Deloitte.

IFRS 4 Fáze II

aneb dočkáme se konce nekonečného příběhu?

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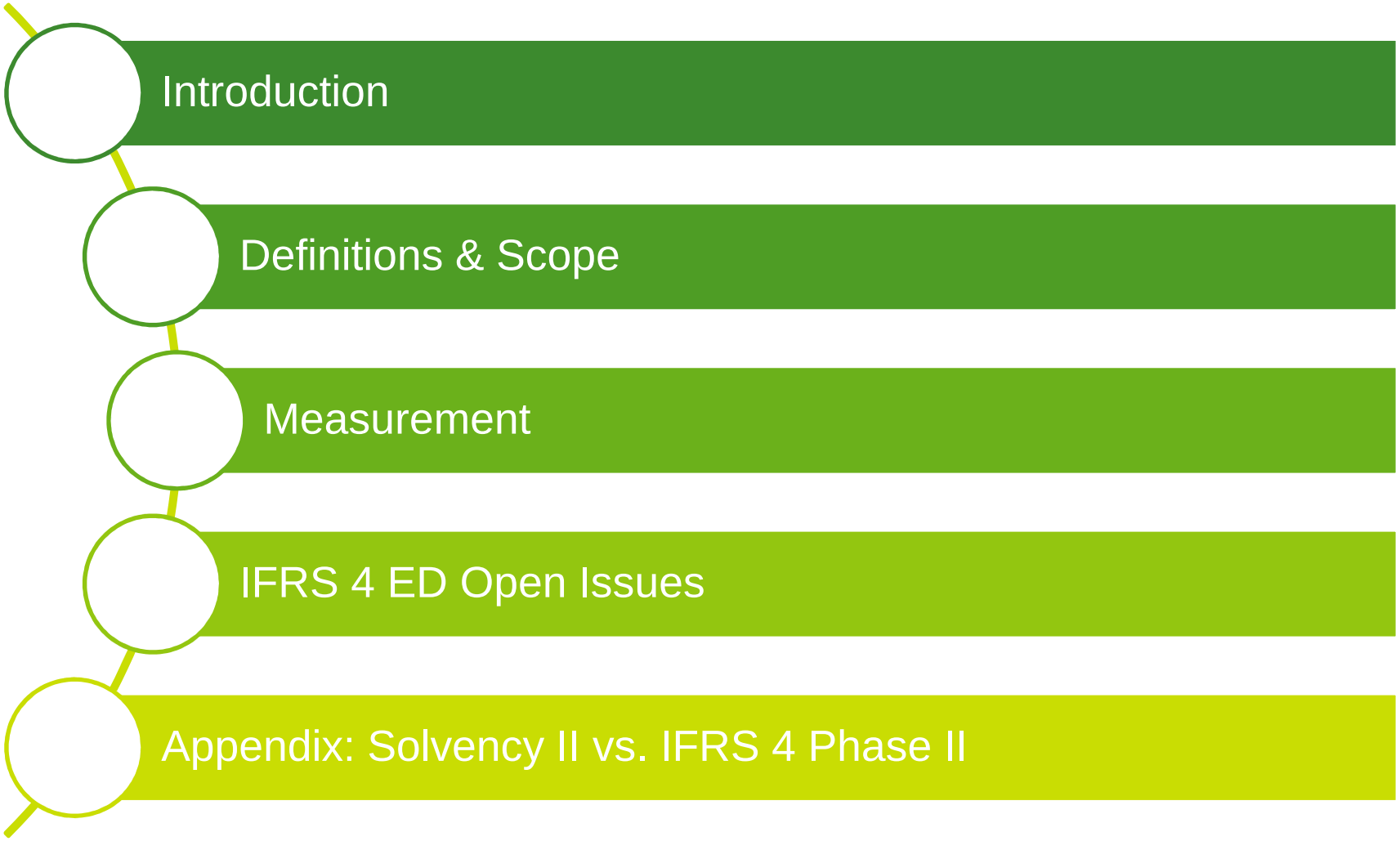
4. října 2013, SAV, Praha

IFRS 4 Phase II

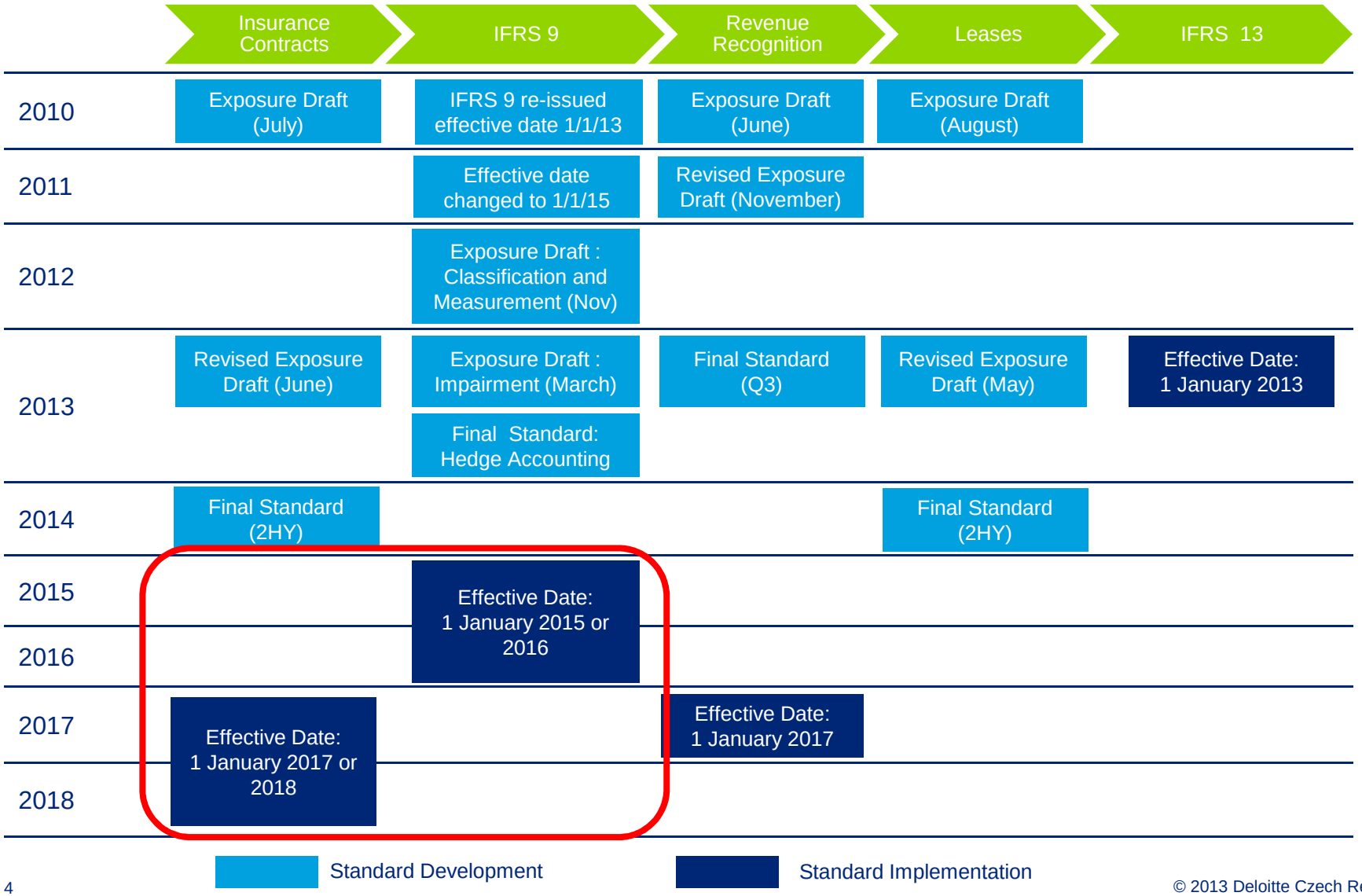
Agenda



Introduction

IFRS Landscape

IASB is substantially rewriting IFRS and building a new IFRS platform



IFRS 4 Insurance Contracts

Reason for Introduction of IFRS4

- Non-existence of IFRS standard related to insurance contracts
- Wide range of accounting methods which are not consistent with methods used in other sectors ⇒ unification

Phase I (since January 2005)

- Provide key definitions
- Wide range of accounting methods allowed
- Requires LAT
- What is not forbidden it is allowed
- Prohibits catastrophe and equalisation provisions
- Requires significant disclosure
- Requires unbundling of some components from insurance contracts

Phase II (since January 2017?)

