IFRS 4 Phase II Transition

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In this briefing note we take a closer look at the proposed accounting standard for insurance contracts "IFRS 4 Phase II" and how insurance companies' opening balance sheets will change at the transition date.

INTRODUCTION

The International Accounting Standards Board (IASB) continues to work on the Insurance Contracts project. The aim of this project is to provide a single principle-based standard to account for all types of insurance contracts that an insurer holds. The project also aims to enhance comparability of financial reporting between companies, jurisdictions, and capital markets.

Phase I of this project was completed in 2004 with the introduction of International Financial Reporting Standards (IFRS) 4: *Insurance Contracts*. However, this was intended only as an interim standard.

Phase II of this project is currently being undertaken. In July 2010, the IASB issued an exposure draft of IFRS Phase II. In June 2013, a second exposure draft was issued outlining the draft standard and focusing on key areas for consultation. Since then, the IASB has been considering the feedback received. While tentative decisions have been reached in some areas, further consideration is being given to other areas. Deliberations are expected to continue throughout 2015; the final standard will follow once these discussions are complete.

TRANSITION DATE

Mandatory adoption of the proposals is currently foreseen to be three years after the issue of the final standard, recognising the complexity of implementation. Early application is likely to be permitted. The transition date is the date that the insurance company first adopts the final standard.

CURRENT PROPOSAL FOR TRANSITION

It is important to note that, at this point, the measurement model for participating contracts is still under consideration by the IASB. Therefore, the current proposal, outlined in this briefing note, relates to non-participating contracts only.

At the transition date, the company must adjust retained earnings to allow for the following:

a) Derecognising existing balances of deferred acquisition costs
b) Measuring each portfolio of insurance contracts as the sum of the **fulfilment cash flows** *(present value of future cash flows including a* ***risk adjustment***[1]*)* and the **contractual service margin** *(the unearned profit that the company recognises as it provides* services)
c) *Recognising the cumulative effect of the difference between the expected present value of the cash flows, discounted using:
    i. Current discount rates
    ii. The discount rates that were applied when the portfolios were initially recognised

*The IASB has tentatively decided to allow companies to choose to recognise the change in discount rates in the profit and loss or as an equity item. It is therefore expected that this adjustment will only apply to blocks of business where the change in discount rate is recognised in an equity component.

The 2013 exposure draft and subsequent tentative decisions made by the IASB provide a hierarchy of three approaches for determining the contractual service margin at the transition date.

The three approaches are:

- Full retrospective application
- Simplified retrospective approach
- Fair value approach

[1] Risk adjustment is the compensation that a company requires for bearing the uncertainty about the amount and timing of the cash flows that arise as the company fulfils the insurance contract.

In accordance with IAS 8: *Accounting Policies, Changes in Accounting Estimates and Errors,* a change in accounting policy should, where practical, be applied retrospectively and should adjust the opening balance of each equity component as if the new accounting policy had always been applied.

> ***IAS 8 (26)***
>
> ***Retrospective application to a prior period is not practicable unless it is practicable to determine the cumulative effect on the amounts in both the opening and closing balance sheets for that period.***

Full Retrospective Approach

The full retrospective approach should be used where practicable. This approach will require relevant pricing and historical data to be available for all in-force contracts. This information is required in order to estimate the fulfilment cash flows and contractual service margin at the date of initial recognition and to roll them forward to the transition date.

> ***The full retrospective approach may be considered impractical as measuring the following amounts would often be subject to bias through the use of hindsight:***
> - ***The expected cash flows at the date of initial recognition***
> - ***The risk adjustment at the date of initial recognition***
> - ***The discount rate at the date of initial recognition***
> - ***For each accounting period, the changes in estimates that would have been recognised in profit or loss because they did not relate to future coverage, and the extent to which such changes in estimates would have been reversed as claims were incurred***

Simplified Retrospective Approach

If the full retrospective approach of the standard is impracticable, the simplified retrospective approach should be used.

Using the simplified retrospective approach, the company need not undertake exhaustive efforts to obtain objective information but must take into account all objective information that is reasonably available.

The following simplifications are allowed:

a) Assume all changes in estimates of cash flows between initial recognition and the transition date were known already at initial recognition.
b) Estimate the risk adjustment at the date of initial recognition by adjusting the risk adjustment at the transition date by the expected release of the risk over this period.
c) Estimate the discount rates that applied at the date of initial recognition using an observable yield curve that, for at least three years prior to the transition date, approximates the yield curve used in the current valuation.

This approach therefore requires information on the actual historical cash flows since initial recognition.

Fair Value Approach

If the simplified approach is impracticable, the fair value approach should be used. This approach involves determining the contractual service margin at the transition date as the difference between the fair value of the insurance contract at that date and the fulfilment cash flows measured at that date.

