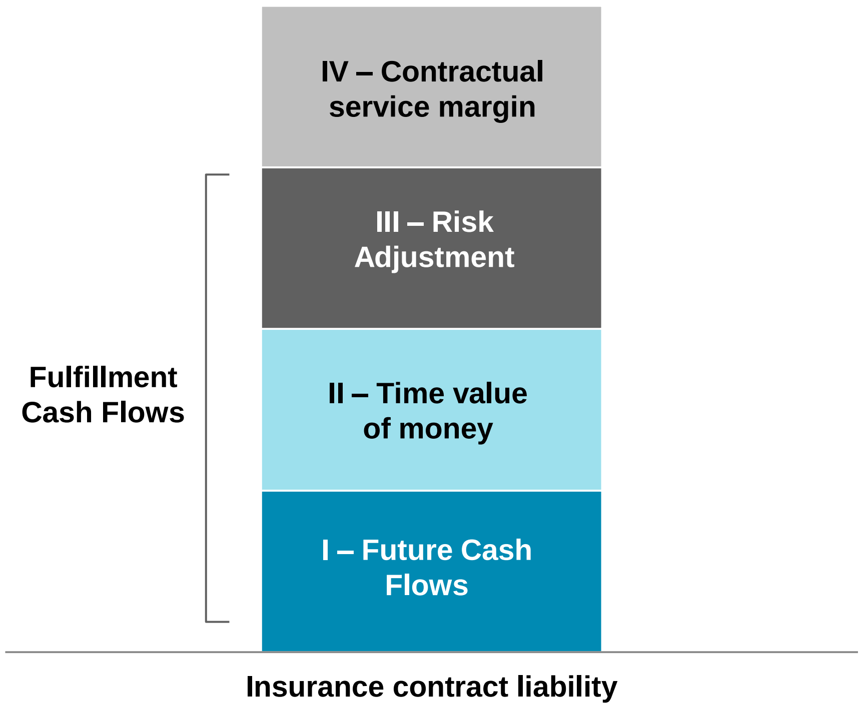
Robert Berendsen
FSA, FCIA, CERA, MAAA

CONFIDENTIALITY

Section 1 | Overview of IFRS4 Phase 2

The general rule is that the liability for insurance contracts will be established using the so-called "Building Block Approach"

Four Building Blocks

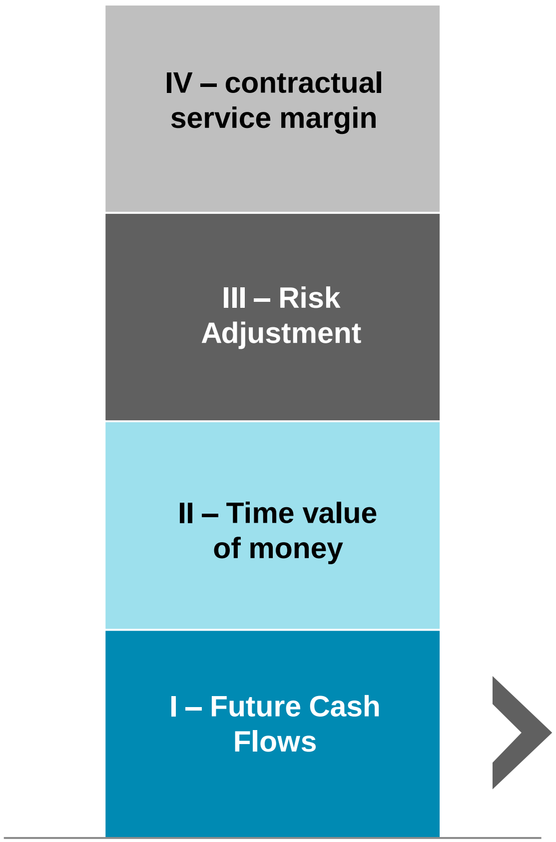


- **IV** Contractual service margin – an estimate of unearned lifetime contractual profits
- **III** Risk adjustment – an Assessment of the uncertainty about the amount of future cash flows
- **II** Time value of money – an adjustment that converts future cash flows into current amount
- **I** Probability weighted expected future cash flows

