2014 EAAC
TAIPEI TAIWAN

18TH EAST ASIAN ACTUARIAL CONFERENCE

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Taipei International Convention Center in Taipei Taiwan

IFRS 4 Phase II Update & Key Insights

Actuarial Institute of Chinese Taipei
A. I. C. T.

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Agenda

1. Overview of the current state of play

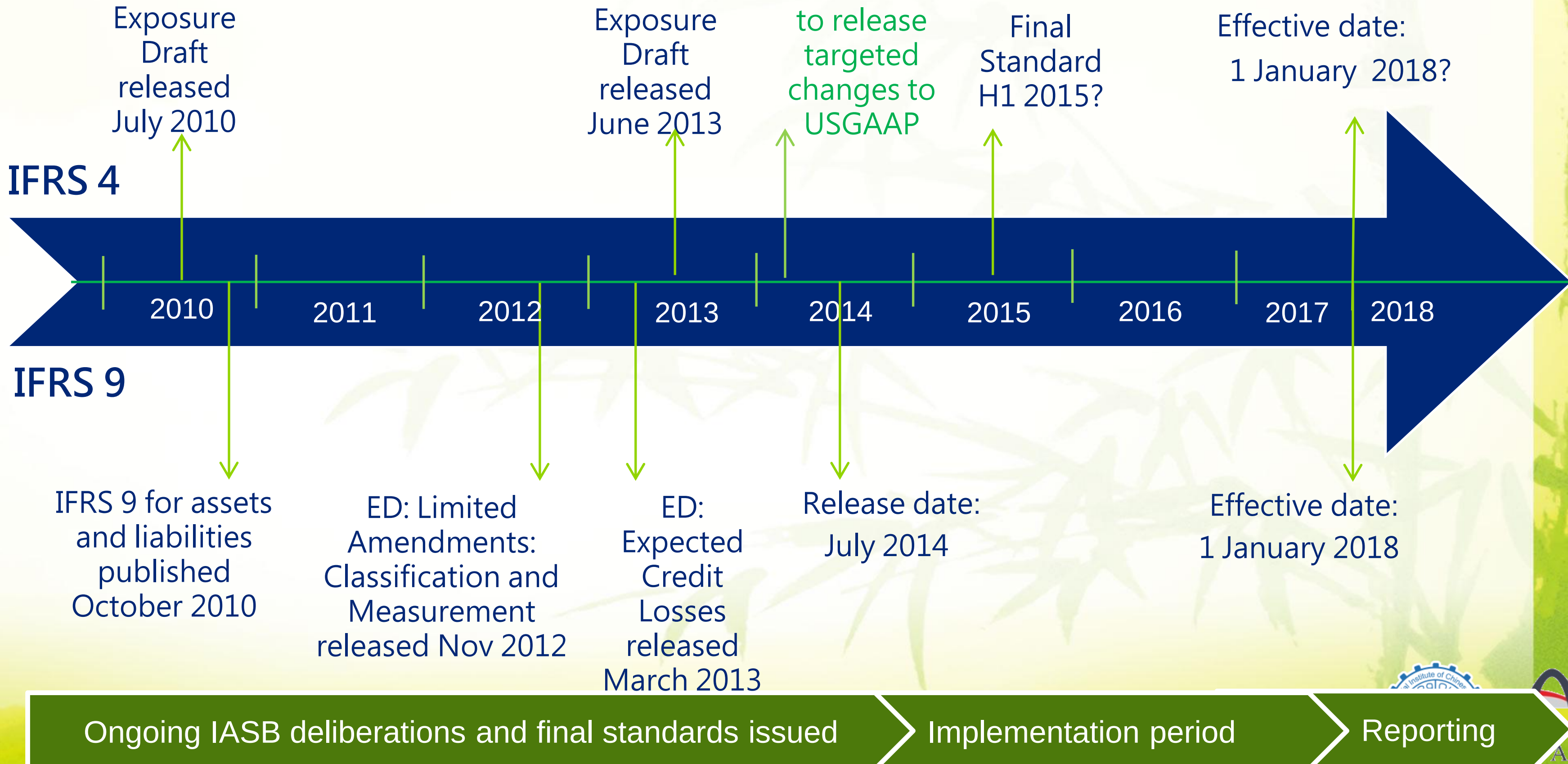
2. Summary of changes expected from the 2013 ED

3. Business impacts under IFRS4 phase II

Overview of the current state of play

Current timetable

- Comment period for IFRS (2013/07) ED ended 25 October 2013
- Expected target date for the final standard is early 2015. The IASB only sought input on five areas. **All other areas are decided, but some still lack clarity**.
- Effective date of a new standard is “approximately 3 years from the final IFRS date”.



