IFRS 17: Closer than it appears

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for the Polish Actuarial Society
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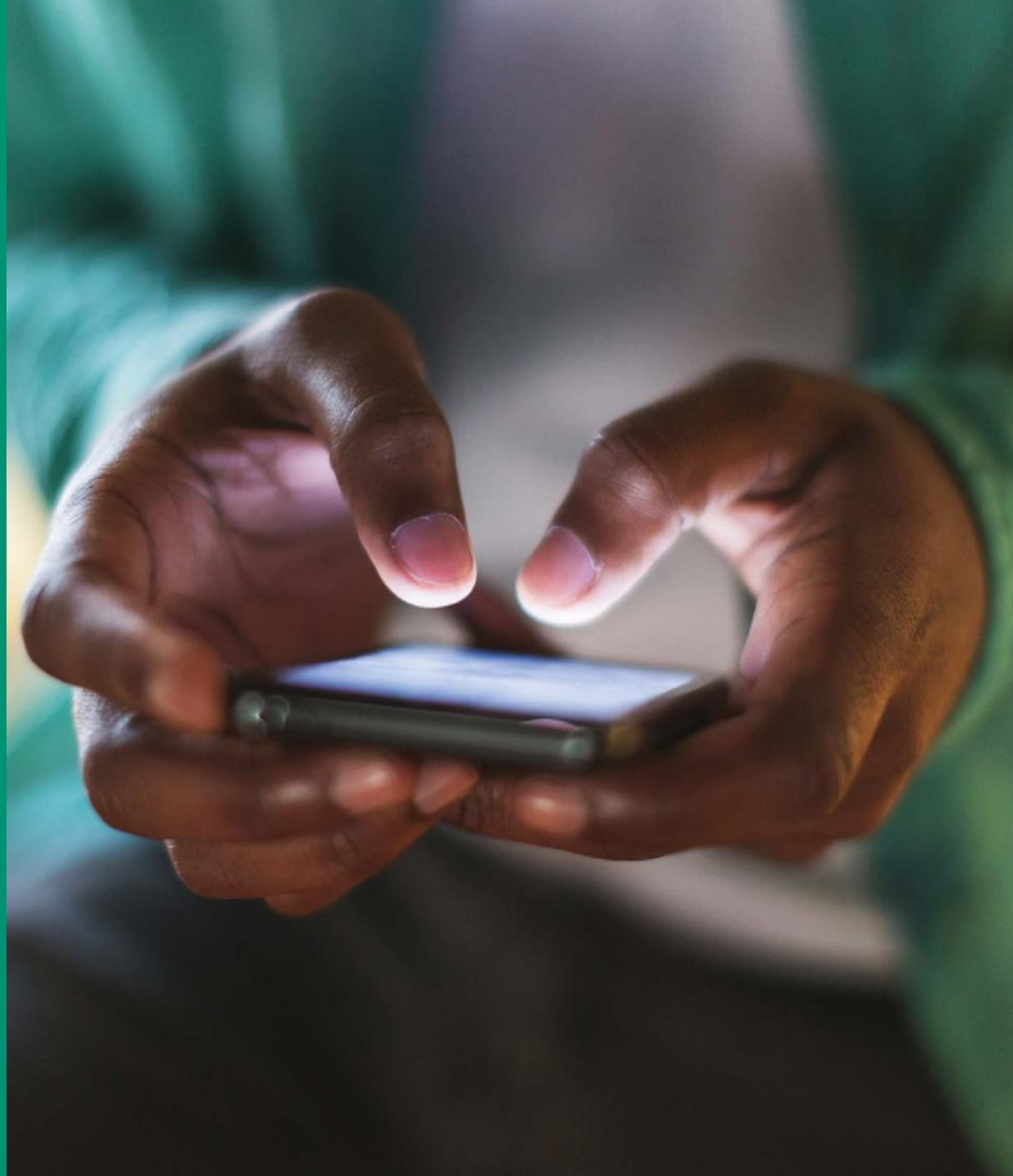
Empowering
the Financial World

Confidentiality Statement

Agenda

- Who am I?
- State of play
- The Approaches
- The Calculations
- Aggregation
- Transition
- Governance and Connectivity
- Conclusion