- New standard should replace the current IFRS4 and introduce consistent accounting method for insurance contracts
- Re-exposure draft released in June 2013
- Simultaneously with the IFRS 4, the IFRS 9 on Recognition and measurement of financial instruments is being developed

IFRS 4 Phase II

Revised exposure draft

- Published on 20 June 2013
- The revised Exposure Draft includes full text of proposed standard
- Comment period of 120 days (until 25 October 2013)

> Targeted questions on certain issues with the rest deemed final because it has already been sufficiently re-deliberated and tested

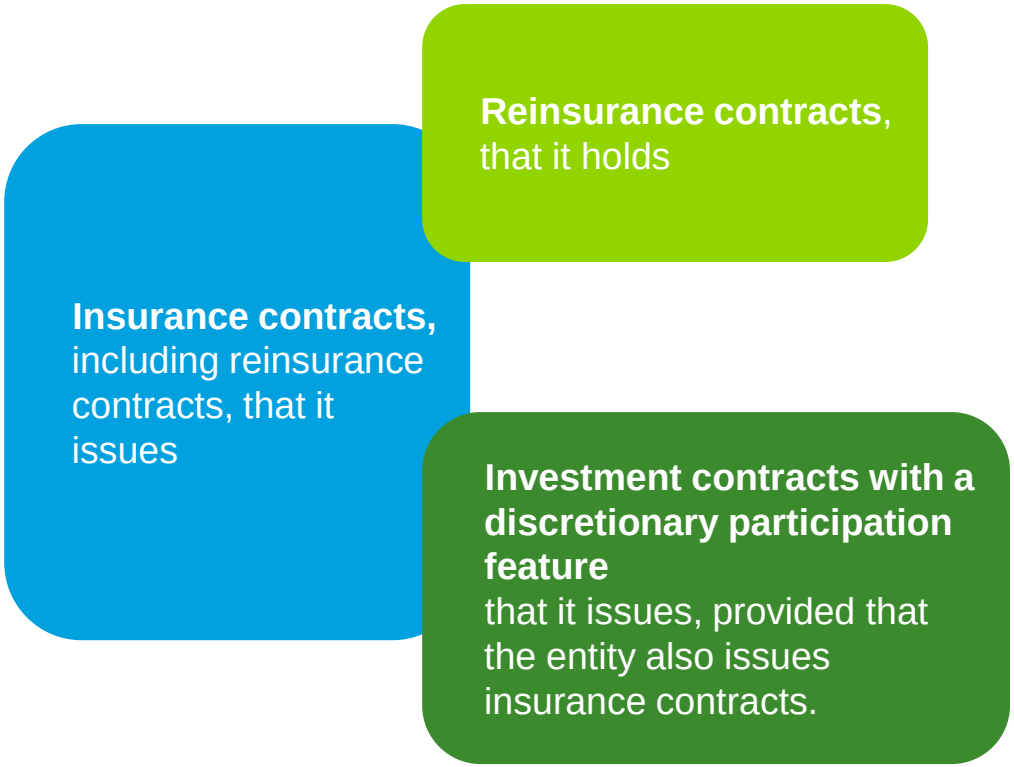
- IASB to allow approximately three years between issuance of the final standard and mandatory adoption date; early adoption permitted

Definitions & Scope

IFRS 4 Phase II

Scope of the new exposure draft

- An entity shall apply this IFRS to :



IFRS 4 Phase I & Phase II

Definitions

Insurance contract

A contract under which one party (the **insurer) accepts** significant **insurance risk from another party (the policyholder) by agreeing to compensate the policyholder** if a specified uncertain future event (the **insured event)** adversely affects the policyholder.

Insurance risk

Risk, **other than financial risk**, transferred from the holder of a contract to the issuer.

Uncertain future event

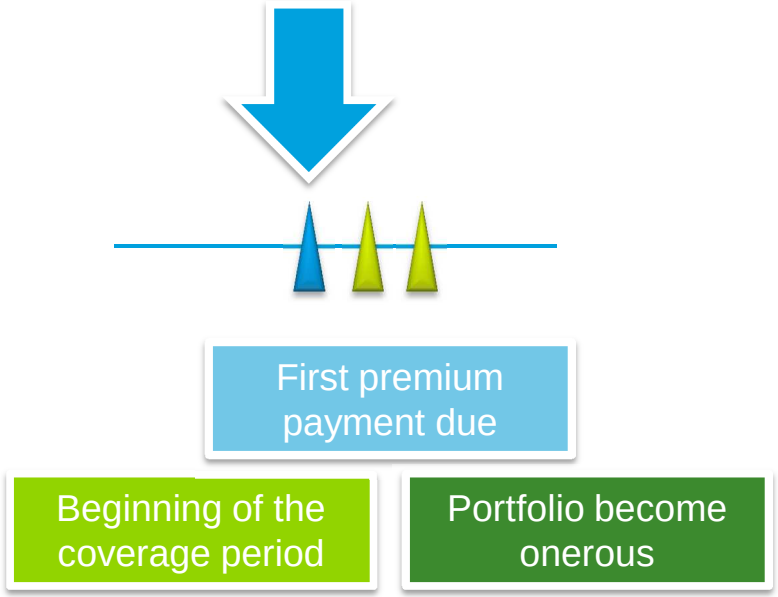
At least one of the following is uncertain at the inception of insurance contract

- Whether an insured event will occur
- When it will occur
- How much the insurer will need to pay if it occurs

IFRS 4 Phase II

Recognition

Recognition **at the earliest** of the following dated:



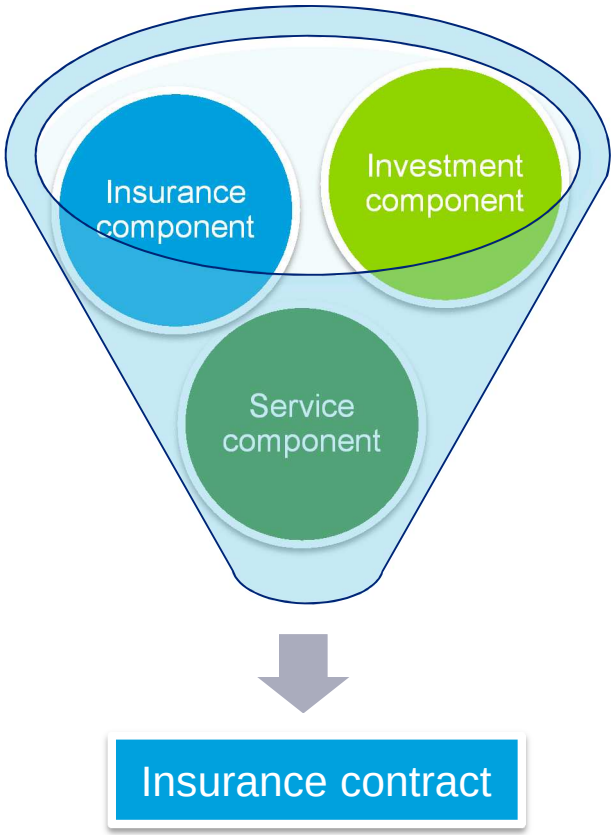
An entity shall recognize any pre-coverage cash flows as they occur as part of the portfolio that will contain the contract to which they relate

Unbundling

Separating components from an insurance contract

Unbundling

Separate or not?



Embedded derivative

Separate an **embedded derivative** and apply IFRS 9 if :

(i) the economic characteristics and risks of the embedded derivative are **not closely related to the host contract**; and

(ii) The separate financial instrument would **meet the definition** of a derivative and would be within the scope **of IFRS 9**.

Investment component

Separate **distinct investment component** (not highly interrelated and contract equivalent sold separately) from the host insurance contract and account for it in accordance with IFRS 9.

Highly interrelated = (a) unable to measure the one component without considering the other (b) the policyholder is unable to benefit from one component unless the other is also present (if lapse or maturity of one component in a contract causes the lapse or maturity of the other => do not unbundle)

Performance obligation to provide goods or services

Separate **distinct performance obligation** (as defined in IFRS on *Revenue from Contracts with Customers*) to provide goods or services only if the obligation related CFs are not highly interrelated to those of insurance contract.