The first three blocks are familiar to those using a Caribbean PPM or similar approach, though there are material differences in the details. The CSM is a new element that will in many cases require significant redesign and upgrade of data requirements, processes and systems

Building Block Approach – Fulfilment cash flows

Four Building Blocks



Insurance contract liability

I Future cash flows

- Company is to use an **explicit, current, unbiased,** and **probability-weighted estimate** of future cash outflows less future cash inflows that will arise as the insurer **fulfills** the insurance contracts (i.e. not exit value)
- To include only cash flows that occur **directly** in fulfilling a portfolio of insurance contracts including
  a. Costs that relate directly to fulfillment of contract obligations (payments to policyholders, claims handling costs, etc.)
  b. Costs directly attributable to contract activity and that can be allocated to the portfolio
  c. Costs specifically chargeable to policyholder under terms of contract
- Acquisition costs are to be included in the cash flows, rather than as a separate deferred acquisition cost asset

Building Block Approach – Discounting

Four Building Blocks

IV – contractual service margin

III – Risk Adjustment

II – Time value of money

I – Future Cash Flows

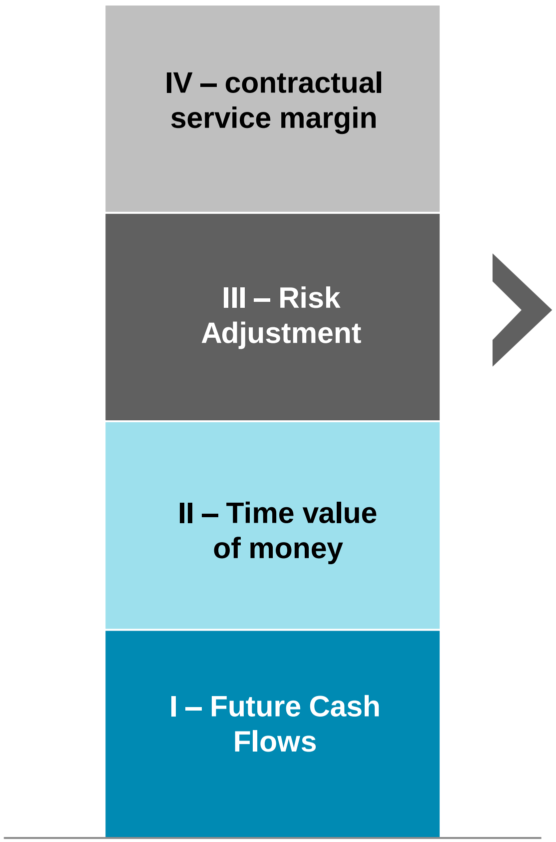
Insurance contract liability

II Time value of money – discount rate to be risk-free plus premium that reflects liability illiquidity

- **Bottom-up**: risk-free rate + an adjustment for illiquidity risk (illiquidity being the inability by the policyholder to convert the promise of future policy benefits into a cash settlement at any time from the insurer)
- **Top-down**: Market return less market risk premium
- Discount rate is consistent with **current observable market prices**, as at the valuation date, though need to also calculate using "at inception" market consistent discount rate
  a. Interest **accrual using "at inception"** discount rate will be shown in the **Profit or Loss**
  b. Impact of **change in current discount** rate will be accounted for in the **OCI**
- The net impact is such that the P&L volatility will be reduced as the impact will be absorbed by the OCI
- Will require that **supporting assets** be allowed as **Fair Value through OCI**, otherwise there will be an accounting mismatch