> ***IFRS 13 - Fair Value***
>
> Definition: ***The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.***

Within this approach, the contractual service margin at the transition date represents the amount in excess of the fulfilment cash flows, which market participants would require to accept these contracts.

Unlike the two retrospective approaches, the fair value approach does not require historical policyholder cash flows to determine the contractual service margin. Although this approach may be seen as the least complex of the three, resources will need to be available to determine the fair value of the contracts.

For blocks of business where companies choose to recognise changes in discount rates in an equity component, some retrospective estimates are still required under this approach. For this business, the interest expense at the initial locked-in discount rates is reported in the profit and loss while the interest expense due to changes in discount rates (since inception) is reported in the equity component.

For blocks of business where companies choose to recognise changes in discount rates in profit and loss there is a requirement to disclose the effect of changes in discount rates. It is not yet clear whether this requirement will also apply retrospectively on transition.

Determining Practicality?

In order to use the fair value approach, the full and simplified retrospective approaches must be deemed impractical.

As yet, there is no guidance available on determining practicality and it remains to be seen how this will be determined in practice.

Here are some possible scenarios where the retrospective approaches may be considered impractical and the fair value approach may be used:

- ***Historical data or cash flows may be difficult or impossible to obtain because of system deficiencies.***
- ***The value gained from using the retrospective approaches may be incommensurate with the effort required to obtain historical data or cash flows for some portfolios.***

PRACTICAL DIFFICULTIES

Regardless of the approach taken, companies will face some challenges when determining the opening balance sheet at the transition date. Some of the key practical difficulties are discussed below.

Managing Multiple Discount Rates

For the simplified retrospective approach and, in at least some cases for the fair value approach, companies will need to estimate the discount rates that applied at the date of initial recognition.

This gives rise to a number of practical challenges:

- How often to lock in interest rates?
- Whether/how to consider changes in interest rate volatilities?
- How to estimate past interest rates in case of lack of / gaps in historical data?

It would be a very ambitious endeavour to give definite answers to these questions now, as some time will be needed for best practices to emerge and be accepted as such. For example, some experts believe that interest rates should be locked in monthly. Indeed, interest rates can change quite markedly from one month to the next or even within a month. However, we do believe that it would be ambitious enough to lock in interest rates annually and arrange for a (typically stochastic) valuation model to simultaneously work with a large list of economic scenario generator (ESG) files for each past inception year, especially for mature companies featuring material blocks of business written over the course of many years. One possible way to reduce this workload is to lock in an effective yield at inception. This approach is currently being considered by the IASB for participating contracts.

It is not clear if past interest rate volatility surfaces should be locked in just like past interest rates. We believe that locking in past interest rate volatility surfaces would reflect the true effect of the change in discount rates. Hence, one would need separate market-consistent ESG files calibrated to each past set of locked-in market data. However, in most cases, such a collection of ESG files would not be available beyond a few past years and even those files available will have been created using different capital market models or even using different ESG provider software.

In other words, IFRS 4 modellers will have to ensure that their set of ESG files will cover a long range of relevant inception years with appropriate interest rates and volatilities locked in, and will be produced using the same capital market models and the same ESG calibration approaches.

Of course, it would be possible to procure such a large set of market-consistent ESG files from an ESG provider. Alternatively, one might be tempted to create all the necessary past ESG data from the market-consistent base ESG file as of the current valuation date.

Indeed, it is possible to transform a base ESG file to another ESG file featuring different initial interest rates as well as different implied volatilities. This process, which would be automatically executed for each relevant past point in time, is called *ESG rebasing*. The engine of ESG rebasing is an optimisation routine which would seek to approach the following targets as closely as possible:

- Initial interest rate targets
- Implied volatility targets
- Martingale test targets

In order to accomplish this task, the optimisation routine would assign different weights to different scenarios rather than keep uniform weights of 1/N for each of the N scenarios in the base ESG file. This is why ESG rebasing is also referred to as *ESG reweighting*. This approach, quite well-known

in the financial community, has been more recently applied to several insurance challenges.

Remark on ESG Rebasing

In order to ensure compatibility with the outputs of ESG rebasing, the life office model would have to accommodate different weights provided for different ESG scenarios. Alternatively, this task could be assigned to the output processing layer activated once the (stochastic) model runs have been finished.

Retrospective Stochastic Modelling

The IFRS 4 Phase II requirement to value the economic and time value of options and guarantees embedded in insurance contracts would typically involve stochastic modelling. As this requirement is present in Market Consistent Embedded Value (MCEV), Solvency II, and other reporting regimes, it is likely that many companies will have systems in place already to produce such results.

However, the transitional requirement to determine the interest expense since inception (present in all three approaches if companies choose to present changes in discount rate in an equity component) will require additional stochastic valuations to be produced. This requirement may result in a strain on computing resources and an increase to run times.