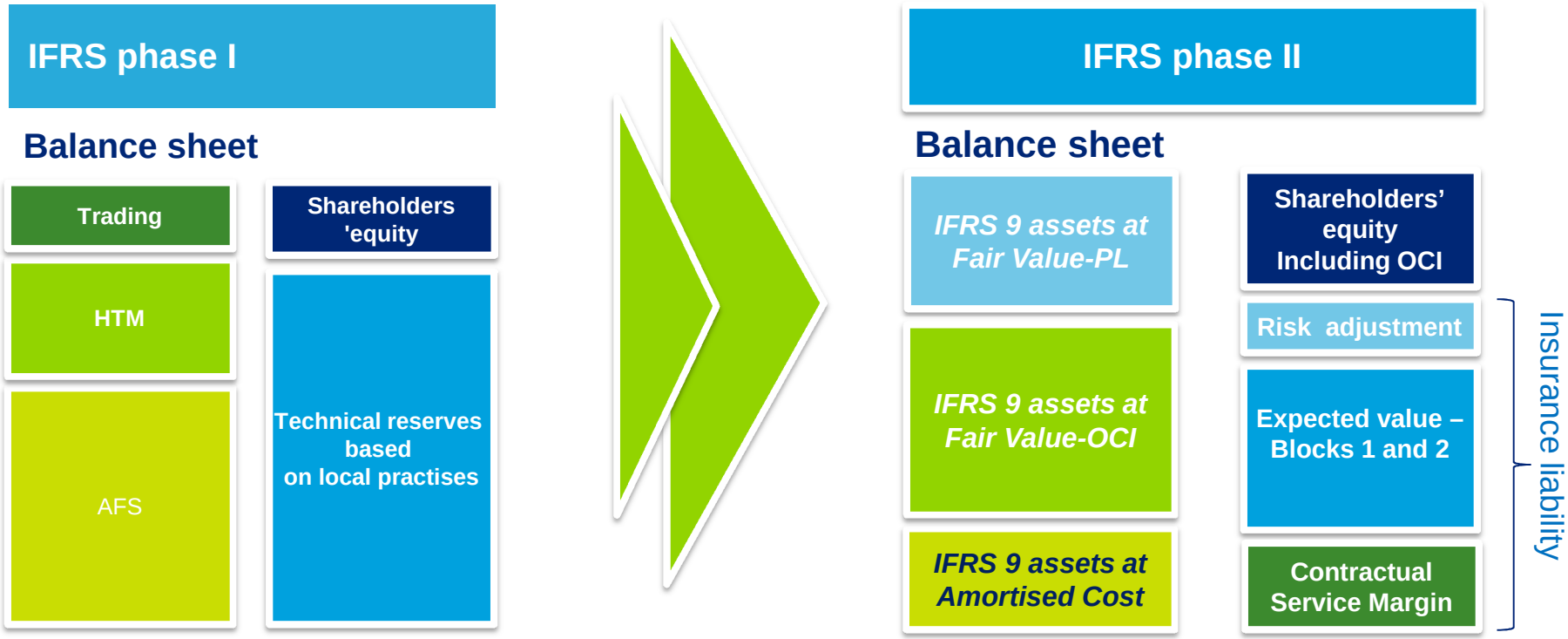
Remaining components

Apply this IFRS 4 to the **remaining components** of an insurance contract.

Measurement

From IFRS 4 Phase I to Phase II

What are the key changes?



- **The insurance liability :**
  - Includes the expected value of cash flows incurred in fulfilling the contract, considering all relevant information and an explicit risk adjustment
  - Reflects only the characteristics of the insurance contract liability unless cash flows depend on other items (mirroring approach required)
  - Adjusts future cash flows for time value of money (current measure on balance sheet and historical measure in P&L)
  - Include a contractual service margin to eliminate gains at inception and representing deferred profit
- **The contractual service margin is amortised AND adjusted prospectively for changes in estimates of cash flows (unlocking) related to future coverage/ future services**

Fulfillment cash flows
Main characteristics

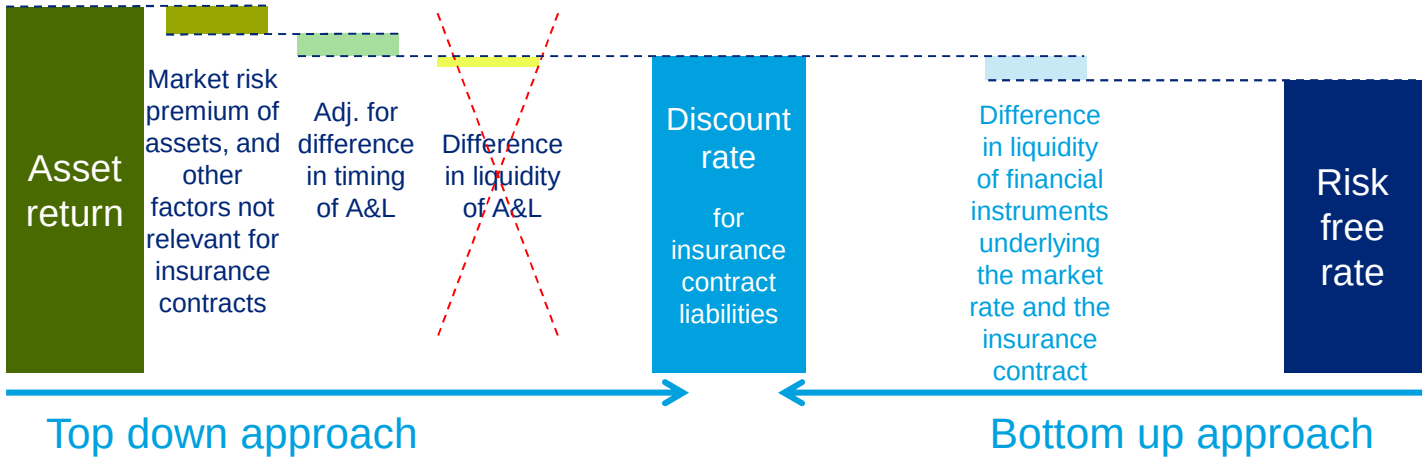
Fulfilment cash flow definition

An explicit, unbiased and probability-weighted estimate (ie expected value) of the present value of the future cash outflows less the present value of the future cash inflows that will arise as the entity fulfils the insurance contract, including a risk adjustment.

- Includes all cash flows related **directly** to the **fulfilment** of the portfolio of contracts.
  - CFs re-assessed at each reporting period based on current information
  - CFs reflect the perspective of the entity (market variables should be consistent with observable market variables)
- CF included only if arise within the "**contract boundary**"
  - Premiums and CFs that arise from those premiums
  - Claims and benefits paid to policyholders, plus associated costs
  - CFs resulting from options and guarantees
  - Directly attributable costs of selling, underwriting and initiating the contract (all other acquisition costs expense immediately)
  - Policy administration and maintenance costs

Discounting
Main characteristics

- Discount rate shall
  - reflect the **characteristics** of cash flows **of** an insurance **liability** (duration, liquidity, currency)
  - Be **consistent with** observable **market** prices for instruments with CFs whose characteristics are consistent with those of insurance contract
  - **Exclude** effect of any factors that are **not relevant** to the CFs of the insurance contract
  - Do **not include** the **OCS** of the entity (based on going concern principle)
- No prescribed method for derivation
- Both top-down and bottom-up approaches are allowed



Risk adjustment
Main characteristics

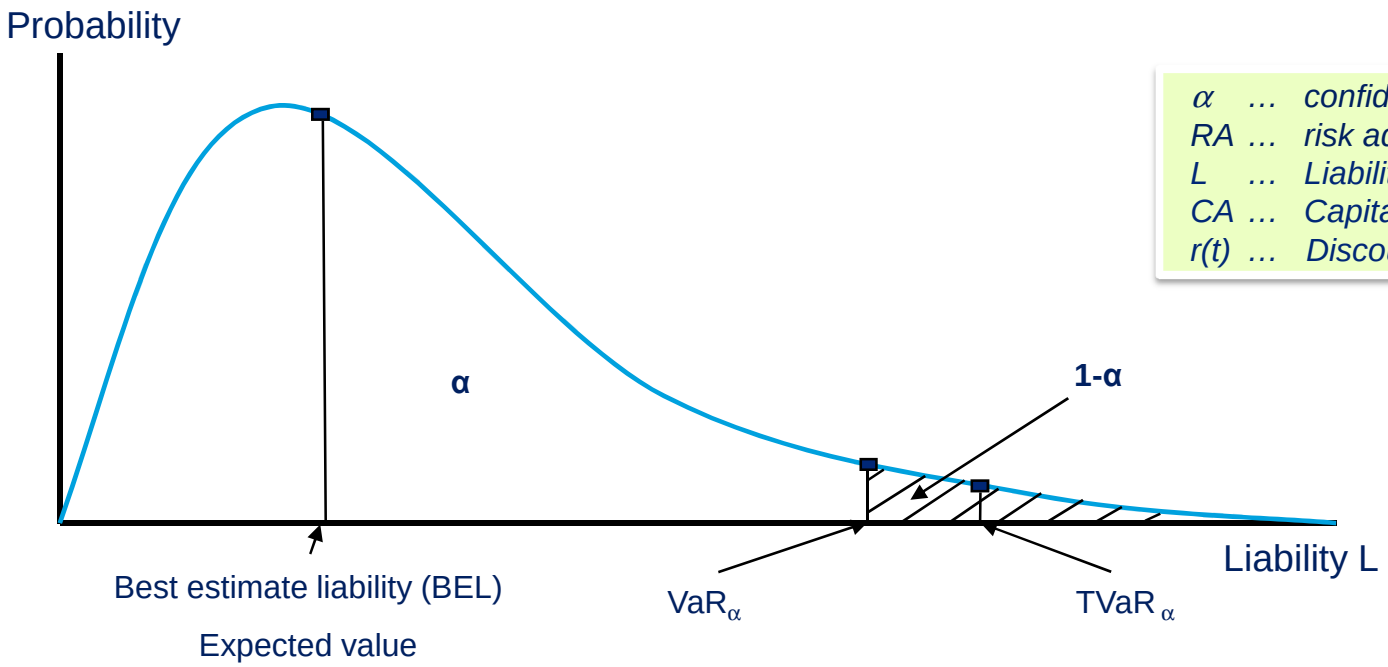
Risk adjustment definition

The compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arise as the entity fulfil the insurance contract.