Background

- **After nearly three years since it published its draft IFRS on insurance contract the IASB made significant changes in five key topics which were re-exposed in 2013.**
- The revised Exposure Draft related to the proposed requirements for:
  - Unlocking of contractual service margin (CSM): Adjusting the deferred profit from insurance contracts
  - OCI solution: Presentation of interest expense between profit or loss and the other comprehensive income ('OCI') – changes in original discount rate
  - Mirroring approach for participating contracts: Accounting for contracts that specify a link to the returns on underlying items that the entity is required to hold
  - Earned premium approach: Presentation of insurance contract revenue and expenses (volume measure)
  - Retrospective application: Transition mechanics to new standard
- IASB did not intend to revisit other aspects of the proposed standard. These were deemed final following the IASB deliberations, the associated outreach and field testing

Reserve components

Insurance contracts liability – Single model for Life and Non-Life contracts

Principles

- Measurement model uses a “building block” approach.
- Measurement uses current estimate assumptions.
- Measurement objective are based on notion of “fulfillment of obligations”.
- Discount rate can be developed using either a “top down” or “bottom up” approach.
- Discount rates are based on characteristics of liability (currency, duration, liquidity).

Block 3: Contractual Service Margin | **Zero at end of coverage period**

Quantifies the deferred profit the insurer expects to earn as it fulfils the contracts (e.g. Premiums less Expected Claims less Risk Adjustment)

Block 2: Risk Adjustment

Quantifies the amount to compensate for uncertain vs. certain liabilities

Block 1: Present Value of Expected Future Cash Flows (unbiased prob ability weighted mean)

Quantifies the amount the insurer expects to collect from premiums and pay out as it acquires, services and settles the contract

Fulfillment cash flows

Total IFRS Insurance Liability

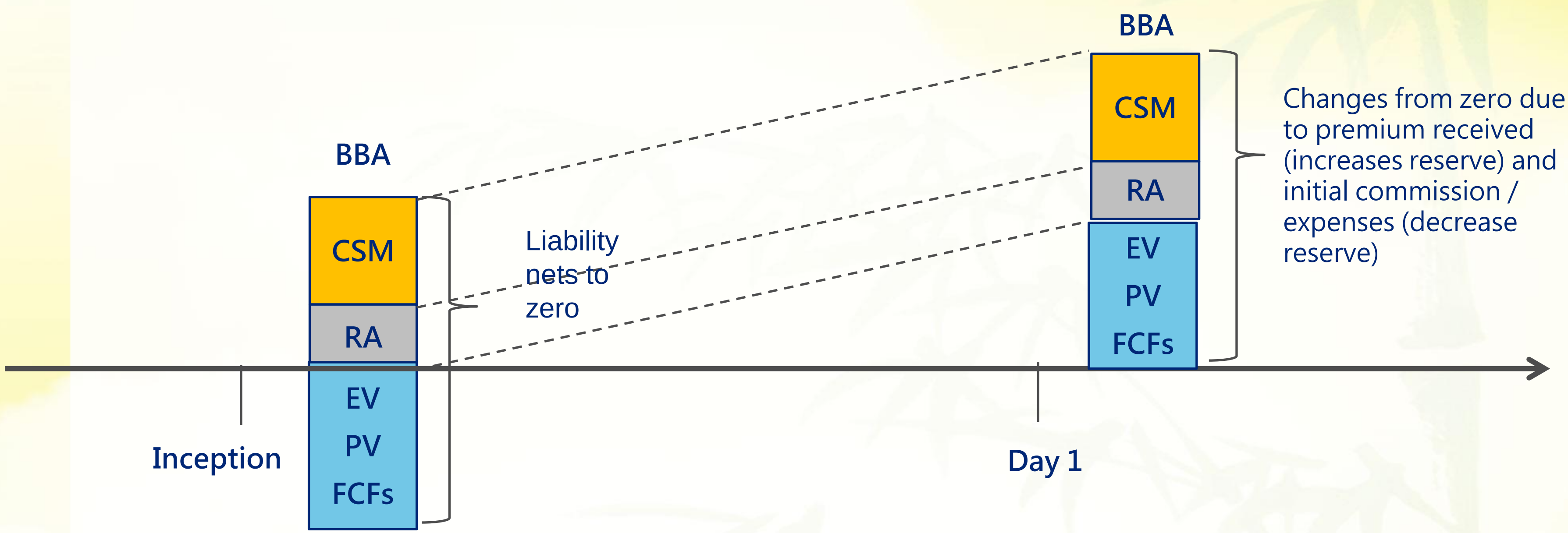
Acquisition expenses

Premium allocation approach (PAA) for pre-claims liability for short duration contracts (coverage period of 1 year or less)

Zero at end of coverage period

Alternative “simplified pre-claims approach” permitted

Reserve components : Inception



LEGEND

BBA
Building Block Approach

PV
Present Value (Discounted for Time Value of Money)

RA
Risk Adjustment

EV
Expected Value (unbiased probability-weighted statistical mean)

CSM
Contractual Service Margin (unlocked for future CFs)