One option available to reduce the computing requirements and run times is to use cluster modelling[2].

Cluster Modelling

This data compression technique allows for the grouping of policies into clusters. Unlike other data compression techniques, clusters are determined based on the importance of the financial results of the policy. Cluster modelling produces demonstrably high goodness of fit across various scenarios and can be applied in a fully automated way.

[2] For more information see "Cluster Analysis – A spatial approach to actuarial modelling," by A. Friedman and C. Reynolds.

Data Storage

IFRS 4 Phase II brings challenges in terms of the additional data storage requirements. In particular, the requirement to calculate interest expense means that yield curves from the inception of each cohort of policyholder must be stored. The granularity of the cohort is determined by the company.

For portfolios with financial options or guarantees there will be a need to store or regenerate the scenarios used at inception for use at each valuation date.

The issue of storage will be an immediate concern at the transition date. Yield curves and/or scenarios from the inception date of the portfolio at the transition date will be required to be determined and stored. For some companies such scenarios may span 30 to 50 years.

Determining Fair Value

When the fair value approach is used, a calculation of liabilities using fair value accounting is required. The fair value of the liabilities may differ from the fulfilment cash flows for a number of reasons, including the following:

- Fulfilment cash flows include an estimate of future company-specific expenses required to fulfil the portfolio. The expenses used in the fair valuation are market participants' expectations about the costs of fulfilling the obligation. Fair value expenses are likely to be similar to current pricing expenses assumptions.
- Fulfilment cash flows exclude overhead expenses which are not directly attributable to the contracts. The fair value of the portfolio should include an allowance for overhead expenses.
- Fulfilment cash flows include a risk adjustment. The fair value includes a risk premium. Both the risk adjustment and risk premium represent compensation for the uncertainty in the amount and timing of cash flows. Different approaches may be taken to determine these items.

Most companies do not currently calculate the fair value of liabilities on a regular basis. Companies using this approach on transition should ensure that there are resources available to perform this one-off calculation on transition.

DISCLOSURE REQUIREMENTS

A company must use the most practical transitional approach suitable for each portfolio. Therefore a combination of the three approaches outlined may be used.

For contracts that were measured under the simplified retrospective approach or the fair value approach, the company must disclose the following at each reporting date:

a) The earliest date of initial recognition for the portfolio
b) The methods used to measure insurance contracts and the processes for estimating the inputs to those methods
c) The methods used to estimate the:
    i. Risk adjustment
    ii. Discount rates
    iii. Pattern of recognition of contractual service margin (CSM)
d) The effect of changes in the methods and inputs that are used to measure insurance contracts
e) The yield curve (or range of yield curves) that is used to discount the cash flows

CONCLUSION

An opening balance sheet must be produced under IFRS 4 Phase II at the transition date. There is a hierarchy of three approaches to be applied for determining the contractual service margin in the opening balance sheet. Companies must use the most suitable approach for each portfolio of contact. The three approaches are:

- Full retrospective approach
- Simplified retrospective approach
- Fair value approach

Each approach brings its own challenges for the company in terms of determining discount rates, additional modelling requirements and data storage needs.

We recommend that companies consider the transitional requirements of IFRS 4 Phase II. Any system or modelling developments needed to meet these requirements should be fully incorporated into the company's IFRS 4 planning process.

HOW MILLIMAN CAN HELP

Milliman is a leading global advisor and has consultants working internationally on understanding and assessing the impact of the IASB's latest proposals for insurance contracts.

Milliman consultants can assist in understanding the proposals including:

- The areas of consultation highlighted by the IASB
- Systems implications and design
- The influence that the exposure draft may have on your business, including new business impact

Milliman also has extensive expertise of industrialisation of reporting processes. Integrate™ is Milliman's unique, holistic system which gives an approach to automation and governance of actuarial reporting processes.

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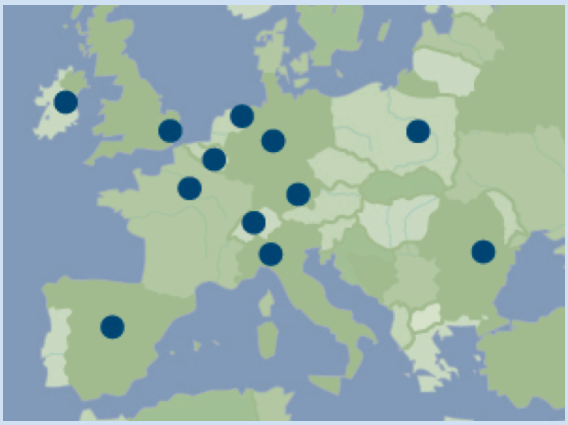

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