- Measures the compensation that the entity would require to make the entity indifferent between:
  a) Fulfilling an insurance contract liability that has a range of possible outcomes, and
  b) Fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contract.
- Re-measured at each reporting date
- Based on the entity's own perception of its degree of risk-aversion, rather than market participant's perception
- No techniques prescribed (in 2010 ED only VaR, TVaR, CoC methods were allowed)
- Confidence level equivalent disclosure required
- Diversification benefits allowed (in 2010 ED diversification benefits between the portfolios were not allowed)

Risk adjustment
Methods

Liability Probability Distribution



α … *confidence level*
RA … *risk adjustment*
L … *Liability = PV of future CFs*
CA … *Capital amount*
r(t) … *Discount rate*

1 $RA = VaR_{\alpha}(L) - BEL = \inf \{l \in R: P(L>l) \leq 1-\alpha\} - BEL$

2 $RA = TVaR_{\alpha}(L) - BEL = E[\, L \mid L > VaR_{\alpha}(L) \,] - BEL$

3 $RA_{CoC} = CoC_{fac} * \sum_{t+1} CA_t * [\, 1 / (1 + r_{t+1}) \,]$

Contractual service margin
Main characteristics

Contractual service margin definition

A component of measurement of the insurance contract representing the unearned profit that the entity recognises as it provides services under the insurance contract.

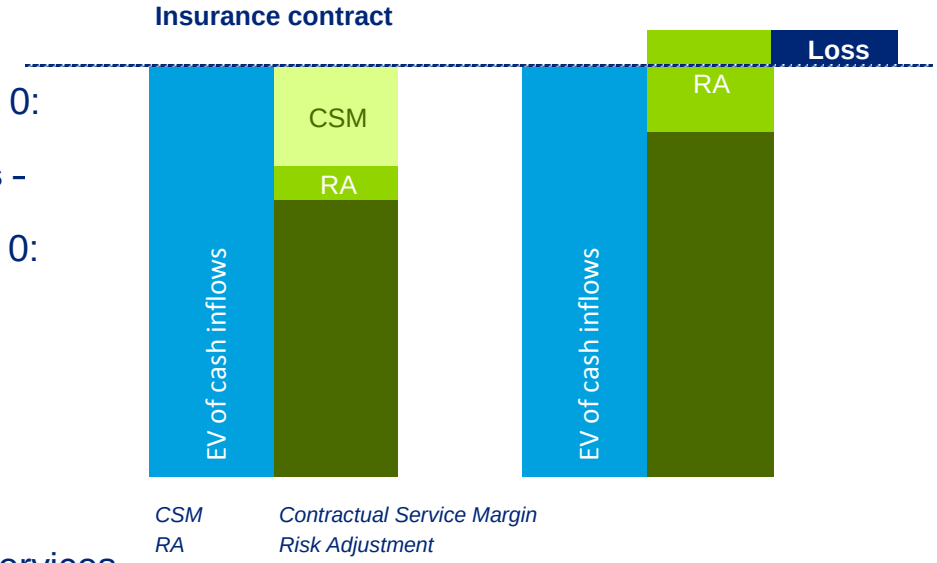
Initial measurement

If PV of future inflows – PV of future outflows – RA > 0:

CSM = PV of future inflows – PV of future outflows –

If PV of future inflows – PV of future outflows – RA ≤ 0:

CSM = 0



Subsequent measurement
(Unlocking of contractual service margin)

- Released with the pattern of provision of services
- Adjust prospectively for changes in estimates for cash flows related to future coverage and/or services
- May increase or decrease, but cannot result in a negative CSM amount

IFRS 4 Phase II

Level of measurement

Fulfilment cash flows including risk adjustment

- At the level of a portfolio of insurance contracts

> **Portfolio of insurance contracts** is defined as a group of insurance contracts that:
> (a) provide coverage for similar risks and that are priced similarly relative to the risk taken on; and
> (b) are managed together as a single pool.

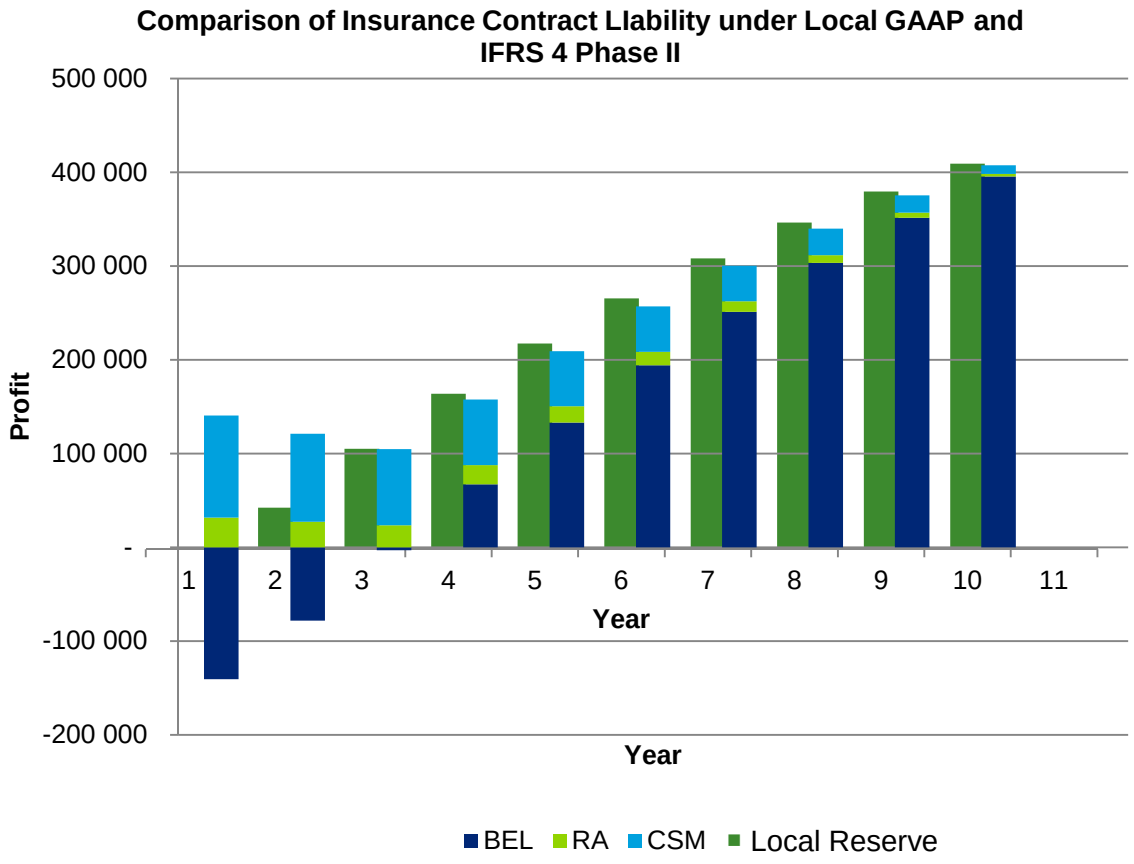
- Unit of account not prescribed as long as the objectives are met

Contractual service margin

- At initial recognition at the level of a portfolio of insurance contracts, consistent with the cash flows; and
- At subsequent measurement, recognised in profit or loss at a level of aggregation such that once the coverage period of the insurance contract has ended, the related contractual service margin has been fully recognised in profit or loss.