FCFs
Future Cash Flows

Reserve components: 2 margins

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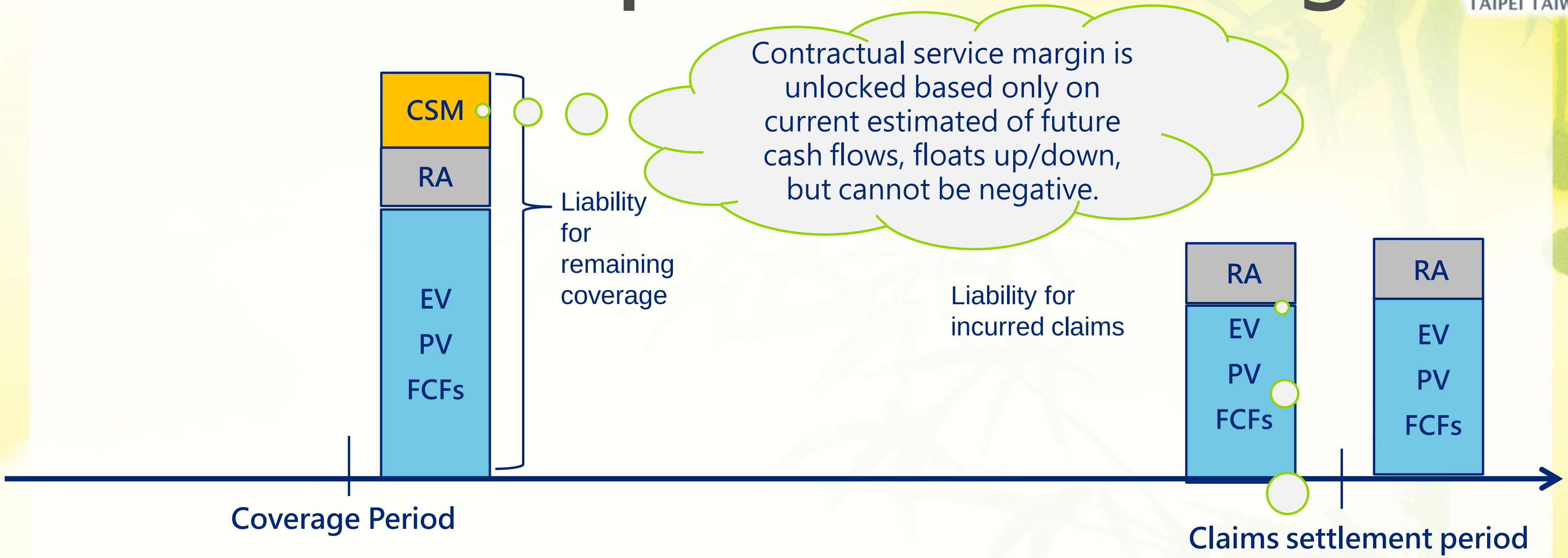

Risk adjustment is released over combined coverage and claims handling period.

LEGEND

AC
Acquisition Costs

CSM*
Contractual Service Margin (unlocked for future CFs)

RA
Risk Adjustment

EV
Expected Value (unbiased probability-weighted statistical mean)

PV
Present Value (Discounted for Time Value of Money)