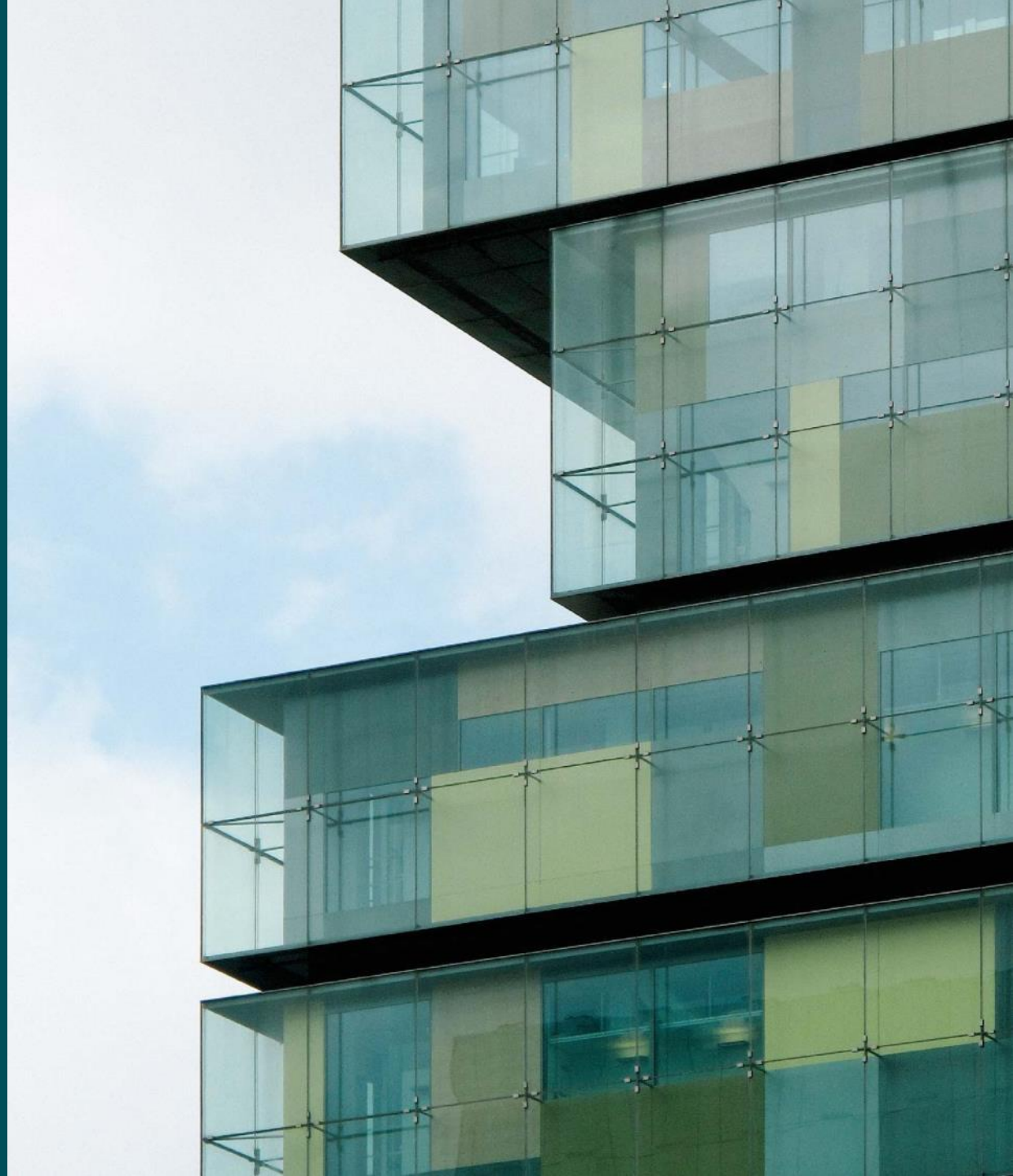
Who am I?



Who am I?

- I'm a UK actuary
- I work for FIS – we make the Prophet actuarial software
- I've worked for insurers, actuarial consultancies, and now a software company
- My job is to make our software better …
- … to do this, I go all over the world asking people what they need it to do
- I'm not a thought leader …
- … but I am a thought gatherer

The State of Play



State of play on IFRS ~~Insurance Contracts Phase II~~ 17

- New global insurance accounting standard …
- … existing standard is IFRS 4 …
- … so people often call this new standard IFRS 4 Phase II