Comparison of reserving under local GAAP with IFRS 4

Life: Local GAAP Liabilities, IFRS II Liabilities

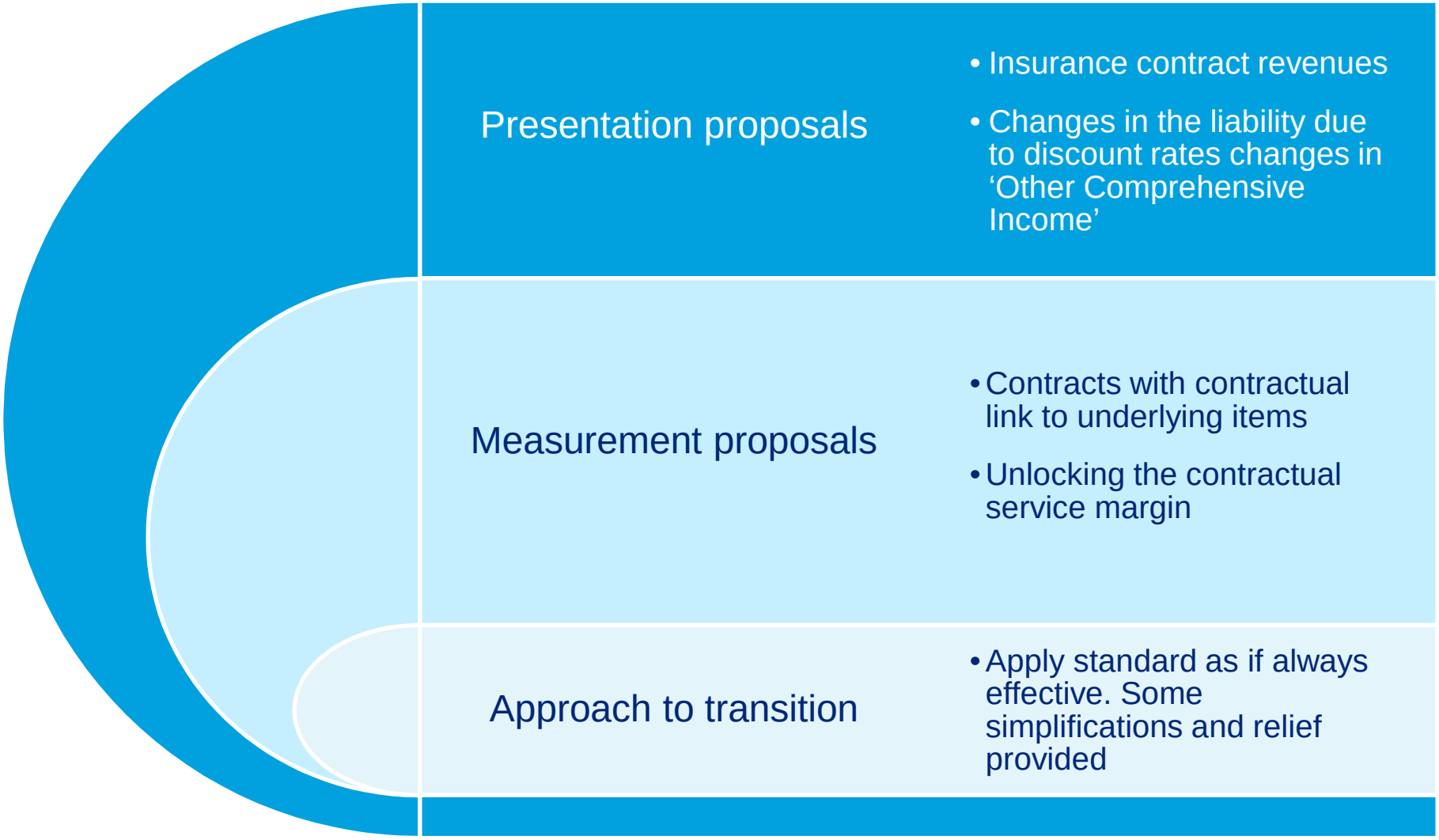


Exposure Draft

Open Issues

IFRS 4 Phase II

Key areas of focus of the revised Exposure Draft



Presentation Proposals

Earned Premium Approach

Earned premium approach

What has changed?

Statement of comprehensive income 2010 ED

Statement of comprehensive income

	20XX
Risk adjustment	X
Residual margin	X
Experience adjustments and changes in estimates	X
Underwriting result	**X**
Investment income	X
Interest on insurance liability	X
Net interest and investment	**X**
Profit or loss	**X**

- ***All premiums treated as deposits, all payments as return of deposits***
- ***All changes in estimate presented in profit and loss***

Statement of comprehensive income 2013 ED

Statement of comprehensive income

	20XX
Premium revenue	X
Incurred claims and expenses	(X)
Underwriting result	**X**
Investment income	X
Interest on insurance liability, based on locked in discount rate	X
Net interest and investment	**X**
Profit or loss	**X**
Effect of discount rate changes in insurance contract liability	X
Total comprehensive income	**X**

- ***Profit and loss presents:***
  - ***Revenue, representing the price the insurer charged for coverage in the period***
  - ***Claims on incurred basis***
  - ***Interest on insurance liability based on locked in discount rate***
- ***Changes in the insurance liability arising from changes in the discount rate presented in OCI unless the CFs in the insurance contract are affect by asset returns***
- ***When there is a contractual link to assets changes in the insurance contracts liability presented on consistent basis with corresponding changes in underlying items***

Earned premium approach

More details…

- Presents non-claims fulfilment costs as expenses when the costs themselves, or the claims to which they relate, are incurred.
- Presents **direct acquisition** costs as if they were amortised over time grossing up the release to income of the unearned profit.
- Insurers are required to disclose inputs into the determination of the **revenue recognised** in the period, i.e.

  a) expected cash flows;

  b) change in risk adjustment; and

  c) change in contractual service margin, and amortisation of deferred acquisition costs

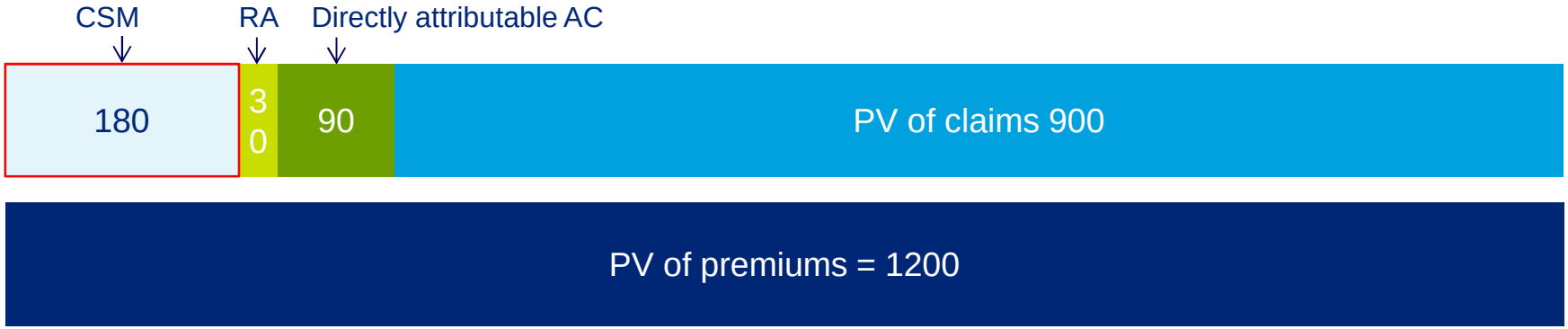
Earned premium approach

Example 1: 3-year contract

3-year contract	
Single premium	1 200 paid at inception
Risk adjustment at initial recognition	30
Expected outflows	1 020
Acquisition costs	120
Directly attributable	90
Not directly attributable	30
Expected claims	900 (300 + 300 + 300)

Assume the following pattern for release of CSM and amortisation of directly attributable acquisition costs: 2/9 : 3/9 : 4/9

Assume the Risk adjustment will decrease every year by 10.



Earned premium approach

Example 1: 3-year contract – Balance sheet

Statement of financial position	Inception	Day 1	Year 1	Year 2	Year 3
Expected inflows	-1 200	0	0	0	0
Expected outflows for claims/benefits and related expenses	900	900	600	300	0
Expected outflow for acquisition costs (directly attributable)	90				
Risk adjustment	30	30	20	10	0
Contractual service margin	180	180	140	80	0
Insurance liability	**0**	**1 110**	**760**	**390**	**0**

Roll forward of insurance contract liability	Inception	Day 1	Year 1	Year 2	Year 3
Opening balance		**0**	**1 110**	**760**	**390**
Payment of premiums		1 200			
Payment of claims			-300	-300	-300
Payment of acquisition costs		-90			
Risk adjustment			-10	-10	-10
Contractual service margin			-40	-60	-80
Closing balance	**0**	**1 110**	**760**	**390**	**0**

Earned premium approach

Example 1: 3-year contract – P&L

Insurance contract revenue calculation	Inception	Year 1	Year 2	Year 3	Total
Change in insurance claims	-900	300	300	300	0
Change in risk adjustment	-30	10	10	10	0
Change in CSM	-180	40	60	80	0
Premiums received	1 200	0	0	0	1 200
Acquisition costs	-90	20	30	40	0
Insurance contract revenue	**0**	**370**	**400**	**430**	**1 200**

Statement of comprehensive income	Year 1	Year 2	Year 3	Total
Insurance contract revenue	370	400	430	1 200
Claims incurred	-300	-300	-300	-900
Acquisition costs	-50	-30	-40	-120
Profit	**20**	**70**	**90**	**180**

