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ACTUARIAL SOCIETY OF SOUTH AFRICA

IFRS 17 – Implementation Issues in Developing Countries

IAA Colloquium / ASSA Conference
Cape Town, 2 Apr 2019
Kyle Rudden FIA, FSA, ACAS, FCCA, ACIB

Section Colloquium 2019

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Objectives

- **Continue the dialogue** on relevant practical solutions to the challenges of IFRS 17 for insurance companies in developing markets.
- **Share some simplified approaches** we think can be used.

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Outline

- IFRS 17 - Background
- Setting discount rates
- Risk adjustment options
- Transition
- Materiality
- Discussions

What is IFRS 17?

- *"… the biggest disruption to financial reporting for insurance companies that I have seen in 50 years as an actuary … "*
  - Trevor Howes, Moody's, Caribbean Actuarial Association Conference, Jamaica, Nov 2018
- A massive opportunity to improve internal and external financial reporting by insurers
  - … if it does not kill them first.

IFRS 17 Challenges for us …

1. Complexity
2. Lack of implementation resources
3. High implementation costs
4. Irrelevant models
5. Irrelevant reference materials
6. Lack of national data / guidance
7. Lack of practical discussion

IFRS 17 Background

- Insurance and reinsurance contracts
- Reporting on or after 1 Jan 2022
  - 1 Jan 2021 = 21 months away …
- Practical implications:
  - Measurement of insurance contract reserves
  - Financial statements including disclosures
  - Transition for in force contracts

Latest IASB Updates

- Oct 2018 : IASB Board
  - Proposed deferring implementation to 1Jan2022.
  - Agreed to look at 25 items starting in Dec 2018
- Apr 2019 : Meeting to approve 12 changes
- Jun 2019 : Exposure Draft
- IFRS 17 is moving forward largely unchanged …

Insurance Contract Liabilities

- BEV / IFRS 4 Insurance Liability / Asset =

NEPV of Future Cash Flows + Margins for Adverse Deviations

- IFRS 17 Insurance Contract Liability =

NEPV of Future Cash Flows + Risk Adjustment + Unearned Profit [CSM]

Discount Rates

Insurance Contract Liabilities

- **BEV / IFRS 4 LAT**

NEPV of Future Cash Flows

"Best Estimate"

≈ Same

Net Present Value of probability adjusted expected future cash flows

- **IFRS 17**

NEPV of Future Cash Flows

"Unbiased Mean"

Different = DISCOUNT RATE!

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IFRS 17 Discount Rate (1)

- BEV / IFRS 4 LAT:
  - Expected returns on underlying assets 7%
  - Less risk margin [optional for LAT] (1)%

    6%
- IFRS 17
  - It's a LOT more complicated … 6%?

Insurance Contract Liquidity

- IFRS 17 Theory
  - Use risk free rate reflecting insurance contract liquidity.
- Liquidity = policyholder's ability to exit policy without significant loss of value.
  - Whole life policy with high surrender values = more liquid
  - Immediate annuity = less liquid
- Aim: Discount illiquid policyholder liabilities at higher rate of interest.

IFRS 17 Discount Rate (2)

"Top Down"

Reference Asset Portfolio Yield

Less: Credit, Mismatching & Other Adjustments

IFRS 17 Discount Rate

"Bottom Up"