- "Current" exposure draft dates back to June 2013

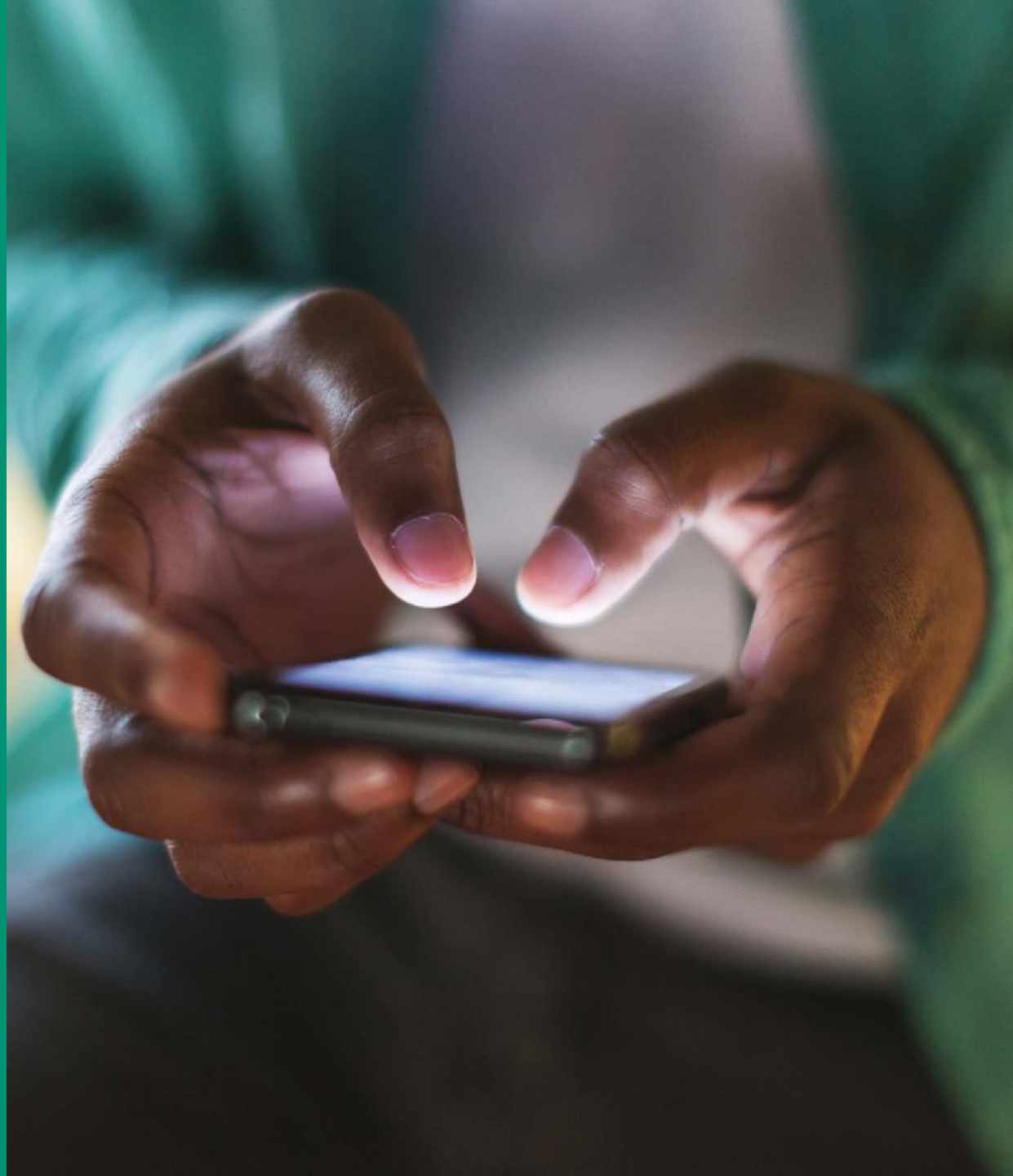
- Substantial new sections of text published earlier in 2016 as part of a consultation

- Final IFRS standard currently expected March 2017 …
- … so all the cool kids are now calling it "IFRS 17"

- Expectations in Europe are for a 2020/2021 implementation date

- So we can just relax, then?

The Approaches



IFRS 17 Calculation “Approaches”

