IFRS 4 Fáze II

aneb dočkáme se konce nekonečného příběhu?

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4. října 2013, SAV, Praha
Introduction
### IFRS Landscape

IASB is substantially rewriting IFRS and building a new IFRS platform

<table>
<thead>
<tr>
<th>Year</th>
<th>Insurance Contracts</th>
<th>IFRS 9</th>
<th>Revenue Recognition</th>
<th>Leases</th>
<th>IFRS 13</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>Exposure Draft (July)</td>
<td>IFRS 9 re-issued effective date 1/1/13</td>
<td>Exposure Draft (June)</td>
<td>Exposure Draft (August)</td>
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<td>2011</td>
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<td>Effective date changed to 1/1/15</td>
<td>Revised Exposure Draft (November)</td>
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<td>2012</td>
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<td>Exposure Draft: Classification and Measurement (Nov)</td>
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<td>Revised Exposure Draft (June)</td>
<td>Exposure Draft: Impairment (March)</td>
<td>Final Standard (Q3)</td>
<td>Revised Exposure Draft (May)</td>
<td>Effective Date: 1 January 2013</td>
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<td>2014</td>
<td>Final Standard (2HY)</td>
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<tr>
<td>2015</td>
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<td>Effective Date: 1 January 2015 or 2016</td>
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<tr>
<td>2016</td>
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<td>2017</td>
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<td></td>
<td>Effective Date: 1 January 2017</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td></td>
<td></td>
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<td>Effective Date: 1 January 2017 or 2018</td>
<td></td>
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</table>

<table>
<thead>
<tr>
<th></th>
<th>Standard Development</th>
<th>Standard Implementation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010-2014</td>
<td></td>
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</tr>
</tbody>
</table>
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:

  - Insurance contracts, including reinsurance contracts, that it issues
  - Reinsurance contracts, that it holds
  - Investment contracts with a discretionary participation feature that it issues, provided that the entity also issues insurance contracts.
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
Recognition at the earliest of the following dated:

- Beginning of the coverage period
- First premium payment due
- Portfolio become onerous

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?

<table>
<thead>
<tr>
<th>IFRS phase I</th>
<th>IFRS phase II</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance sheet</td>
<td>Balance sheet</td>
</tr>
<tr>
<td>Trading</td>
<td>Shareholders’ equity Including OCI</td>
</tr>
<tr>
<td>HTM</td>
<td>Risk adjustment</td>
</tr>
<tr>
<td>AFS</td>
<td>Expected value – Blocks 1 and 2</td>
</tr>
<tr>
<td></td>
<td>Contractual Service Margin</td>
</tr>
</tbody>
</table>

**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

Best estimate liability (BEL)
Expected value

Probability

Liability L

α

1 - α

VaR_α

TVaR_α

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

RA = TVaR_α(L) – BEL = E[ L | L > VaR_α(L) ] - BEL

RA_{CoC} = CoC_{fac} \* \sum_{t+1} CA_t \* \left[ \frac{1}{1 + r_{t+1}} \right]

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

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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:

\[ CSM = PV \text{ of future inflows} - PV \text{ of future outflows} - RA \]

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

Comparison of Insurance Contract Liability under Local GAAP and IFRS 4 Phase II

BEL  RA  CSM  Local Reserve
Exposure Draft
Open Issues
IFRS 4 Phase II
Key areas of focus of the revised Exposure Draft

Presentation proposals
- Insurance contract revenues
- Changes in the liability due to discount rates changes in ‘Other Comprehensive Income’

Measurement proposals
- Contracts with contractual link to underlying items
- Unlocking the contractual service margin

Approach to transition
- Apply standard as if always effective. Some simplifications and relief provided
Presentation Proposals
Earned Premium Approach
Earned premium approach
What has changed?

Statement of comprehensive income 2010 ED

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

Statement of comprehensive income 2013 ED

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

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

- 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 affected 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.