IFRS 17 Discount Rate

Add: Illiquidity Adjustment

Liquid Risk Free Rate

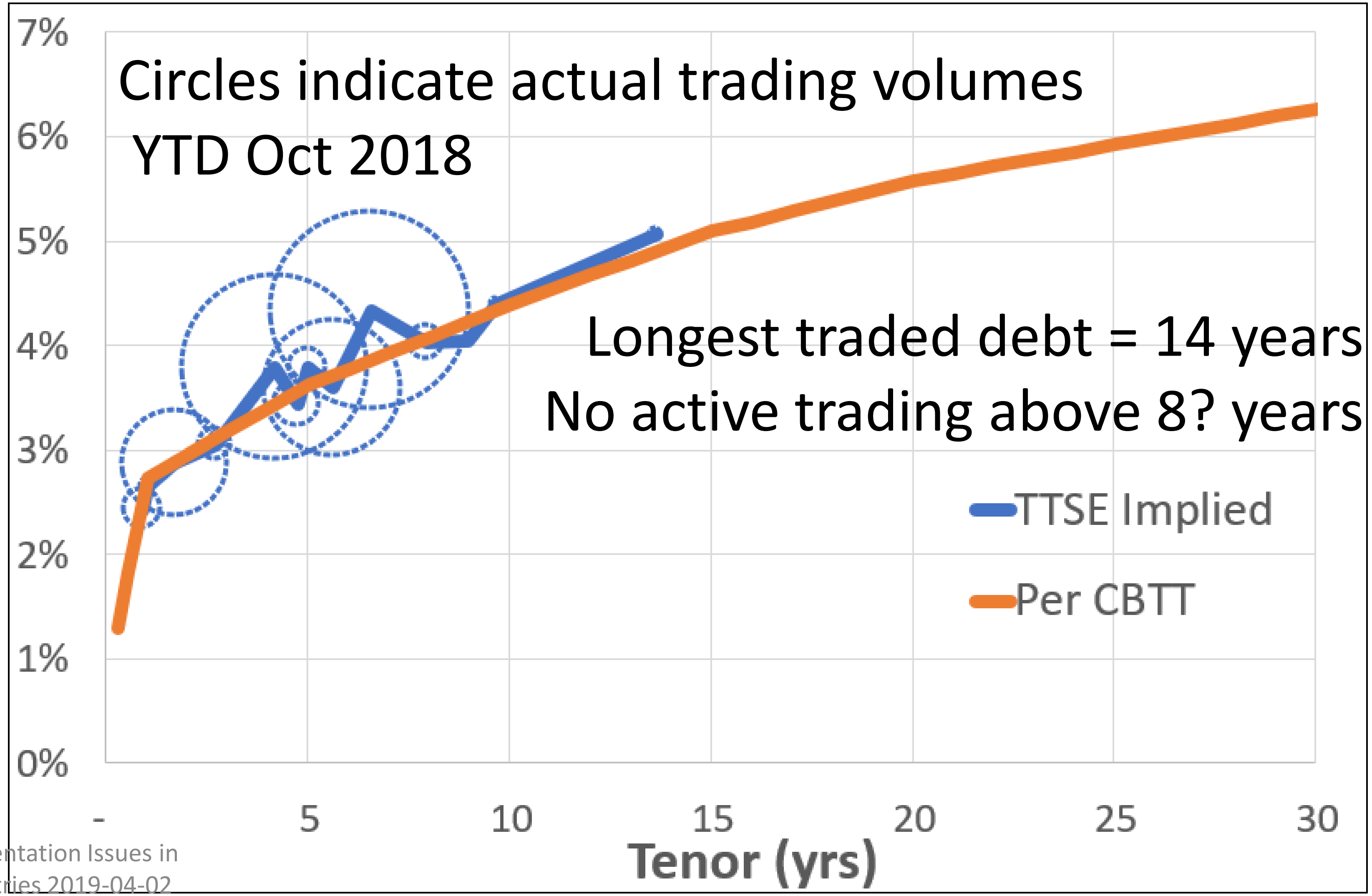
Developing Market Problems

- Illiquid local markets.
  - Even in Govt bonds, far less corporates
  - Few available investments
- Can't identify supportable adjustments.
  - Illiquidity difficult to measure even in large developing markets – Brazil, India etc.
  - No market prices of corporate bonds, credit default swaps, options etc to calibrate models.
  - Difficult to justify use of illiquidity premiums from a developed market.

Possible Approach

- Bottom Up approach – most practical
- Risk free based on govt bonds.
  - Extrapolation required
  - Adjust for known credit risk issues? Non trivial issue!
- Illiquidity Adjustment = 0%
  - Simple, low implementation cost
  - Probably not materially different to how much excess yield from past corporate bond issues was from illiquidity as opposed to credit risk.
  - Reflect in risk tolerance in Risk Adjustment?

Risk Free Rates – Trinidad & Tobago



Notes on Extrapolation

- Technically, you use the “spot” or zero coupon rates derived from the bond yield curve to discount future cash flows.
  - You can express as an equivalent average
- We prefer smoothed forward rates to generate curves.
  - We could use a specified model like Europe
- Check reasonableness of ultimate rates by reference to e.g. expected inflation.

Risk Adjustments

Insurance Contract Liabilities

- BEV / IFRS 4 Insurance Liability / Asset =

NEPV of Future Cash Flows + Margins for Adverse Deviations

- IFRS 17 Insurance Contract Liability =

NEPV of Future Cash Flows + Risk Adjustment + Unearned Profit [CSM]

Risk Adjustment (1)

- *IFRS 17.37 … the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk.*
- Entity specific
  - Risk appetite not specified
  - Method not specified
- Disclosure of corresponding “confidence interval”
- Expenses and expense inflation = non-financial risk

Main methods internationally

- Modified Canadian
  - Add explicit margins for adverse deviation (MAD) to best estimate assumptions
- Modified Solvency II
  - Calculate required capital at all future dates
  - Discount annual changes in required capital at cost of capital
  - Cost of capital = risk free + margin (6%?)

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Canadian Style

- Advantages
  - Statutory MAD’s already in legislation in many countries and programmed into actuarial models.
  - Canadians (hopefully) working out confidence intervals equivalent to margins.
  - Best if you are already Canadian style
- Disadvantages
  - Canadian confidence intervals (developed country, large volumes) may not be relevant for local use.