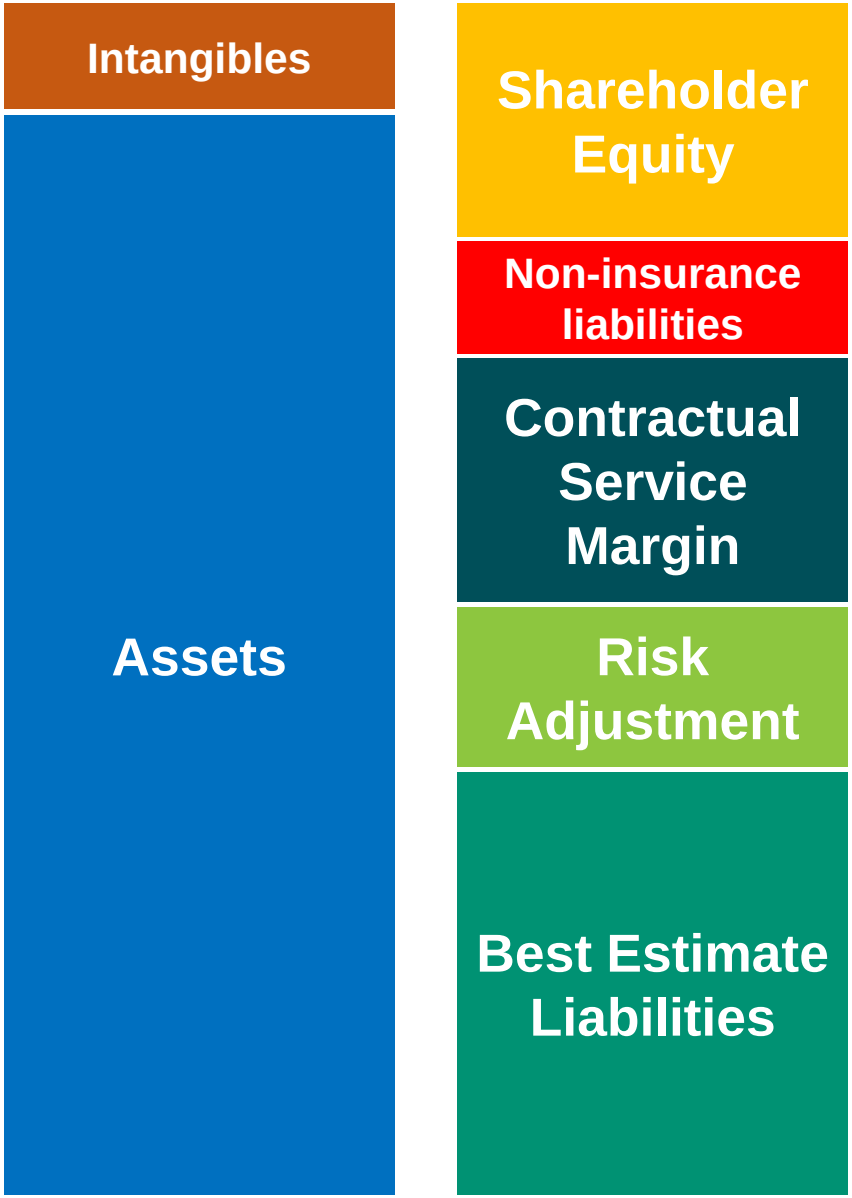
- **General Model**
- **Variable Fee Approach**
- **Premium Allocation Approach**

General Model

- **Originally the Building Block Approach, it is now commonly referred to as the "General Model", as it is effectively the default approach**

- **The building blocks are probably now familiar to most of us:**
  - Future Cashflows
  - Time Value of Money
  - Risk Adjustment
  - Contractual Service Margin

IFRS 17 Balance Sheet



Variable Fee Approach

- Components are the same as the General Model
- The policyholder participates in the return on a pool of underlying items
- General model rules are modified to account for fluctuating investment returns
- The concept of “direct participation” not only covers investment-linked and unit-linked …
- … it is intended to cover profit participation too