<table>
<thead>
<tr>
<th>CSM</th>
<th>RA</th>
<th>Directly attributable AC</th>
<th>PV of claims 900</th>
</tr>
</thead>
<tbody>
<tr>
<td>180</td>
<td>30</td>
<td>90</td>
<td></td>
</tr>
</tbody>
</table>

PV of premiums = 1200
### Earned premium approach

**Example 1: 3-year contract – Balance sheet**

#### Statement of financial position

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>Day 1</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected inflows</td>
<td>-1 200</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Expected outflows</td>
<td>900</td>
<td>900</td>
<td>600</td>
<td>300</td>
<td>0</td>
</tr>
<tr>
<td>Expected outflows</td>
<td>90</td>
<td>90</td>
<td>60</td>
<td>30</td>
<td>0</td>
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<tr>
<td>Risk adjustment</td>
<td>30</td>
<td>30</td>
<td>20</td>
<td>10</td>
<td>0</td>
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<tr>
<td>Contractual service margin</td>
<td>180</td>
<td>180</td>
<td>140</td>
<td>80</td>
<td>0</td>
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<tr>
<td><strong>Insurance liability</strong></td>
<td>0</td>
<td>1 110</td>
<td>760</td>
<td>390</td>
<td>0</td>
</tr>
</tbody>
</table>

#### Roll forward of insurance contract liability

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>Day 1</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
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</thead>
<tbody>
<tr>
<td><strong>Opening balance</strong></td>
<td>0</td>
<td>1 110</td>
<td>760</td>
<td>390</td>
<td>0</td>
</tr>
<tr>
<td>Payment of premiums</td>
<td>1 200</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payment of claims</td>
<td></td>
<td>-300</td>
<td>-300</td>
<td>-300</td>
<td></td>
</tr>
<tr>
<td>Payment of acquisition costs</td>
<td></td>
<td>-90</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Risk adjustment</td>
<td></td>
<td>-10</td>
<td>-10</td>
<td>-10</td>
<td></td>
</tr>
<tr>
<td>Contractual service margin</td>
<td></td>
<td>-40</td>
<td>-60</td>
<td>-80</td>
<td></td>
</tr>
<tr>
<td><strong>Closing balance</strong></td>
<td>0</td>
<td>1 110</td>
<td>760</td>
<td>390</td>
<td>0</td>
</tr>
</tbody>
</table>
# Earned premium approach

## Example 1: 3-year contract – P&L

### Insurance contract revenue calculation

<table>
<thead>
<tr>
<th>Insurance contract revenue calculation</th>
<th>Inception</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in insurance claims</td>
<td>-900</td>
<td>300</td>
<td>300</td>
<td>300</td>
<td>0</td>
</tr>
<tr>
<td>Change in risk adjustment</td>
<td>-30</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>Change in CSM</td>
<td>-180</td>
<td>40</td>
<td>60</td>
<td>80</td>
<td>0</td>
</tr>
<tr>
<td>Premiums received</td>
<td>1 200</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1 200</td>
</tr>
<tr>
<td>Acquisition costs</td>
<td>-90</td>
<td>20</td>
<td>30</td>
<td>40</td>
<td>0</td>
</tr>
<tr>
<td><strong>Insurance contract revenue</strong></td>
<td><strong>0</strong></td>
<td><strong>370</strong></td>
<td><strong>400</strong></td>
<td><strong>430</strong></td>
<td><strong>1 200</strong></td>
</tr>
</tbody>
</table>

### Statement of comprehensive income

<table>
<thead>
<tr>
<th>Statement of comprehensive income</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance contract revenue</td>
<td>370</td>
<td>400</td>
<td>430</td>
<td>1 200</td>
</tr>
<tr>
<td>Claims incurred</td>
<td>-300</td>
<td>-300</td>
<td>-300</td>
<td>-900</td>
</tr>
<tr>
<td>Acquisition costs</td>
<td>-50</td>
<td>-30</td>
<td>-40</td>
<td>-120</td>
</tr>
<tr>
<td><strong>Profit</strong></td>
<td><strong>20</strong></td>
<td><strong>70</strong></td>
<td><strong>90</strong></td>
<td><strong>180</strong></td>
</tr>
</tbody>
</table>

-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

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>Inception</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected inflows</td>
<td>-900</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Expected outflows for claims/benefits and related expenses</td>
<td>600</td>
<td>400</td>
<td>200</td>
<td>0</td>
</tr>
<tr>
<td>Contractual service margin</td>
<td>300</td>
<td>200</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td><strong>Insurance liability</strong></td>
<td>0</td>
<td>600</td>
<td>300</td>
<td>0</td>
</tr>
</tbody>
</table>

#### Actual in Year 2 & Revised assumptions future assumptions

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>Inception</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected inflows</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Expected outflows for claims/benefits and related expenses</td>
<td>400</td>
<td>150</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Contractual service margin</td>
<td>200</td>
<td>150</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Insurance liability</strong></td>
<td>600</td>
<td>300</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