FCFs
Future Cash Flows

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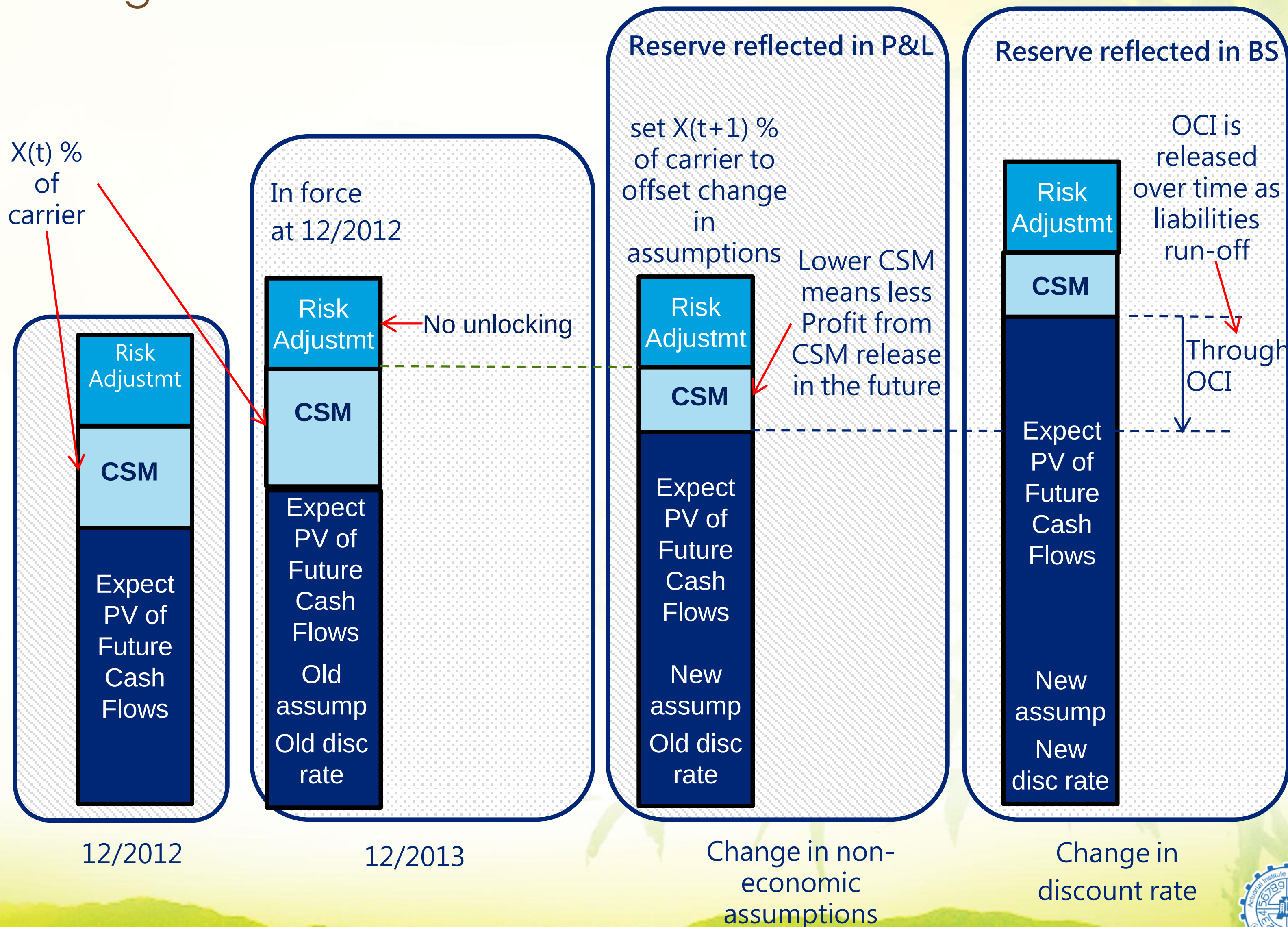
Progression of liabilities over time

Building blocks: Non-Par



Summary of changes expected from the 2013 ED

7 Key areas for comment
What was the industry saying?

Check out comment letters on the IFRS website

http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Exposure-Draft-June-2013/Pages/Comment-letters.aspx

http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Exposure-Draft-June-2013/Pages/Comment-letters.aspx

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2013-11-06	Veronica Poole	Deloitte Touche Tohmatsu Limited
2013-11-06	Rob Jones	S&P
2013-11-06	Kelly Groh	Genworth Financial
2013-11-06	Craig Mense	CNA Financial Corporation
2013-11-06	Michael Monahan	American Council of Life Insurers

Heat map of comment letters

What was the Asian Insurance industry saying?

	Questions	AIA	China Life	HSBC	Manulife/ MetLife/ NY Life/ Prudential	MetLife	Prudential	DTT	E&Y	KPMG	PWC	Actuarial Society of Hong Kong
Q1 - Adjusting the contractual service margin	**Unlocking the CSM** - Was it supported?											
	Cash flow comments - Are the cashflows that will cause updates to the CSM well-defined and/or appropriate?											
	Reflecting past losses - Should all gains immediately reestablish a CSM if it was previously zero?											
Q2 - Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items	**General approval** - Is the implementation of mirroring appropriate, particularly for participating products?											
	Holistic cash flows - Is bifurcation preferable to the BBA approach for participating contracts?											
	Options and Guarantees - Is the treatment of O&GS well-considered and appropriate?											
Q3 - Presentation of insurance contract revenue and expenses	**General approval** - Is the presentation recommended appropriate?											
Q4 - Interest expense in profit or loss	**OCI Optionality** - Will a mandatory FVTOCI generate an appropriate level of volatility and asset/liability matching?											
	Hedging changes - Are existing hedging rules adequate?											
	Long-term rates - Should observable market data always take precedence? E.g. Should long term rates be driven by the "observable market yield curve for shorter durations" in preference to long term averages for unobservable periods?											
Q5 - Effective date and transition	**Retrospective approach** - Is it appropriate?											
	Increased expediency - Are expediency measures strong enough?											
	IFRS 9 alignment - Is providing no allowance for asset reclassification under IFRS 9 at the time of adoption appropriate?											
Q6 - The likely effects of a Standard for insurance contracts	**Net positive** - Given that complexity and cost are universally expected to increase, are the overall effects expected to be a net positive?											
	Presentation onerous - Is presentation an appropriate balance of effort and value?											
Q7 - Clarity of drafting	**Further clarification** - Were all provisions/requirements of the draft adequately described?											