Building Block Approach – Risk adjustment

Four Building Blocks



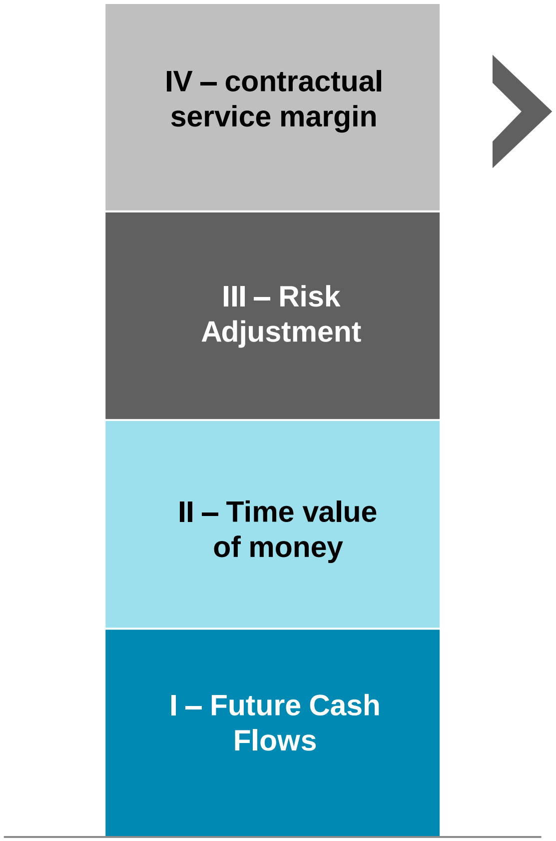
Insurance contract liability

III Risk adjustment

- An assessment of the **uncertainty about the amount and timing** of future cash flows
- Risk adjustment can be viewed as the **compensation the insurer requires for bearing the uncertainty** inherent in the cash flows that arise as the insurer fulfills the contract
- Similar concept as **PfADs** and reflects diversification benefit
- **No prescribed approach** but three approaches proposed
  a. Cost of Capital
  b. CTE
  c. VaR
- Challenges
  a. Cost of capital may emerge as the preferred method
  b. How to “translate” the current Caribbean/Canadian practice of MfAD into the IFRS definition
  c. Narrowing range of practice through peer review
  d. System/knowledge requirement if using CTE

Building Block Approach – Contractual Service Margin (CSM)

Four Building Blocks



Insurance contract liability

IV Contractual service margin

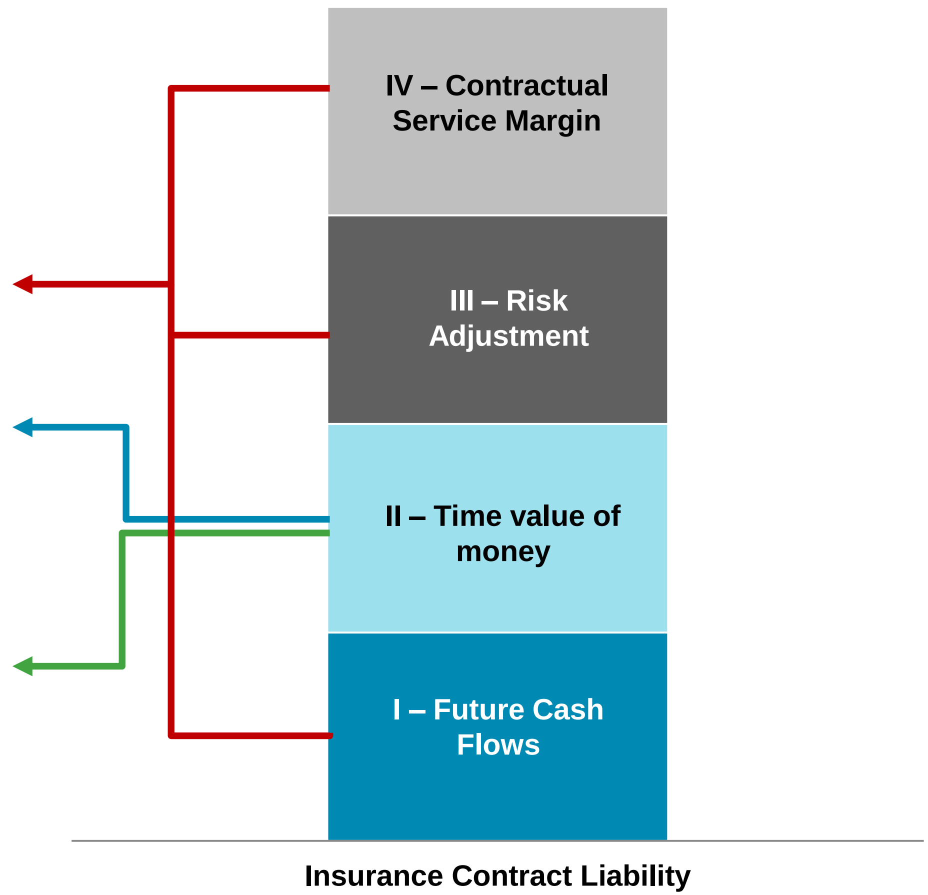
- Set up such that there is **no gain at inception**
- Set up and tracked at "**portfolio cohort**" level, similar risks with similar issue dates… could have hundreds of these
- Amortized over time **in proportion to services rendered**
- Will **absorb impact of changes to estimates** of future cash flows (as long as the CSM >0); but if change in estimates reduces CSM to zero, then "loss" will be recognized in Profit or Loss
- If there is a **loss at inception** ("onerous contract"), such loss is recognized immediately in P&L. If the onerous contract later becomes profitable (due to improvement in best estimate assumptions), past losses are first reversed and then a CSM is established and amortized