#### P&L at the end of the second year

<table>
<thead>
<tr>
<th>Insurance contract revenue calculation</th>
<th>Total</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in CSM</td>
<td>350</td>
<td>100</td>
<td>100</td>
<td>150</td>
</tr>
<tr>
<td>Change in future fulfilment CFs that do not adjust CSM</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Difference in the expected and actual fulfilment cash flows in the current period</td>
<td>50</td>
<td></td>
<td>50</td>
<td></td>
</tr>
<tr>
<td><strong>Gain/Loss recognised in the period</strong></td>
<td>400</td>
<td>100</td>
<td>150</td>
<td>150</td>
</tr>
</tbody>
</table>
# Earned premium approach

## Example 2: 3-year contract

### Expected assumptions

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>Inception</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected inflows</td>
<td>-900</td>
<td>0</td>
<td>0</td>
<td>0</td>
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<td>100</td>
<td>0</td>
</tr>
<tr>
<td><strong>Insurance liability</strong></td>
<td>0</td>
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### Actual in Year 2 & Revised assumptions future assumptions

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<th>Inception</th>
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<th>Year 3</th>
</tr>
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<tbody>
<tr>
<td>Expected inflows</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Expected outflows for claims/benefits and related expenses</td>
<td>400</td>
<td>450</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Contractual service margin</td>
<td>200</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Insurance liability</strong></td>
<td>600</td>
<td>450</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

### P&L at the end of the second year

<table>
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<tr>
<th>Insurance contract revenue calculation</th>
<th>Total</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in CSM</td>
<td>200</td>
<td>100</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>Change in future fulfilment CFs that do not adjust CSM</td>
<td>-150</td>
<td>0</td>
<td>-150</td>
<td>0</td>
</tr>
<tr>
<td>Difference in the expected and actual fulfilment cash flows in the current period</td>
<td>-250</td>
<td></td>
<td>-250</td>
<td></td>
</tr>
<tr>
<td><strong>Gain/Loss recognised in the period</strong></td>
<td>-200</td>
<td>100</td>
<td>-300</td>
<td>0</td>
</tr>
</tbody>
</table>
Earned premium approach

Presentation

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

- Total insurance contract liability
  - Liability for remaining coverage
  - Liability for incurred claims

- Liabilities
  - Liability at the beginning of the period
    - Premiums received
    - Accretion of interest
    - Earned premium
    - Liability at the end of the period

Challenges:

- Insurers using BBA would need to separately track liability components which would not be otherwise required
- Educate management on presentation of earned premium and impact to KPIs
- Disaggregate deposit components from premiums and claims/benefits

Challenges:

- Accretion of interest
- Earned premium
- Liability at the end of the period

Calculated as:
+ Expected cash flows, including expected direct acquisition cost
+ Release of CSM
+ Release of risk adjustment for coverage only
Presentation Proposals
Effect of change in discount rate through Other Comprehensive Income (OCI)
OCI solution
Effect of change in discount rates through OCI

Subsequent measurement of insurance liability

- Contractual Service Margin
- Risk Adjustment
- Present Value of Expected Fulfilment Cash Flows

Discount rate
Cash flows

Balance Sheet 1
Balance Sheet 2 (the real one)

Update to reflect current estimates at each reporting period
Unwinding of discount using locked-in discount rate
Difference between locked-in discount rate and discount rate at reporting period

Profit or loss
Other comprehensive income

Total IFRS insurance liability

Challenges

Effectively insurer will be required to develop separate balance sheet to reflect different presentation of the interest rate changes

Need to determine specific assets that backs the insurance liability to prevent accounting mismatch
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.

<table>
<thead>
<tr>
<th>Vary directly with the underlying asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>CF1: death benefit of EUR 4,000</td>
</tr>
<tr>
<td>CF2: 90% of the value of underlying assets</td>
</tr>
<tr>
<td>Vary indirectly with the underlying asset</td>
</tr>
<tr>
<td>CF3: Value of the option to maturity</td>
</tr>
</tbody>
</table>