Solvency II Style

- Advantages
  - Lots of papers supporting methodologies
  - Easy to understand
  - Could use regulatory capital
  - Best if you are already in a Solvency II system
- Disadvantages
  - Developed country / large volume models may not be appropriate for local markets
  - Still don’t know relevant confidence levels

Practical Approach?

- Local portfolios are small and generate very variable statistics.
- Industry / Regulators should agree on some standard parameters to be used.
- Disclosure notes could be along the lines of
  - *"The Risk Adjustment is based on the minimum capital requirements of Country X, discounted at a 6% cost of capital. While information available locally does not permit robust quantification of confidence intervals, the resulting reserves are considered more than adequate to meet policyholder liabilities in all reasonable scenarios".*

Transition

Transition Recommendations

- **Full Retrospective – Ignore as "Undue Cost & Effort"**
- **Modified retrospective - Avoid**
- **Fair Value – Highly Recommended**
  - Easy to understand and explain.
  - Calculate everything at transition date using existing methods.
  - All past years = 1 cohort, much simpler administration.
  - No need to identify onerous contracts.
  - No subjective guesses at past assumptions.
  - At minimum, do this first.

Materiality
- The IFRS Definition!

… the secrets revealed …

Materiality (1)

- **"Applying Materiality Judgements"**
  - IASB Practice Statement 2
  - Effective 14 Sep 2017
  - Covers characteristics of materiality
  - Application advice
    - http://www.ifrs.org/issued-standards/materiality-practice-statement/
- Materiality = Pervasive concept for recognition, measurement, presentation & disclosure.

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Materiality (2)

- Material = useful information that could influence a primary user's decisions.
  - *"provide financial information … that is **useful** to [Primary Users] in making decisions about providing resources to the entity."* *[PS2.IN1]*
  - *"[material] information could reasonably be expected to influence decisions that primary users make on the basis of those financial statements."* *[PS2.11]*
- Primary Users
  - *"existing and potential investors, lenders and other creditors"* *[PS2.13]*

Materiality (3)

- Consider financial statements as a whole:
  - *"Requirements in IFRS Standards only need to be applied if their effect is **material to the complete set of financial statements**."* *[PS2.IN3]*
  - *"An entity need not provide a disclosure specified by an IFRS Standard if the information resulting from that disclosure is not material. This is the case even if the Standard contains a list of specific disclosure requirements or describes them as 'minimum requirements'."* *[PS2.10]*

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Practical Issues & Discussions

Some Thoughts

- Discount rate = risk free rate?
- Risk Adjustment = Canadian or Solvency II methods
  - Confidence interval calculations = Difficult
- Go for simplicity rather than false precision.
- Transition = fair value!
- Use the IFRS definition of materiality to guide your decisions
  - Impact on usefulness of overall financial statements to potential investor / creditor.
  - This includes aggregation decisions!
- Webinars to come!

Conclusion

For further discussion of questions or issues please contact KR Services Limited or kyle.rudden@kr-consulting.com

Thank you!

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Acronyms

CSM	Contractual Service Margin (≈ deferred profit)
FCF	Fulfillment Cash Flows = NEPV cash flows + risk adjustment
FV	Fair Value (see IFRS 13)
GA or GMA	General [Measurement] Approach = “building block approach”
IAA	International Actuarial Association
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standard
LIC	Liability for Incurred Claims (≈ claim liabilities)
LRC	Liability for Remaining Coverage (≈ premium liabilities)
NEPV	Net Expected Present Value (probability adjusted, discounted)
OCI	Other Comprehensive Income
PAA	Premium Allocation Approach (alternative method for LRC)
PL	Profit & Loss
SoFP	Statement of Financial Position (= Balance Sheet)

Further Reading

- General
- https://www.pwc.pt/pt/industrias/seguros/pwc-using-solvencyII-IFRS17.pdf
- www.cia-ica.ca/docs/default-source/ifrs17/ian100060818.pdf
- Discount Rates
- http://us.milliman.com/uploadedFiles/insight/2018/IFRS-17-Discount-Rates.pdf
- https://www.moodysanalytics.com/-/media/article/2018/permitted-approaches-for-constructing-ifrs17-discount-rates.pdf
- www.actuaries.org/CTTEES.../4a_EPS_IAN4_Discount_Rates_20170926clean.docx
- https://eiopa.europa.eu/CEIOPSArchive/Documents/Reports/20100303-CEIOPS-Task-Force-Report-on-the-liquidity-premium.pdf
- Risk Adjustment
- http://www.milliman.com/uploadedFiles/insight/2017/IFRS-17-Risk-Adjustment.pdf

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