-30 not directly attributable
-20 directly attributable

Earned premium approach

Example 2: 3-year contract

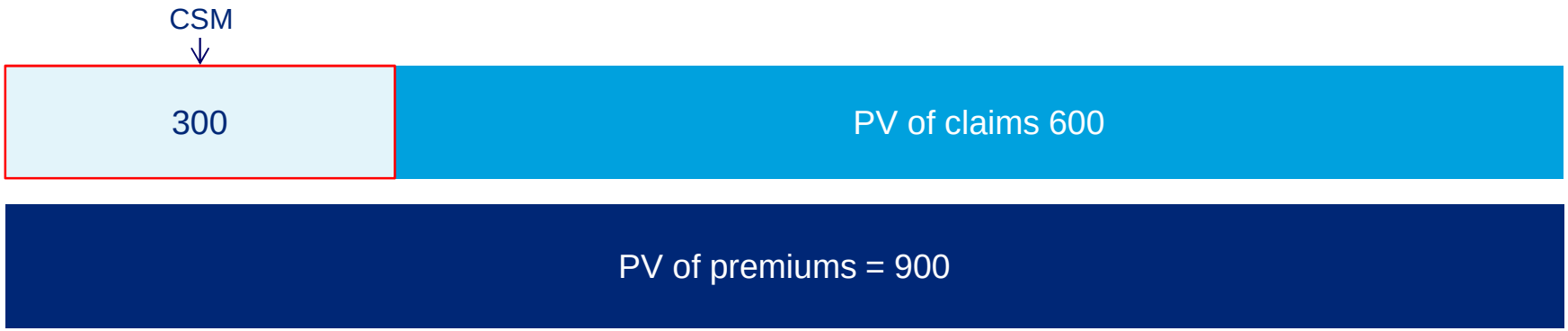
3-year contract	
Single premium	900 paid at inception
Expected outflows	600 (200 + 200 + 200)

For simplicity assume the zero risk adjustment and zero expenses.
Assume the following pattern for release of CSM and amortisation of directly attributable acquisition costs: 1/3 : 1/3 : 1/3

Assume the actual claim in year 2 would be:

a) 150 instead of 200
b) 450 instead of 200

Based on the experience of year 2, the expected outflows for year 3 will be revised.



Earned premium approach

Example 2: 3-year contract

Expected assumptions

Statement of financial position	Inception	Year 1	Year 2	Year 3
Expected inflows	-900	0	0	0
Expected outflows for claims/benefits and related expenses	600	400	200	0
Contractual service margin	300	200	100	0
Insurance liability	**0**	**600**	**300**	**0**

Actual in Year 2 & Revised assumptions future assumptions

Statement of financial position	Inception	Year 1	Year 2	Year 3
Expected inflows		0	0	0
Expected outflows for claims/benefits and related expenses		400	150	0
Contractual service margin		200	150	0
Insurance liability		**600**	**300**	**0**

P&L at the end of the second year

Insurance contract revenue calculation	Total	Year 1	Year 2	Year 3
Change in CSM	350	100	100	150
Change in future fulfilment CFs that do not adjust CSM	0	0	0	0
Difference in the expected and actual fulfilment cash flows in the current period	50		50	
Gain/Loss recognised in the period	**400**	**100**	**150**	**150**

Earned premium approach

Example 2: 3-year contract

Expected assumptions

Statement of financial position	Inception	Year 1	Year 2	Year 3
Expected inflows	-900	0	0	0
Expected outflows for claims/benefits and related expenses	600	400	200	0
Contractual service margin	300	200	100	0
Insurance liability	**0**	**600**	**300**	**0**

Actual in Year 2 & Revised assumptions future assumptions

Statement of financial position	Inception	Year 1	Year 2	Year 3
Expected inflows		0	0	0
Expected outflows for claims/benefits and related expenses		400	450	0
Contractual service margin		200	0	0
Insurance liability		**600**	**450**	**0**

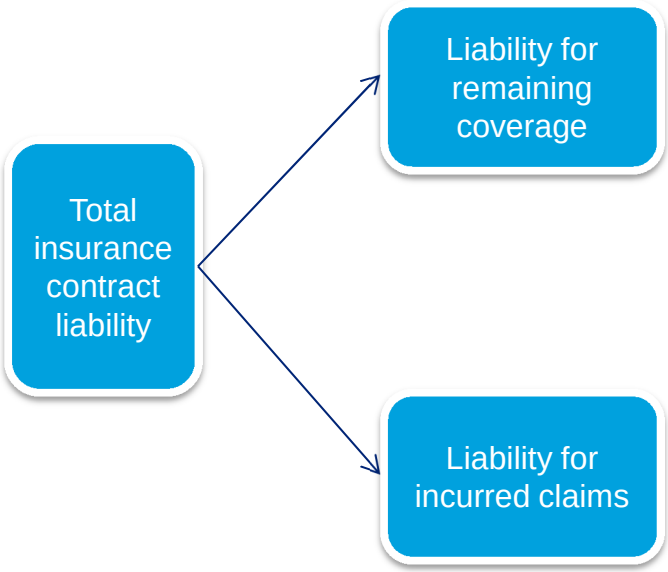
P&L at the end of the second year

Insurance contract revenue calculation	Total	Year 1	Year 2	Year 3
Change in CSM	200	100	100	0
Change in future fulfilment CFs that do not adjust CSM	-150	0	-150	0
Difference in the expected and actual fulfilment cash flows in the current period	-250		-250	
Gain/Loss recognised in the period	**-200**	**100**	**-300**	**0**

Earned premium approach

Presentation

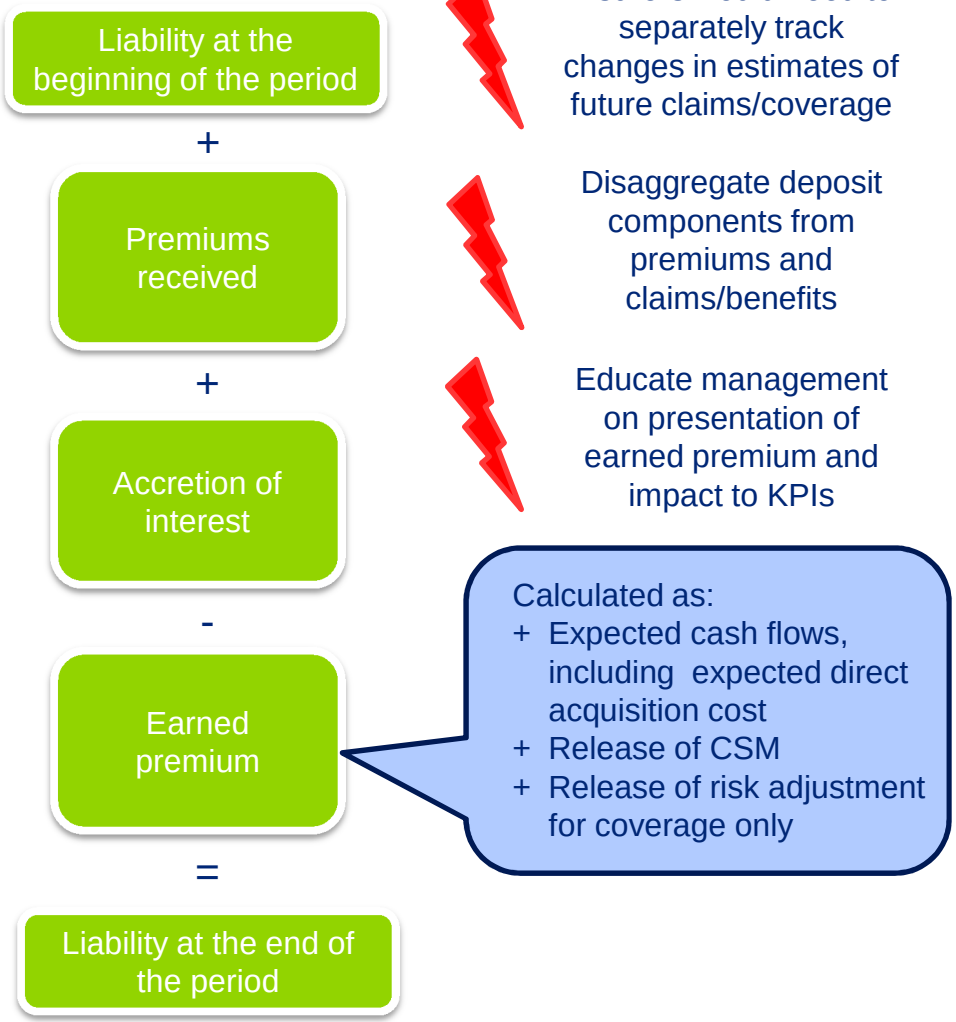
Allocates insurance contract revenue over the coverage period by reference to movement in the insurance liability



Challenges:

Insurers using BBA would need to separate liability components which would not be otherwise required

Challenges



Insurers would need to separately track changes in estimates of future claims/coverage