Presentation – Statement of Comprehensive Income (SCI)

Sample Statement of Comprehensive Income

		201X
Operating result	Insurance contracts revenue	aa
	Incurred Claims and Expenses	bb
	Subtotal	xx
Investment result	Investment Income	cc
	Interest on Liability (accrual at inception rates)	dd
	Subtotal	yy
Profit or Loss		xx + yy
OCI	Effect of changes in Current Discount Rate on Liability	ee
Total OCI		zz
Total Comprehensive Income		xx+yy+zz

Four Building Blocks



Implementation timeline
2013 to 2018?

2013 June	2013 October	H1 2014	Early 2015	Early 2018 –
Revised Exposure Draft	Comment letter Deadline	Board debate issues	Issue IFRS	3 years after the Issue of IFRS Effective date

The consultation period ended October 25, 2013

Changes are expected in light of comments/feedback received by the IASB

Parallel reporting needs to take place two years prior to the effective date

Recommended Action Items towards implementation date

1

Analysis

Conduct gap analysis and studies to quantify potential impacts and to address key issues

2

Education

Organize educational sessions for internal and external stakeholders to communicate the impending changes

3

Plan and strategize

Plan and strategize actions with can help with the transition of existing processes and systems to meet the new reporting requirements

4

Stay informed

Stay informed with the latest IFRS4 development and the proposals from the insurance industry locally and internationally