Premium Allocation Approach

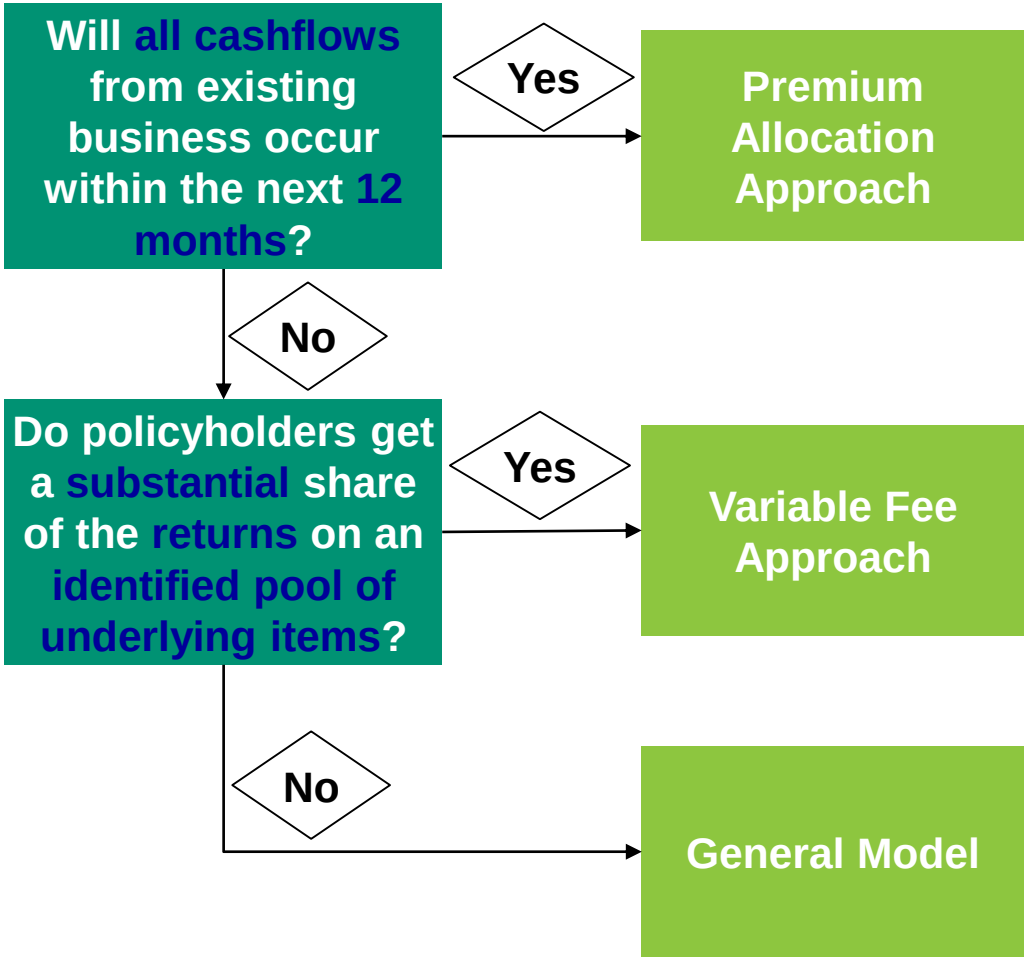
- Similar to the Unearned Premium Reserve / Unexpired Risk Reserve concept in non-life insurance

- Significant simplification compared to the Building Block Approach …
- … IFRS text says the PAA must be a close approximation to the BBA result …
- … but how do you prove that without doing it the hard way?

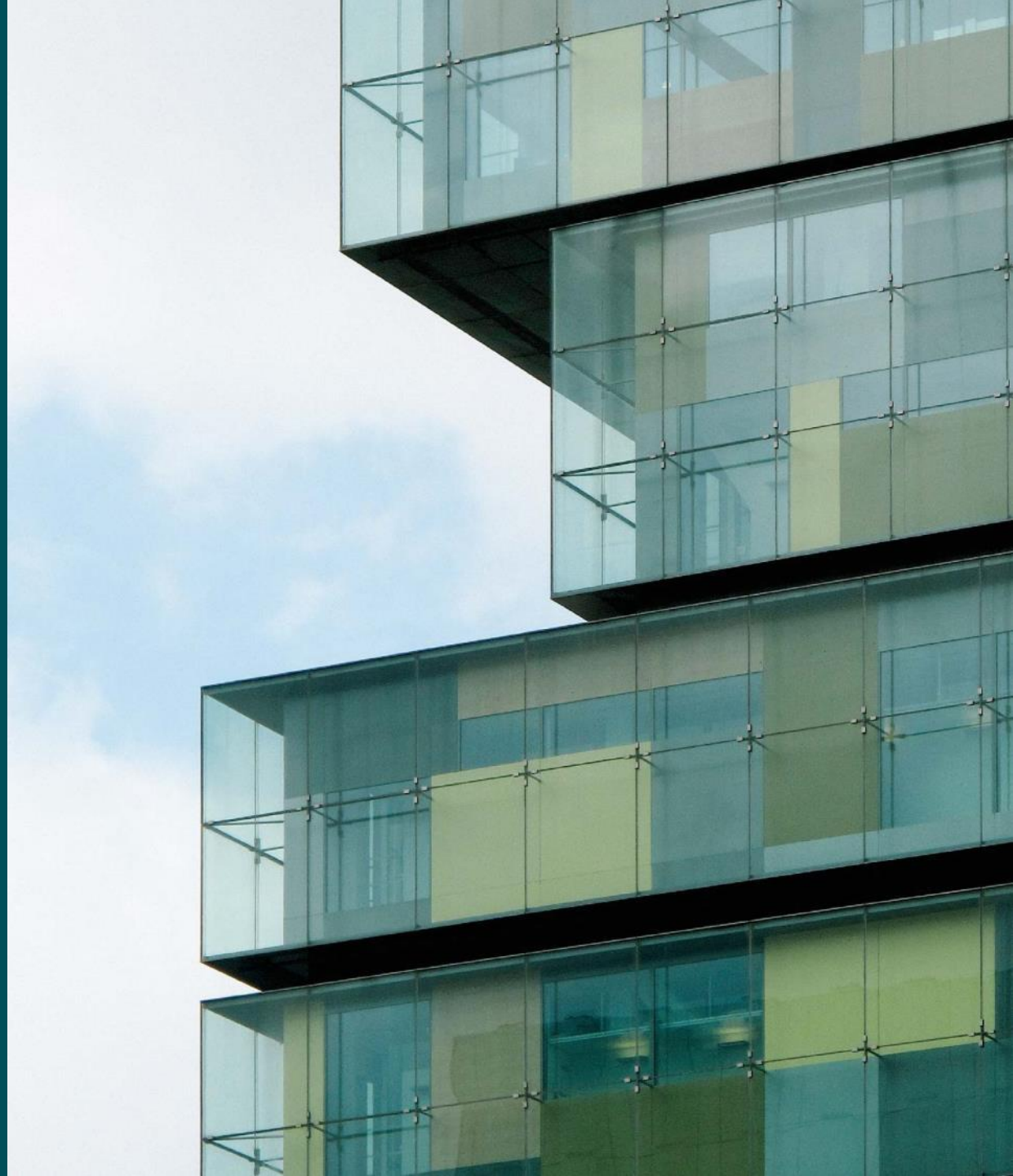
- IASB often reiterate that this is NOT the default approach …
- … even for non-life business