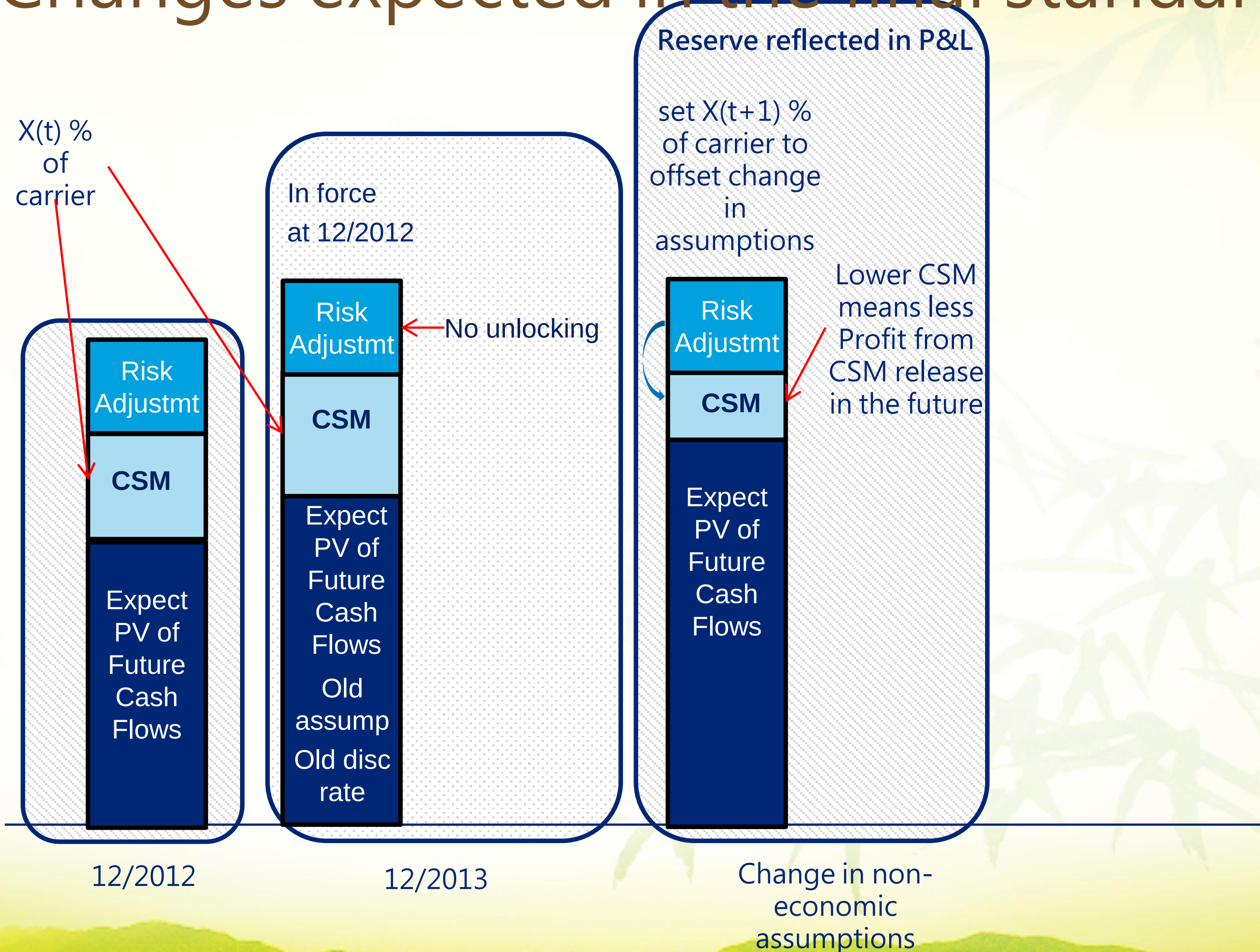
Update
Changes expected in the final standard

Comment area topics:

- **Contractual Service Margin (CSM)**
  - Tentatively decided that the **difference between current and previous estimates of the risk adjustment** that relate to coverage and other services for future periods should **adjust the CSM**
  - Tentatively decided that **losses recognised** due to assumption changes will be able to be **recouped** in future periods if favourable assumption changes are made.
  - Tentatively decided that the **locked-in interest rate at inception** of the contract should be used to acrete interest on CSM, and determine PV expected cash flows that unlocks the CSM.