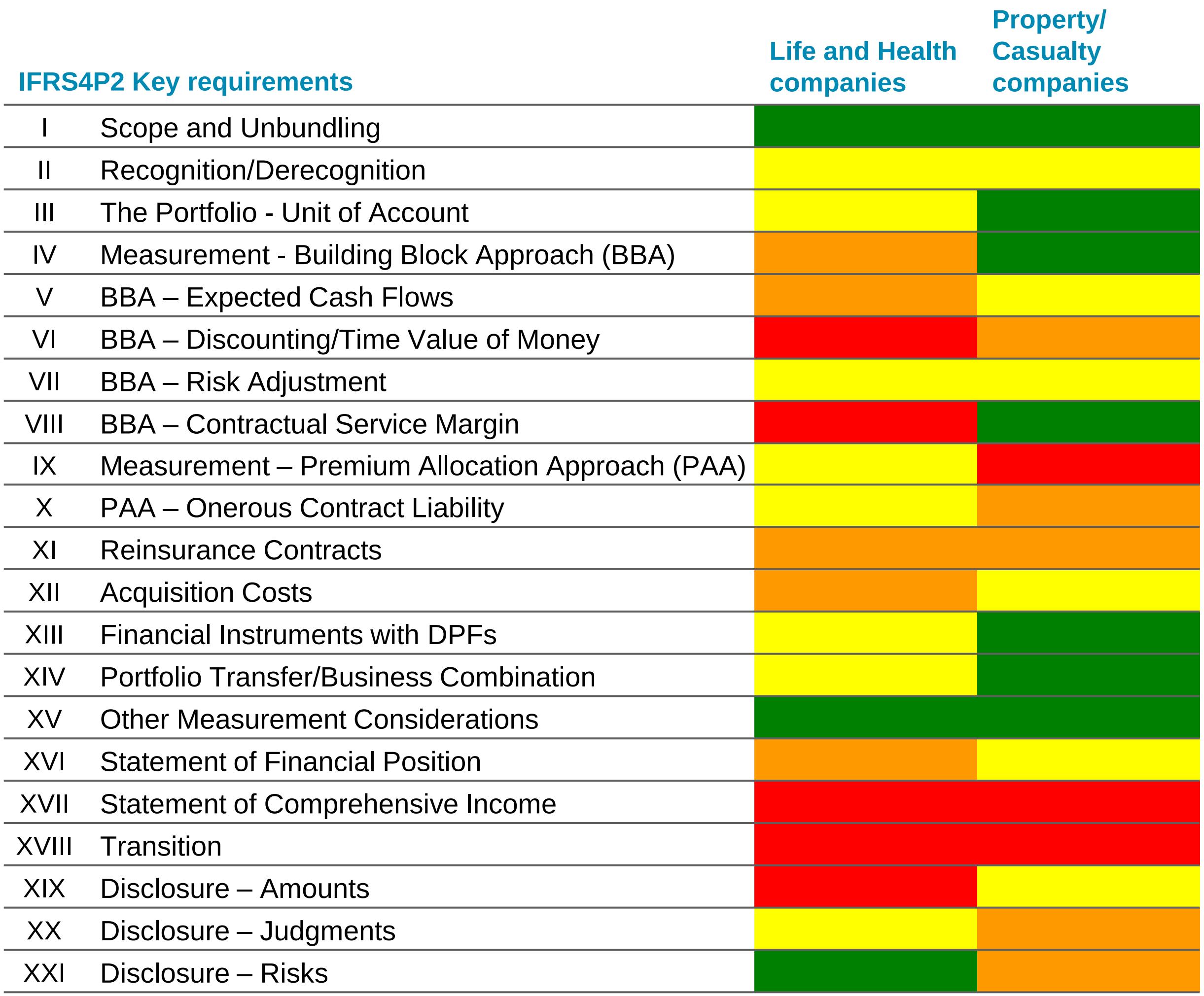
5

Identify new opportunities

Identify areas of opportunity for new business in light of the IFRS4

Section 2 | Implementation challenges

IFRS4 Phase 2 – Sample Company Readiness Heat Map



LARGE GAP

Significant gap between current practice and IFRS 4 Phase 2 requirements. Fundamental need to address this area

MEDIUM GAP

Material gap between current practice and the IFRS 4 Phase 2 requirements

Substantial opportunity for further development

SMALL GAP

Some ability to implement IFRS 4 Phase 2 requirements. Opportunity for further development exists

NO GAP

Current practice materially consistent with IFRS 4 Phase 2 requirements. Limited need for further development

IFRS4 Phase 2 Gap Analysis – Expected Cash Flows
Challenges

1

Expenses

IFRS4P2 requires that expenses be broken down into three categories

a. Direct acquisition expenses (excludes e.g. software dedicated to contract acquisition, equipment maintenance and depreciation, agent and sales staff recruiting and training)
b. Direct non-claims fulfillment expenses (maintenance and claims handling expenses)
c. Other (e.g. overhead, acquisition systems costs, marketing, training, etc.)

2

Acquisition costs

- Acquisition costs are to be included in the cash flows, rather than as a separate deferred acquisition cost asset

3

Contract Boundary

The boundary of an insurance contract is defined as the point at which an insurer either

a. Is no longer required to provide coverage, or
b. Has the right to reassess the risk of a particular policyholder (or portfolio) and reset a price to reflect the risk

IFRS4 Phase 2 Gap Analysis – Time value of money, i.e. Discounting
Challenges

1

Divergence in practice

- Variety of methods are allowed in deriving the market consistent discount rates
- Potential for wide range of practice initially but likely convergence to some industry standard over time through peer-review and audit

2

Availability of data; breakdown of total return into component parts

No easy answer, whether bottom-up or top-down. Questions include

a. Is there enough transaction data to derive reliable risk-free spot curve?
b. How does one extend the spot rate curve beyond “observable” rates?
c. What are the credit risk and illiquidity risk premia available on traded assets?
d. How to adjust asset returns to eliminate asset-specific effects? Can liability illiquidity risk premiums be higher than those available on supporting assets?
e. How to deal with country-specific issues like sovereign risk and incomplete/illiquid markets?