IFRS 17 Calculation “Approaches”

- General Model
- Variable Fee Approach
- Premium Allocation Approach



The Calculations



Future Cashflows

Problem

- Expected value of future cashflows

Principle

- Expected value of all future cashflows required to fulfil insurance liabilities

Considerations

- It may not be the same set of cashflows for different purposes …
- … for example, different interpretation of boundary conditions …
- … and other unusual features such as “pre-policy” cashflows

Time Value of Money

Problem

- Discounting of expected future cashflows

Principle

- Discount rates must be traceable back to observable market data

Considerations

- Risk-free yield curves are acceptable …
- … asset-backed returns are also acceptable …
- ... plus or minus various modifications for credit risk, liquidity premium

Best Estimate Liability

Problem

- Combine Future Cashflows and Time Value of Money

Principle

- The amount you believe you need to hold in order to meet liabilities …
- … essentially with a 50/50 probability

Considerations

- Best Estimate Liability ≠ Liabilities on best estimate assumptions
- Any non-linearity of results with respect to the risk factors, and the Best Estimate Liability effectively becomes a stochastic calculation

Risk Adjustment

Problem

- Compensation for risk of fulfilling insurance liabilities

Principle

- Hold an amount sufficient to be indifferent between the block of insurance business and a certainty equivalent

Considerations

- Value at Risk (or variant such as tail VaR) are acceptable techniques …
- … cost of capital approach is also an acceptable technique
- Can you leverage what you've done for Solvency II using cost of capital approach?

Contractual Service Margin

Problem

- “Zeroise” future profits, then allow profits to emerge smoothly over time

Principle

- Recognise profits over the lifetime of the insurance policy, as the “service” is provided

Considerations

- CSM calculation is just a formula, albeit with a lot of complexities …
- … BEL on original economic assumption, “shadow” negative CSMs
- Practical pain point is passing CSM data from one valuation to the next …
- … storage and retrieval of BEL and CSM - potentially by policy – has no parallels today