Disaggregate deposit components from premiums and claims/benefits

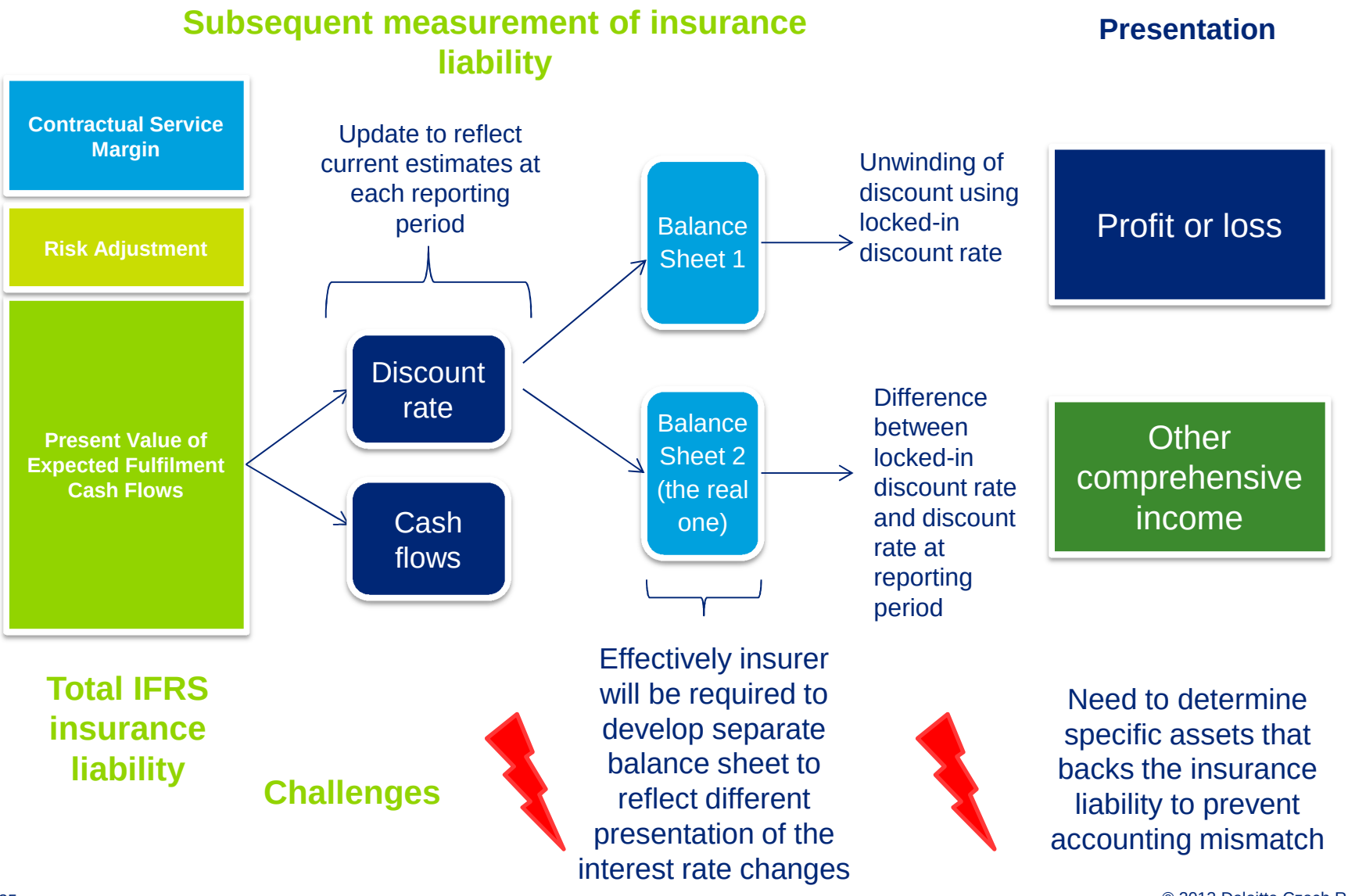
Educate management on presentation of earned premium and impact to KPIs

Presentation Proposals

Effect of change in discount rate through Other Comprehensive Income (OCI)

OCI solution

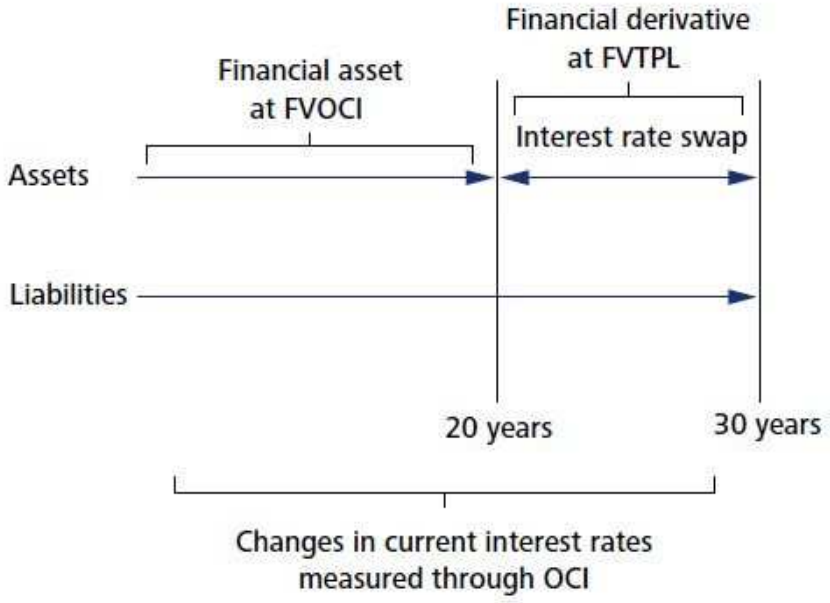
Effect of change in discount rates through OCI



OCI solution

Example

- Liability duration exceeds the duration of the underlying assets
- Insurer hedges these duration mismatches with derivatives (the effects of the 'OCI solution' would not apply to these derivatives and their changes in the fair value would flow through profit and loss as IFRS9 proposed presentation of the change in current market rates through OCI only for simple debt instruments)



Measurement Proposals

Accounting for participating contracts: Mirroring Approach

Participating contracts

Summary of new approach

- where cash flows **vary directly** with returns on the underlying asset (mirroring)
    - measure fulfilment cash flows by reference to the carrying amount
    - present changes in cash flows by reference to the carrying amount and presentation of the underlying item ('mirroring' approach) i.e. either in P&L or OCI depending on presentation of underlying item
- where cash flows **vary indirectly** with the underlying asset (BBA, P&L, no OCI, no unlocking of CSM)
    - measure fulfilment cash flows at risk-adjusted present value
    - present changes in cash flows split between P&L only
- where cash flows **do not vary** with the underlying asset (BBA, OCI, P&L)
    - measure fulfilment cash flows at risk-adjusted present value
    - present changes in cash flows split between P&L and OCI

Mirroring would take precedence over the OCI solution

Participating contracts

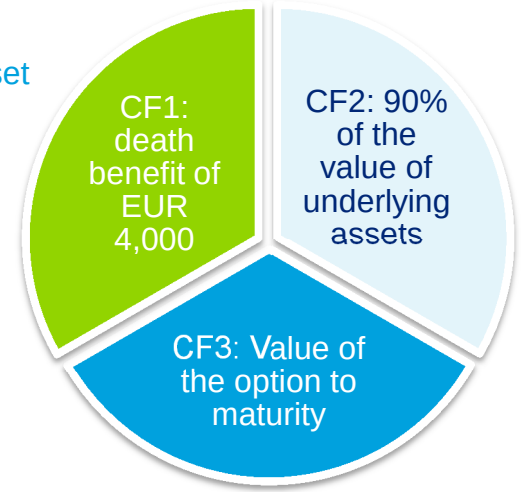
Challenges

Need to ‘decompose’ the different sets of cash flows in a contract to identify those cash flows that vary directly with the underlying assets

Illustrative example

- Assume a 5-year contract with a premium of EUR 2,000 received at inception.
- The policyholder will receive 90% of the returns of a specified pool of assets held by the company
- Death before the end of 5 years triggers a fixed death benefit of EUR 4,000
- At the end of 5 years, the policyholder is guaranteed a payment of at least EUR 2,000.

