ACTUARIAL PERSPECTIVE ON THE PRACTICAL IMPLICATIONS OF IFRS 4 PHASE II

2012 09 04

PETER TRIPE
BACKGROUND

Timelines

- Start (1997)
- Phase I (1999)
- Exposure Draft (2005)
- Re-exposure/Final? (2010)
- 2012?
- Final implementation? (2015/2016?)

Actuarial perspective on practical implications of IFRS 4 Phase II
CURRENT STATE OF PLAY

Question:

What is your current view of IFRS4 Phase II?

1. This is a huge thing that will guarantee me employment for the next decade – I am watching every move of the IASB and waiting in eager anticipation for every new bit of information on it.

2. This has gone on so long now that I have lost interest and when the IASB actually issues something I will pay some attention to it then.

3. Right now I don’t care about it – I have got far more urgent issues to deal with like Solvency 2, SAM, SA QIS2 and the like. I will worry about IFRS4 Phase 2 when I have time.
CURRENT STATE OF PLAY (CONT.)

General view of most people is a combination of:

- Watching and waiting.
- When IASB issues next step formal actions and responses will be needed.
- More important priorities now – Solvency II, SAM

Some risks though

- There will be differences to SAM – be prepared for multiple valuations
- Need to keep aware of the key decisions so that other projects can incorporate/adapt
- Some fairly serious practical issues that might give problems in due course
ACTUARIAL INVOLVEMENT IN THE PROJECT

Individual Actuaries

• Company responses to discussion documents, exposure drafts, etc.

Actuarial Society of SA

• Commenting (along with SAICA) on the various discussion documents, exposure drafts, etc.
• Trying to stay aware of the changes as they are emerging

International Actuarial Association

• Commenting on discussion documents, exposure drafts, etc.
• Providing information sessions to the IASB/FASB (through individual actuaries)
• Developed some initial guidance arising from Phase I of the project
• Developing education monographs on key topics
• Now developing educational notes related to key issues emerging in Phase II
Actuarial perspective on practical implications of IFRS 4 Phase II
WHAT IS THE IAA DOING IN THIS AREA

• Main committee responsible is the Insurance Accounting Committee
• A number of sub groups are looking at key issues and are starting to prepare responses and guidance:
  • Scope, definitions and contract boundaries
  • Recognition
  • Expected cash flows and acquisition expenses
  • Discount rates
  • Risk adjustments
  • Residual / Composite margin subsequent measurement
  • Premium Allocation method
  • Participating contracts
  • Reinsurance-specific
  • Presentation and disclosure
  • Transition / effective date

Actuarial perspective on practical implications of IFRS 4 Phase II
Arising from the above can expect amendment of existing IANs (educational material) and possibly new ones from the Insurance Accounting Committee.

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WHAT IS THE IAA DOING IN THIS AREA (CONT.)

- IAN 3 – Classification of Contracts under IFRS
- IAN 4 – Measurement of Investment Contracts and Service Contracts IFRS
- IAN 5 – Current Estimates under IFRS
- IAN 6 – Liability Adequacy Testing under IFRS
- IAN 7 – Recognition and Measurement of Contracts with DPF under IFRS
- IAN 8 – Changes in Accounting Policies under IFRS
- IAN 9 – Accounting for Reinsurance Contracts under IFRS
- IAN 10 – Embedded Derivatives and Derivatives IFRS
- IAN 11 – Business Combinations under IFRS
- IAN 12 – Disclosure of Information about Insurance Contracts under IFRS
WHAT IS THE IAA DOING IN THIS AREA (CONT.)

Insurance Accounting Committee is producing more comprehensive papers, documents and monographs for use by actuaries.

- A Global Framework for Insurer Solvency Assessment
- Measurement of Liabilities for Insurance Contracts – Current estimates and risk margins
- Stochastic Modeling
- Monograph In development – Risk Adjustment

Actuarial perspective on practical implications of IFRS 4 Phase II
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IFRS INSURANCE ALIGNMENT WITH SAM
Liabilities and Equity Valuation Differences

SAM

- Callable Capital
- Excess Assets
- Subordinated Liabilities
- Non-subordinated Liabilities
- Risk Margin
- Best Estimate Liabilities

Treated as Tier 1 or 3 capital under SAM

IFRS 4 Phase II

- Ancillary Own Funds
  Capital instrument that can be called up to absorb losses inc. unpaid share capital, Letters of Credit (LoCs), Guarantees and other binding commitments

Shareholder Equity

- Other Liabilities
- Residual Margin

- Risk Margin
- Insurance contracts
- Short Term Contracts
- Investment Contracts

Reconciliation

- Categories of Best Estimate Liabilities different to SAM

• Contract Boundary
• Expenses/Overheads
• Different discount rates

• Portfolio definition
• Diversification benefits
• Different valuation techniques and parameters

*Relative size of liabilities & margins are for illustration and could differ significantly by company / product line.