The Fundamental Interconnectedness of All Things

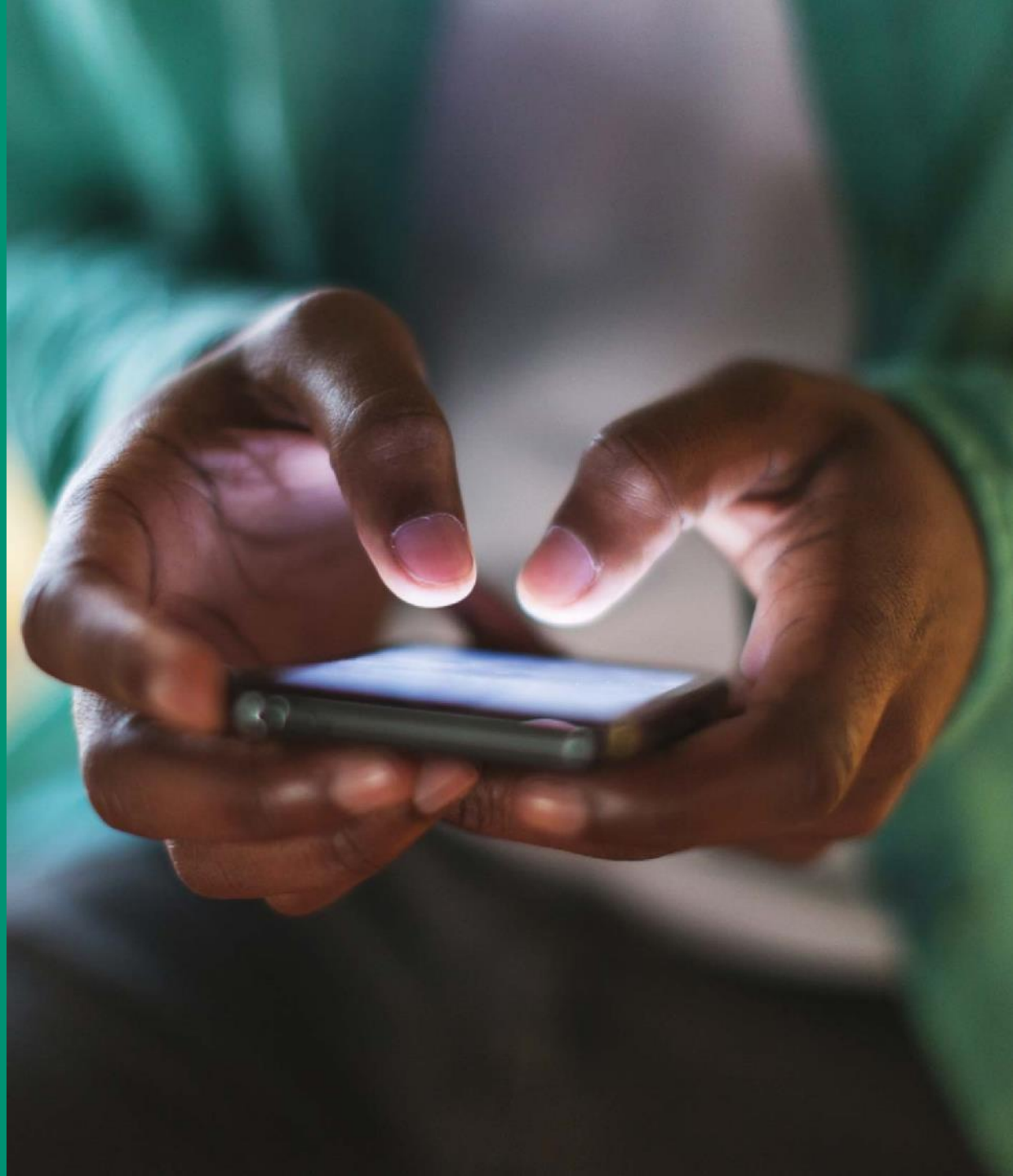
- **An IFRS 17 balance sheet in a Solvency II world**

- **Best Estimate Liability wrap around the cashflows on an IFRS basis …**
- **… discount using a yield curve or asset-backed returns**

- **IFRS Risk Adjustment based on Solvency II Solvency Capital Requirement …**
- **… revalue Solvency II BEL under a series of stresses, calculate risk capital for each stress, aggregate stress capital requirements …**
- **… project business forward in annual time steps on IFRS assumptions …**
- **… evaluate projected SCR on Solvency II assumptions …**
- **… using IFRS cost of capital basis on projected Solvency II SCR**

- **Contractual Service Margin …**
- **… incorporating "properly-calculated" Risk Adjustment into the zeroisation**

Aggregation



Aggregation / Unit of Account

BEL

- Best Estimate Liability should be much the same at any level – it's the mean

RA

- Risk Adjustment should optimally be calculated at entity level …
- … it's a solvency calculation, thus incorporates diversification benefit

CSM

- So you have an entity-level Risk Adjustment …
- … now need to allocate it back down to – potentially – policy level …
- … to obtain the CSM at policy level

Aggregation for assessment of CSM

- **CSM has been the focal point of much of the discussion around aggregation**
- **Example:**

Policy	CSM	Ungrouped CSM Assessment	Grouped CSM Assessment
A	1,000	1,000	1,000
B	-900	0	-900
"Entity" CSM:		**1,000**	**100**

- **Clearly grouping is advantageous in this simplified example, but …**
- **… IFRS 17 says only policies with "similar" profit signatures should be grouped …**
- **… so clear-cut situations like this example are unlikely to happen**