Do not vary with the underlying asset



Vary directly with the underlying asset

Vary indirectly with the underlying asset

Measurement Proposals

Unlocking the contractual service margin

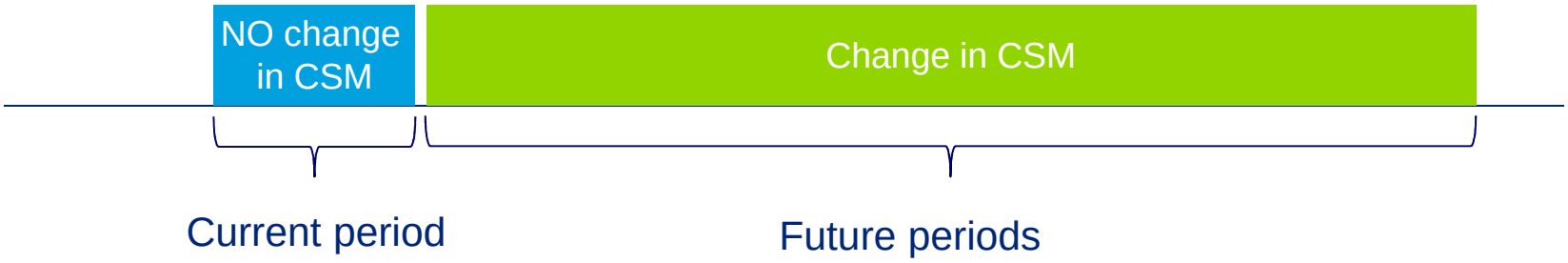
Contractual service margin (CSM)

Basic concept

- Represents unearned profit in a contract
- Calculated as amount equal and opposite to the sum of all cash flows included in the measurement of the insurance contract at initial recognition

Unlocking of contractual service margin

- Adjust prospectively for changes in estimates for cash flows related to future coverage and/or services
- May increase or decrease, but cannot result in a negative CSM amount



IFRS 4 Phase II

Approach to Transition

IFRS 4 Phase II

Approach to transition

- Retrospective application to all prior periods
- This will include the calculation of a CSM on in-force contracts at the transition date, if practicable
- Early application permitted
- Practical expedience provided:
  - If retrospective application is not practicable because of lack of objective data, use estimates based on objective information that are reasonably available
  - Simplification for historical discount rates allowed, practical expedience provided
- Reduced disclosure for transition
- In applying the transitional provisions to in-force contracts previously acquired through business combination, the insurer shall use:
  - The date of the business combination as the inception date of the contract
  - The fair value of the contract at the date of business combination as premium received

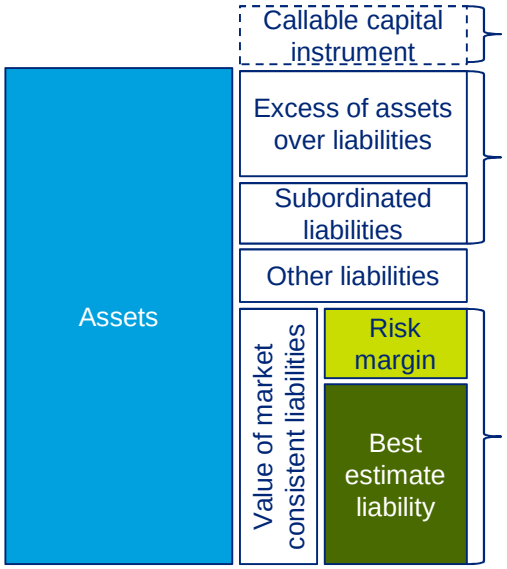
Appendix:

Solvency II vs. IFRS 4 Phase II

IFRS 4 Phase II alignment with Solvency II

Reconciliation of balance sheet components

Typical Solvency II Balance Sheet

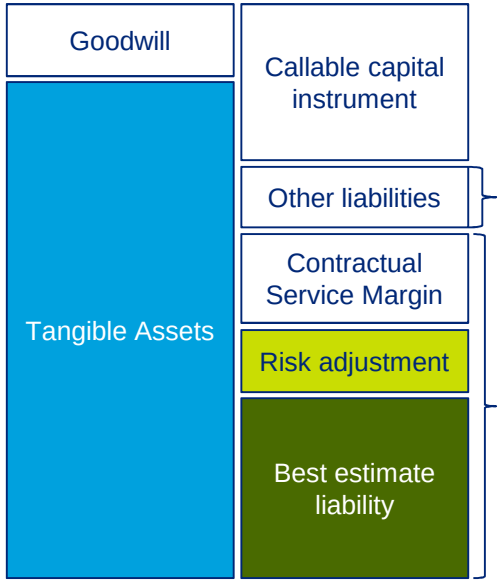


Ancillary own funds

Basic own funds

Technical provisions

Typical IFRS Balance Sheet



Investment contracts

Insurance contracts

Assets

- Differences due to measurement differences (FV versus MV)
- Assets category differences (e.g. goodwill, DAC and intangibles)

Liabilities

- Scope differences mean that UL liabilities are measured differently
- Scope differences mean there is no risk adjustment for investment contracts, unlike SII
- Risk adjustment in IFRS is measured differently to risk margin under SII

Differences caused by possible different discount rates

Difference caused by the contractual service margin in IFRS which is not a component of the SII technical liability

IFRS 4 Phase II alignment with Solvency II

Key challenges

	Solvency II	IFRS 4 Phase II
Differing goals	To establish a single common regulatory framework to maintain capital adequacy and risk management standards	To improve transparency and comparability of insurers' financial statements, regardless of sector, geography or products.

Component	Challenge	Key areas of impact
Scope & unit of measurement	IFRS4 "portfolio" level measurement for certain components may require different data segmentation, and investment contracts measurement is done under IFRS 9	***Data and systems / Assumptions / Inputs to ICM / reporting***
Best estimate cash flows	Some cash flows may differ e.g. costs & contract boundaries	***Assumptions / Methodology***
Discounting	Unlike Solvency II, the discounting under IFRS4 is governed by principles rather than rules	***Assumptions / Systems***
Risk adjustment	The measurement under IFRS4 is governed by principles rather than rules; additional disclosure of equivalent confidence interval requirement	***Data and systems / Methodology / Assumptions***
Contractual service margin	There is no concept of contractual service margin under Solvency II	***Data and systems / Reporting***
Tax	Tax implications need to be fully understood	***Assumptions / Methodology***
Reporting	P&L attribution process needs to be developed Balance sheet reconciliation between IFRS and SII	***Data and systems / Methodology / Reporting***

Target operating model

IFRS 4 Phase II alignment with Solvency II

Scope Consequences

Solvency II	IFRS 4 Phase II
Focuses on regulated entities and their regulated activities Transactions that fall within the business follow the Solvency II valuation rules	Focuses on transactions - “insurance” contract irrespective of regulatory status of issuer
Absence of transfer of insurance risk does not scope liabilities out of Solvency II	IFRS 4 applies to “insurance” contracts as individual transactions
Deals with both sides of the balance sheet	IFRS 4 only deals with the liability side of the balance sheet
Applies to the entire business of insurance undertakings	Insurers selling non “insurance” contracts use different IFRSs. For example: Unit-linked pure savings contracts are accounted for as deposits (IAS 39 / IFRS 9); and Asset management services will be accounted for as service contracts (IAS 18).

IFRS 4 Phase II alignment with Solvency II

Risk margin versus risk adjustment

	Solvency II	IFRS 4 Phase II
Objective	Technical provisions sufficient to meet the insurer's obligations	A margin to reflect uncertainty in the estimate of fulfilment cash flows
Scope	Assumes whole portfolio is transferred to another insurance company	Defined as "The compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contracts".
Methods	Cost of capital approach with the charge varying between Pillar 1 and Pillar 2	Following approaches can be used (but not limited to): confidence interval, conditional tail expectation and cost of capital.
Diversification	Diversification across portfolio segments and legal entities	Unit of account not prescribed as long as objective met => potential for similar diversification benefits.
Risks covered	Typically, includes non-hedgeable risks such as underwriting, counterparty and operational risks. All market risks are typically assumed to be hedgeable.	Includes market risks (to the extent that they affect the payments to the policyholders only) and underwriting risks.
Reporting	Re-measured at each reporting period and explicitly reported at the same level of granularity as the best estimate liability.	Re-measured at each reporting period and explicitly reported in the financial statements as part of the insurance liability. Equivalent confidence disclosure requirements.

IFRS 4 Phase II alignment with Solvency II

Contractual Service Margin

- Day 1 measurement:
  - Eliminates gains at inception of a contract i.e. premiums less BEL less risk adjustment; and
  - Measured at “portfolio” level, and within a portfolio, by similar date of inception / coverage period leading to additional data requirements.
- Subsequent measurement:
  - Adjust for favourable and unfavourable changes in estimates (excluding economic);
  - Contractual margin can increase or decrease, but cannot become negative;
  - Experience adjustments recognised in P&L account to the extent that there is no contractual service margin left;
  - The release of the RM should be over the coverage period, on a systematic basis that is consistent with the pattern of transfer of services provided under the contracts *(still under debate)*; and
  - Accretes interest on carrying amount of contractual service margin using discount rate at inception.

IFRS 4 Phase II alignment with Solvency II

Discounting

	Solvency II	IFRS 4 Phase II
Principles	Consistent with current market prices. Risk-free interest rate term structures will be the sum of: a. basic risk-free interest rate term structure; b. counter-cyclical premium (if applicable); and c. Matching adjustment (if applicable). This is still subject to debate between the industry and EIOPA.	Consistent with current market prices. Exclude factors not relevant to the insurance contract. Only reflect risks not included elsewhere in the measurement. Yield curve may be determined using “top down” or “bottom up”.
Method	Highly prescriptive method published by EIOPA.	No prescribed method. Guidance provided.
Non-participating contracts		Reflect the characteristics of the insurance contract liability.
Participating contract		The discount rate should also reflect the dependence between the assets and liabilities.

Contacts

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