Do not vary 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

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

<table>
<thead>
<tr>
<th>Component</th>
<th>Challenge</th>
<th>Key areas of impact</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Differing goals</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Solvency II</td>
<td>To establish a single common regulatory framework to maintain capital adequacy and risk management standards</td>
<td></td>
</tr>
<tr>
<td>IFRS 4 Phase II</td>
<td>To improve transparency and comparability of insurers’ financial statements, regardless of sector, geography or products.</td>
<td></td>
</tr>
<tr>
<td><strong>Component</strong></td>
<td><strong>Challenge</strong></td>
<td><strong>Key areas of impact</strong></td>
</tr>
<tr>
<td>Scope &amp; unit of measurement</td>
<td>IFRS4 “portfolio” level measurement for certain components may require different data segmentation, and investment contracts measurement is done under IFRS 9</td>
<td>Data and systems / Assumptions / Inputs to ICM / Reporting</td>
</tr>
<tr>
<td>Best estimate cash flows</td>
<td>Some cash flows may differ e.g. costs &amp; contract boundaries</td>
<td>Assumptions / Methodology</td>
</tr>
<tr>
<td>Discounting</td>
<td>Unlike Solvency II, the discounting under IFRS4 is governed by principles rather than rules</td>
<td>Assumptions / Systems</td>
</tr>
<tr>
<td>Risk adjustment</td>
<td>The measurement under IFRS4 is governed by principles rather than rules; additional disclosure of equivalent confidence interval requirement</td>
<td>Data and systems / Methodology / Assumptions</td>
</tr>
<tr>
<td>Contractual service margin</td>
<td>There is no concept of contractual service margin under Solvency II</td>
<td>Data and systems / Reporting</td>
</tr>
<tr>
<td>Tax</td>
<td>Tax implications need to be fully understood</td>
<td>Assumptions / Methodology</td>
</tr>
<tr>
<td>Reporting</td>
<td>P&amp;L attribution process needs to be developed Balance sheet reconciliation between IFRS and SII</td>
<td>Data and systems / Methodology / Reporting</td>
</tr>
</tbody>
</table>
## IFRS 4 Phase II alignment with Solvency II

### Scope Consequences

<table>
<thead>
<tr>
<th>Solvency II</th>
<th>IFRS 4 Phase II</th>
</tr>
</thead>
<tbody>
<tr>
<td>Focuses on regulated entities and their regulated activities</td>
<td>Focuses on transactions - “insurance” contract irrespective of regulatory status of issuer</td>
</tr>
<tr>
<td>Transactions that fall within the business follow the Solvency II valuation rules</td>
<td></td>
</tr>
<tr>
<td>Absence of transfer of insurance risk does not scope liabilities out of Solvency II</td>
<td>IFRS 4 applies to “insurance” contracts as individual transactions</td>
</tr>
<tr>
<td>Deals with both sides of the balance sheet</td>
<td>IFRS 4 only deals with the liability side of the balance sheet</td>
</tr>
<tr>
<td>Applies to the entire business of insurance undertakings</td>
<td>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).</td>
</tr>
</tbody>
</table>
# IFRS 4 Phase II alignment with Solvency II

## Risk margin versus risk adjustment

<table>
<thead>
<tr>
<th>Objective</th>
<th>Solvency II</th>
<th>IFRS 4 Phase II</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technical provisions sufficient to meet the insurer's obligations</td>
<td>A margin to reflect uncertainty in the estimate of fulfilment cash flows</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Scope</th>
<th>Assumes whole portfolio is transferred to another insurance company</th>
<th>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”.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Methods</td>
<td>Cost of capital approach with the charge varying between Pillar 1 and Pillar 2</td>
<td>Following approaches can be used (but not limited to): confidence interval, conditional tail expectation and cost of capital.</td>
</tr>
<tr>
<td>Diversification</td>
<td>Diversification across portfolio segments and legal entities</td>
<td>Unit of account not prescribed as long as objective met =&gt; potential for similar diversification benefits.</td>
</tr>
<tr>
<td>Risks covered</td>
<td>Typically, includes non-hedgeable risks such as underwriting, counterparty and operational risks. All market risks are typically assumed to be hedgeable.</td>
<td>Includes market risks (to the extent that they affect the payments to the policyholders only) and underwriting risks.</td>
</tr>
</tbody>
</table>

| 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

<table>
<thead>
<tr>
<th>Principles</th>
<th>Solvency II</th>
<th>IFRS 4 Phase II</th>
</tr>
</thead>
</table>
|            | 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”. |

<table>
<thead>
<tr>
<th>Method</th>
<th>Solvency II</th>
<th>IFRS 4 Phase II</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Highly prescriptive method published by EIOPA.</td>
<td>No prescribed method. Guidance provided.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Non-participating contracts</th>
<th>Solvency II</th>
<th>IFRS 4 Phase II</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reflect the characteristics of the insurance contract liability.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Participating contract</th>
<th>Solvency II</th>
<th>IFRS 4 Phase II</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The discount rate should also reflect the dependence between the assets and liabilities.</td>
<td></td>
</tr>
</tbody>
</table>
Contacts

Hana Havlíčková
Senior Consultant, Actuarial & Insurance Solutions

Tel.: +420 246 042 334
Email: hhavlickova@deloittece.com