CAA developed a discount rate paper which can be used as a guidance for discount rate development

3

System constraints to track and monitor original and current discount rates

- Current valuation systems do not track and store two discount rates for each policy

IFRS4 Phase 2 Gap Analysis – Contractual Service Margin (CSM)
Challenges

1

CSM is a brand new concept

- Mechanism to enforce no gain at inception
- The CSM is amortized over the coverage period in proportion to services provided
- Viewed as profit the insurer expects to earn as it fulfills the insurance contract

2

Portfolio cohorts

- CSM established at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period… Could have hundreds of CSMs to track

3

Unlocking

- The CSM is not locked in at inception. Any changes in estimate of cash flows on future coverage will be absorbed by CSM, as long as CSM >0
- Need to track impact of assumption changes, and adjust CSMs, at granular level
- Similar changes in risk adjustment do not flow through CSM

4

Onerous contract

- If there is loss at inception (onerous contract) need to recognize immediately in P&L
- If onerous contract later becomes profitable (due to changes in best estimate assumptions), a CSM will then need to be established and amortized over time

IFRS4 Phase 2 Gap Analysis – Statement of Comprehensive Income
Challenges

1

Insurance Contract Revenue, not the more familiar Premium Income

- Insurance contract revenue is recognized on an "earned premium" basis
  a. Release from liability for expected "insurance benefits"
  b. Non-claims fulfillment costs as "originally expected"
  c. An allocation of premium for acquisition costs amortized over the coverage period
  d. Release of risk adjustment
  e. Release of CSM
- "Deposit" component of premium is excluded from revenue and claims
- Education/communication required with other departments such as accounting, finance; as well with other stakeholders such as senior management, external investors and analysts
- Requires a complete overhaul of reporting platform/templates, process and methodologies

2

Interest expense/Use of OCI

- Interest expense on insurance contract liabilities in profit or loss is determined using the discount rate that applied at the inception of the contract. The impact of changes in the discount rates is reflected in OCI

3

Direct vs. Reinsurance items

- Show income and expense on insurance contracts separately from reinsurance contracts, including premiums, claims, interest on insurance liabilities based on locked-in rates, and impact of change in discount rates
- Do not offset

IFRS4 Phase 2 Gap Analysis – Transition
Challenges

1

Historical information related to in-force portfolio cohorts

- Need a lot of historical information: policy data, original pricing assumptions, original discount rates (but in accordance with IFRS4P2)… by portfolio cohort

2

CSM for in-force contracts

- Determine CSM for in-force contracts at the date of transition to IFRS4P2
- Determine retrospectively, for all past issue years, maximizing use of objective data
- Can assume all changes in estimates of cash flows between initial recognition and the beginning of the earliest period presented were already known at initial recognition

3

Discount Rate

- If cannot determine the discount rate for historical periods, can apply a practical expedient which is based on an observable reference rate

4

Restate financial statements

- Restate for comparative purposes the financial position and income for prior periods included in the financial statements

IFRS4 Phase 2 Gap Analysis – Disclosure
Challenges

1

Amounts

- Permit reconciliation to the line items in the SCI and SFP
- Aggregate or disaggregate information so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics
- Tabular reconciliation of opening and closing balances of the following items, separately for direct and ceded: Liability for remaining coverage, Liability for incurred claims, Expected value of future cash flows, Risk adjustment, Contractual Service Margin

2

Judgment

- For measurements with the most material effect, disclose methods and process for estimating inputs, including quantitative information where practical
- Discuss methods and inputs used to estimate risk adjustment, discount rates and policyholder dividends

3

Risks

- If any method or input change has a material effect on financial statements, disclose it along with an explanation of the reason for the change and the type of contracts affected
- Disclose the confidence level associated with the risk adjustment

QUALIFICATIONS, ASSUMPTIONS AND LIMITING CONDITIONS