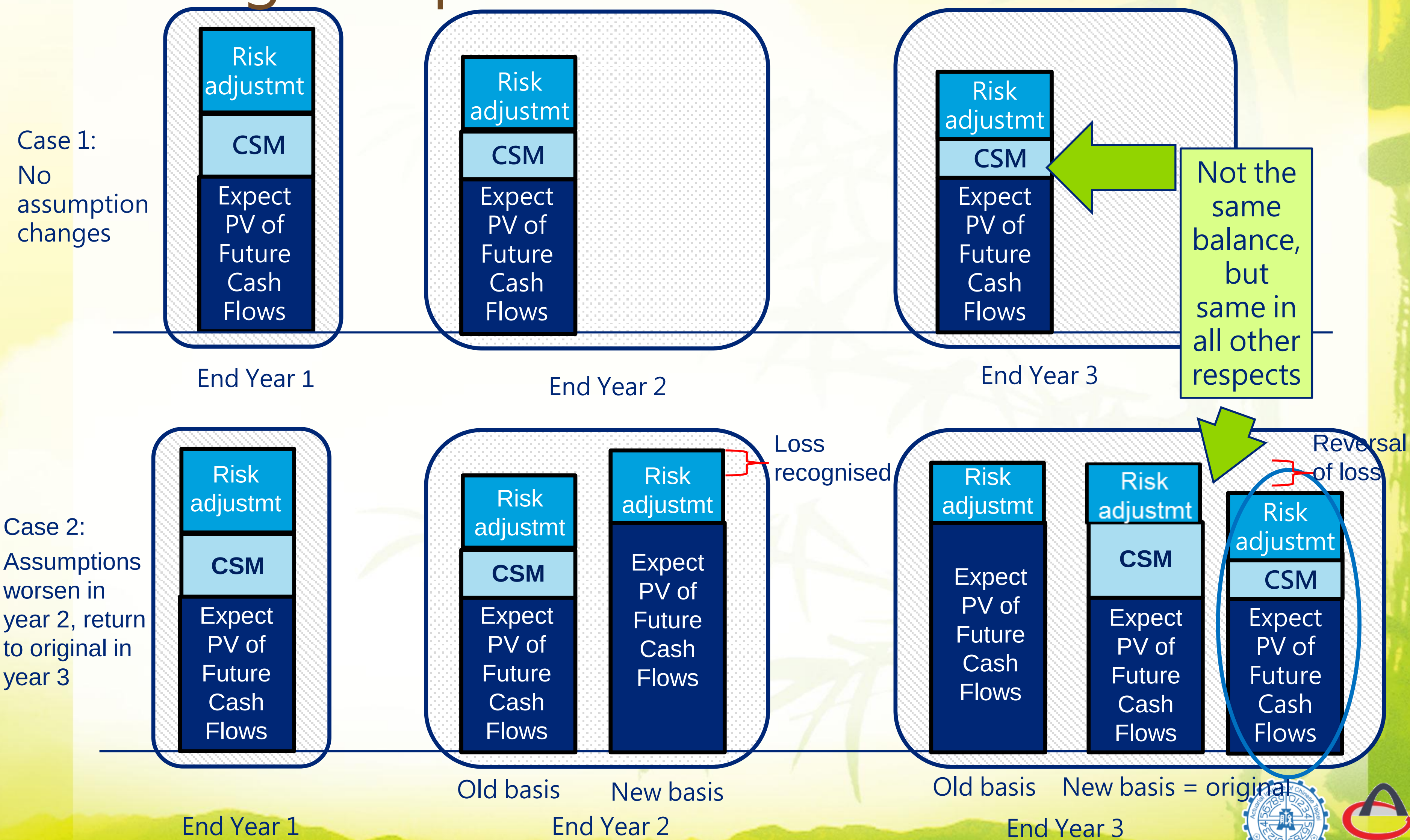
Update

Changes expected in the final standard



Update

Changes expected in the final standard



Update
Changes expected in the final standard

Comment area topics (continued):

- **Other Comprehensive Income (OCI)**
  - **Tentatively decided to become optional**; but CSM will still need to roll-up using a locked-in rate even if the OCI approach is not adopted by a business
  - May not be able to be used for participating contracts using the book yield approach to present interest expense
  - Disclosures required on impact of current vs locked-in rate

Update

Changes expected in the final standard

	CSM	OCI	P&L
Lapse / surrender	✓		
Mortality	✓		
Morbidity	✓		
Other claims incidence and recovery rates for active lives	✓		
Acquisition expenses with direct link	✓		
Maintenance expenses	✓		
Expense inflation	✓		
Investment expenses	✓		
Discount rate		✓	
Risk Adjustment			✓
Expected credit losses on RI assets			✓
Claims recovery rates for claims cases			✓
IBNR assumptions			✓
Other assumptions in respect of past coverage			✓

If OCI approach not adopted

Exceptions

- Assumption that usually impacts CSM, **when CSM = 0** and assumption change is unfavourable
- **Cash flows that are asset dependent**

Update
Changes expected in the final standard

Comment area topics (continued):

- **Presentation**
  - Despite much criticism, the presentation is **unlikely to change**. So will still need to strip our investment components and smooth expenses so that revenue reported is also smooth.
  - Revenue will be controlled by Actuaries … Risk margin released + CSM released + Expected net cash outflows
- **Transition**
  - No real criticisms, and no real change from the ED.