Actuarial perspective on practical implications of IFRS 4 Phase II
IFRS INSURANCE ALIGNMENT WITH SAM

Asset Valuation Differences

**SAM**

- **Assets**
  - Valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm’s length transaction

**IFRS 4 Phase II**

- **Goodwill & Intangibles**
- **IFRS 9 assets at Fair Value**
- **IFRS 9 assets at Amortised Cost**
- **Deferred tax assets**
- **Other assets**
- **Reinsurance Assets (Impairment Test)**

Mostly disallowed for SAM

**Reconciliation**

- **Deferred tax assets**
- **Reinsurance Assets**

**Same valuation principles**

**Different measurement of DTA’s**

Actuarial perspective on practical implications of IFRS 4 Phase II
## IFRS 4 ALIGNMENT WITH SAM

### Key challenges

<table>
<thead>
<tr>
<th>Key Feature</th>
<th>Nature of challenge</th>
<th>Key Areas of Impact</th>
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<tr>
<td>Residual Margin</td>
<td>Residual margin does not exist within SAM</td>
<td>Data and actuarial systems</td>
</tr>
<tr>
<td>Portfolio vs. Entity</td>
<td>IFRS portfolio reporting level may require different data segmentation within core systems</td>
<td>Data and systems / Assumptions</td>
</tr>
<tr>
<td>Risk Margin</td>
<td>Techniques other than Cost of Capital can be used for IFRS</td>
<td>Data and actuarial systems</td>
</tr>
<tr>
<td>Discount Rate</td>
<td>There is more freedom of approach to discounting in IFRS than SAM</td>
<td>Assumptions</td>
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<tr>
<td>Best Estimate cashflows</td>
<td>Interpretation may be different for certain components of the best estimate cash flows e.g. expenses, contract boundaries and scope of contracts</td>
<td>Actuarial Assumptions / Methodology</td>
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<tr>
<td>Reconciliation and P&amp;L</td>
<td>P&amp;L attribution process needs to be developed</td>
<td>Data and systems / Methodology</td>
</tr>
<tr>
<td>Tax</td>
<td>Tax implications need to be fully understood</td>
<td>Assumptions / Methodology</td>
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Actuarial perspective on practical implications of IFRS 4 Phase II
The new requirements from IFRS Insurance put sources of profit under the spotlight with a more transparent external reporting of insurers’ profit.

The earning of risk adjustments and residual margins would be new key line items on the face of insurers’ income statements that must be reconciled with internal forecasting and planning.

Planning and forecasting tools would need to be recalibrated to the new parameters and internal analysis of results re-defined accordingly. Forward looking statements may need to be restated to be supported by future reporting of actual profits.
LESSONS LEARNED FROM IMPACT STUDIES (1)

The majority of the impact arising from the changes to IFRSs will come from the changes to insurance contract accounting. There are a number of common themes seen in IFRS 4 Phase II impact studies conducted to date which are informative:

**Strategic implications**
- A strategic approach will deliver long-term benefits such as the ability to explain clearly the differences between regulatory and accounting results to internal and external stakeholders.
- There will be consequences for different products lines arising from the changes to profit profiles.

**Interaction with SAM and other projects**
- Significant interaction between IFRS 4 Phase II, SAM and the other changes to accounting standards, for example, the proposed changes to IFRS 9 ‘Financial Instruments’.
- Efficiencies can be realised from joint planning of the programmes to implement these changes.

**Information system requirements**
- There is likely to be significant spend on technology such as the financial reporting systems in order for it to support IFRS 4 Phase II.
- Need to identify and budget for this change.
LESSONS LEARNED FROM IMPACT STUDIES (2)

Programme planning

• Many of the requirements of IFRS 4 Phase II will present significant technical and implementation challenges.
• Identification of the areas that are likely to have the greatest financial impact.
• Need to ensure that the implementation plans fully considers and addresses these difficult areas.

Impact on reserves and the reserving process

• The new insurance contract accounting standard will impact reserves. Understanding this impact will require both a quantitative study of insurance contract liabilities under the new accounting standard as well as a qualitative assessment of the methods and resources required for the process for calculating the reserves.

Interaction with EV

• Current EV models could be used to provide the information required for IFRS 4 Phase II.
• This would save considerable implementation cost but insurers will need to understand what additional work will be needed in order to adapt their EV models.

Embedding

• Significant resources will be needed to develop in order to support IFRS 4 Phase II post implementation
• Competition for highly skilled accounting, tax and actuarial resource is fierce so an early view will help the resource planning.
CONCLUSION
The actuarial ‘issues’ likely to generate the most challenge

- Scope & definitions (What is in and what is out?; What is a portfolio?)
- Contract Boundaries (Same as SAM?; How do some products deal with this?)
- Acquisition expenses (What can we include?)
- Discount rate (How do we set it?; Where do the effect of changes get shown?)
- Risk Adjustments
- Residual/Composite Margin (How do you calculate it and how do you manage it?)
- Presentation issues
- Participating Contracts (What do we do with a BSA?)
- Transition