Update
Changes expected in the final standard

Profit / Loss

Revenue

+ Release of CSM ± Release of risk adjustment + Expected net cash outflows during the period (excl. inv component & adjusting to spread acq costs)

Actual claims / expenses

− Actual net cash outflows during the period (excl. inv component & adjusting to spread acq costs)

Other underwriting profit items

± (Reversal of) Loss recognition on onerous contracts (incl initial) ± Change in projected cash flows that go directly to P&L + Effect of changes in credit standing of issuer of RI held

Investment gain / loss

− Expected unwind of discount rates on insurance liabilities + Actual investment earnings on assets backing liabilities

Other Comprehensive Income

Other Comprehensive Income

+ Present value of projected cash flows using current discount rates − Present value of projected cash flows using initial recognition discount rates

Update
Changes expected in the final standard

Non-targeted issues raised in the comment letters:

- **Fixed fee service contracts**
  - Apply IFRS 15
- **Significant insurance risk guidance**
  - Only when possibility that an insurer incurs a loss on a present value basis
- **Portfolio definition**
  - Defn: *Insurance contracts that provide coverage for similar risks and are managed together as a single pool.*
  - No need to be priced similarly, but cannot combine contracts that are onerous at inception with those that are profitable.
- **Discount rates**
  - When there is a **lack of observable data**, use judgement to adjust observable inputs or using the best information available in the circumstances

Update

Changes expected in the final standard

Non-targeted issues raised in the comment letters (continued):

- **Asymmetrical treatment of reinsurance contracts**
  - If an insurance contract is onerous, then changes in estimates of reinsurance cash flows due to changes in estimates of cash flows for the insurance contract should also go to P&L
- **Portfolio transfers / business combinations**
  - Account as if issued on transfer date
- **CSM allocation pattern**
  - For non-par the service provided is insurance coverage, which is provided on the basis of the passage of time and reflects the expected number of contracts in force

Update

Changes expected in the final standard

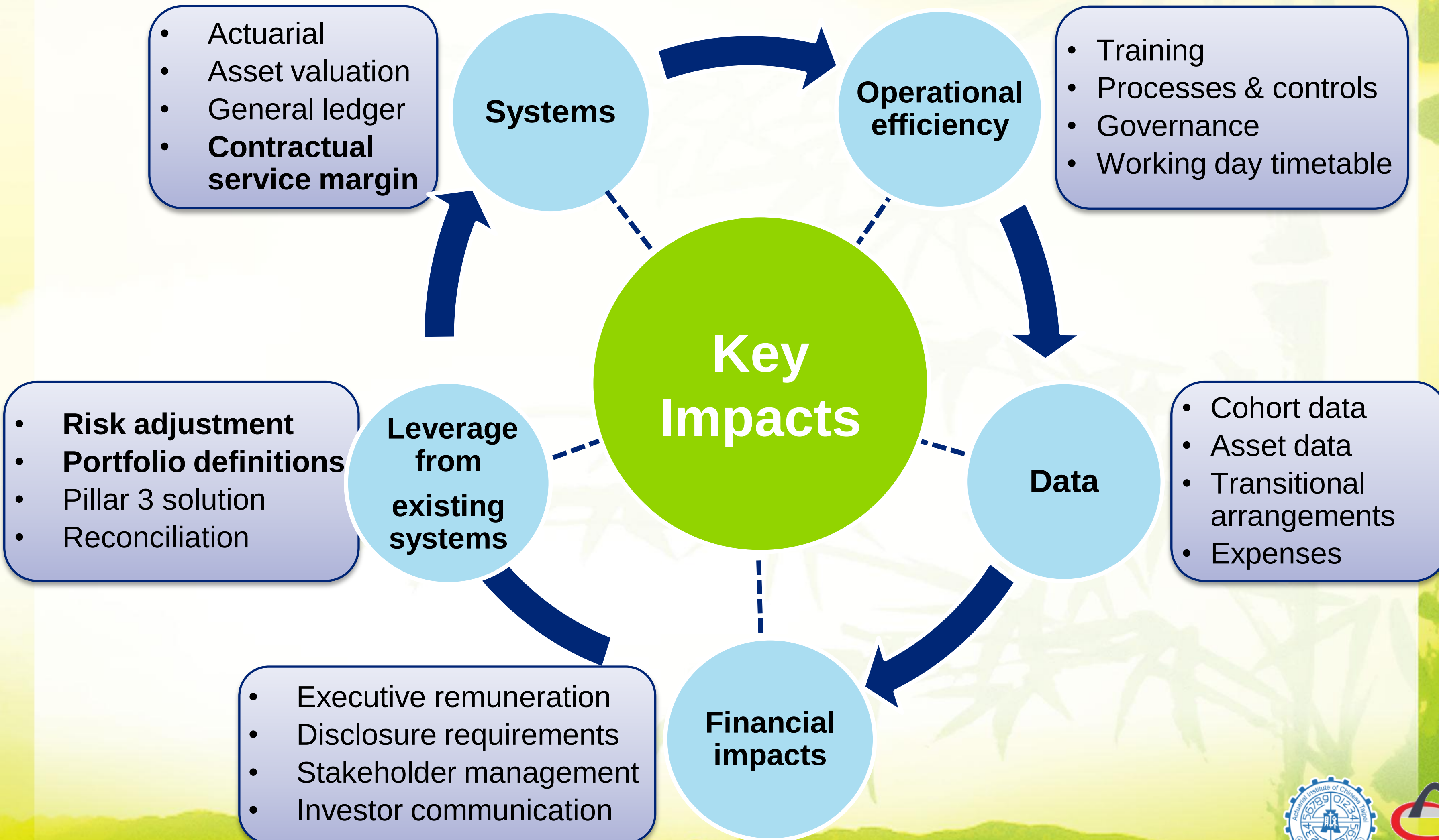
Comment area topics:

- **Mirroring (participating business)**
  - **Requirements will definitely change**, but still awaiting tentative decisions.
  - Accounting through the **CSM for insurer's share of underlying items**, if:
    - Returns passed to p/h arise from the underlying items held;
    - There is a minimum amount that the insurer must retain; and
    - P/h will receive a substantial share of the total return on underlying items.
  - Use of book yield or effective yield method to present **interest expense in profit or loss** – i.e. liability unwind of discount rate in a period (but will not affect measurement of liabilities on the statement of financial position)
    - Book yield: Book yield of underlying items (adjusted at initial recognition to eliminate any OCI if policyholders inherit underlying items); and
      - Only if equity investments accounted for at FV through profit or loss
    - Effective yield: Projected crediting method preferred.
      - Level yield method: discount rate to equate PV FCFs to carrying amount of liability determined on an amortised cost basis, and can be reset); or
      - Projected crediting method: discount rates based on rates insurer intends to credit to policyholders

Business impacts under IFRS 4 Phase II

A Wide Range of BAU Impacts

Wide ranging impacts with varying degrees of complexity and lead time



As well as One-Off Work at Transition

- Two main differences vs BAU the first time companies report:

1. Two years of historical balance sheets & one year of historical P&Ls
   - If the standard applies from 1 January 2018, the first balance sheet needed is at 31 December 2016

2. Calculation of the CSM and OCI in the first balance sheet require look-back to inception date of in force policies
   - The CSM at 31 December 2015 depends on the CSM at 31 December 2014, which depends on…. which depends on the CSM at inception
   - If the company has material blocks of business that are 30 years old, then calculations at inception of policies sold in 1988 are needed
   - The ED allows certain approximations, but substantial effort is needed

Where insurers are now?

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Global IFRS Insurance Survey 2013

- Companies are beginning implementation.
  - In 2012, 3% of companies had started. In 2013, 55% have.
- What will it cost?
  - In 2012, most expected the cost at less than USD 15M. In 2013, the expectation was USD 25-50M.
- Significant organizational change
  - Integration of risk and finance – 57%
  - Significant IT changes – 58%

Asia-specific Data Analysis

- Asia is behind the global market.
  - Only 25% of companies in Asia have begun.
- Cheaper to implement in Asia
  - Many Asian companies still expect costs to be less than USD 10M.
- Less change required in Asia
  - Integration of risk and finance – Asia (ex. China) 38%; China 50%
  - Significant IT changes – 35%, but more undecided in Asia

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Where insurers are now? (continued)

Global IFRS Insurance Survey 2013

- Mixed benefits
  - 63% believe the benefits outweigh the costs.
- Boards lack understanding
  - Only 27% of respondents ranked their boards understanding as "high"
- Improvement for investors
  - Agree – 54%
  - Disagree – 9%

Asia-specific Data Analysis

- Asia sees less benefit and more cost.
  - Asia (ex. China) – 38% see more benefit
  - China – 61% see more benefit
- Board understanding in Asia is similarlary low
- Asia again broadly in line
  - Respondents with Asian business were less uncertain. Slightly more Asian companies agreed, but many more disagreed.

Next Steps for Insurers

- Fully understand the Exposure Draft (and comments submitted by 25 Oct) and link your understanding with the ED IFRS 9
- Develop illustrative examples for your own book of business and for your existing asset and liability strategies
- Use model contracts to assess:
  - impact on BAU accounting choices, systems, data, processes, and people
  - impact on BAU actuarial choices, models, data, processes, and people
  - transition models, data and assumptions needed
  - changes to financial KPI’s
- Coordinate with IFRS9 working group
- Develop plans and budgets
- Understand IT choices
- Investigate resourcing models including need for temporary support
- Engage in lobbying where appropriate
- Anticipate impact on future:
  - product design
  - M&A
  - Investment strategy

Questions