A software vendor's perspective

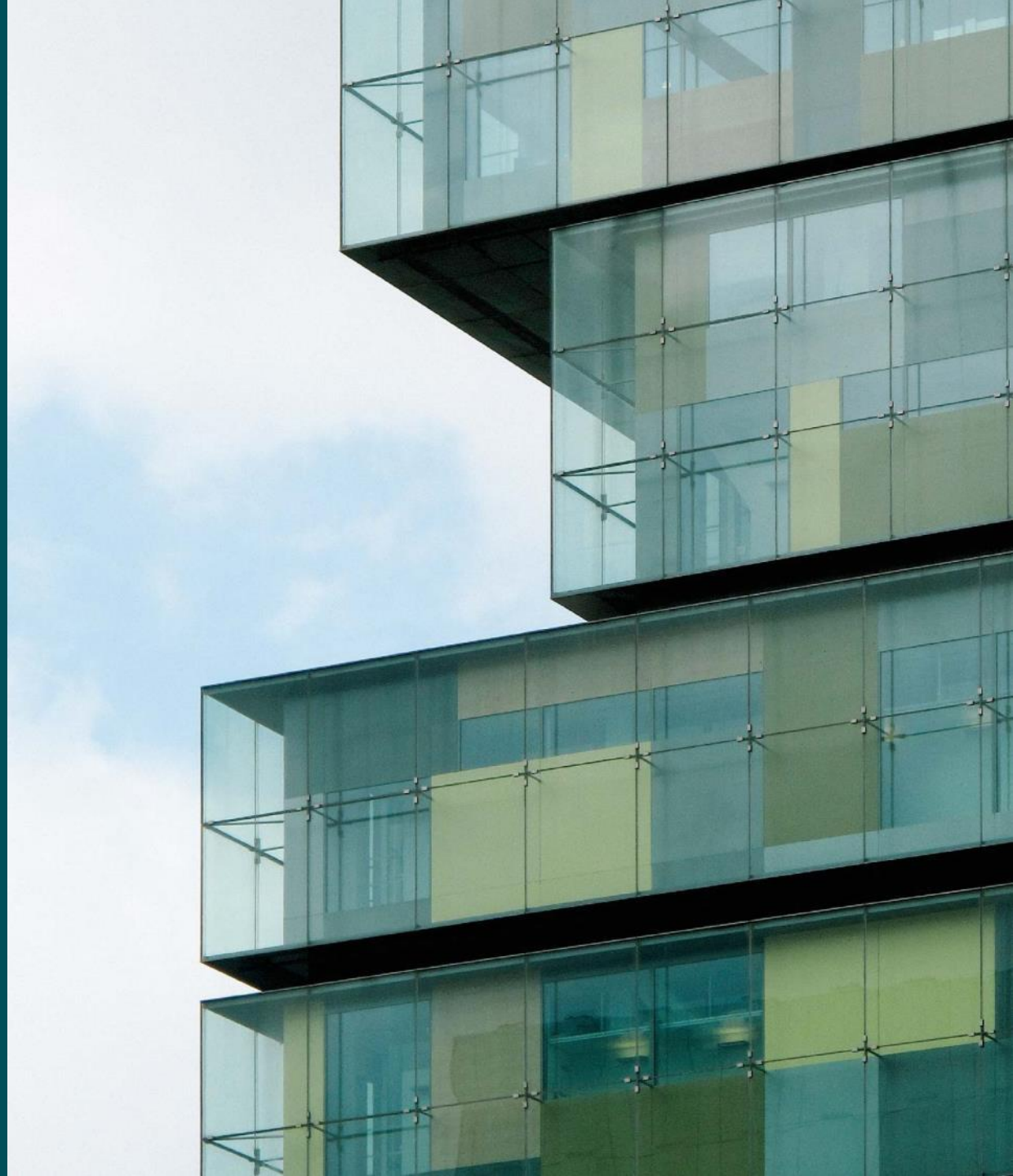
- There may be advantages to aggregating data in order to reduce the CSM …
- … though even that statement is questionable …
- … you're not supposed to use it as an opportunity to reduce CSM

- The IFRS 17 wording is trying to be pragmatic …
- … allowing you to group if it helps …
- … and, within reason, to disregard the "unintended" positive consequences

- But grouping does lead to an increase in operational complexity

- Addressing the operational complexity costs real money …
- … is it worth spending real money to adjust a notional balance?

Transition



Transition

- If possible, need to fully recreate the predicted profitability at inception …
- … this means recreating everything – assumptions, policy data, pricing models

- If that's impracticable, proposed "simplification" is to estimate future cashflows from today …
- … then use actual historic experience to step back to inception

- Only if that's impracticable can you assess a fair value on current assumptions

Practical considerations

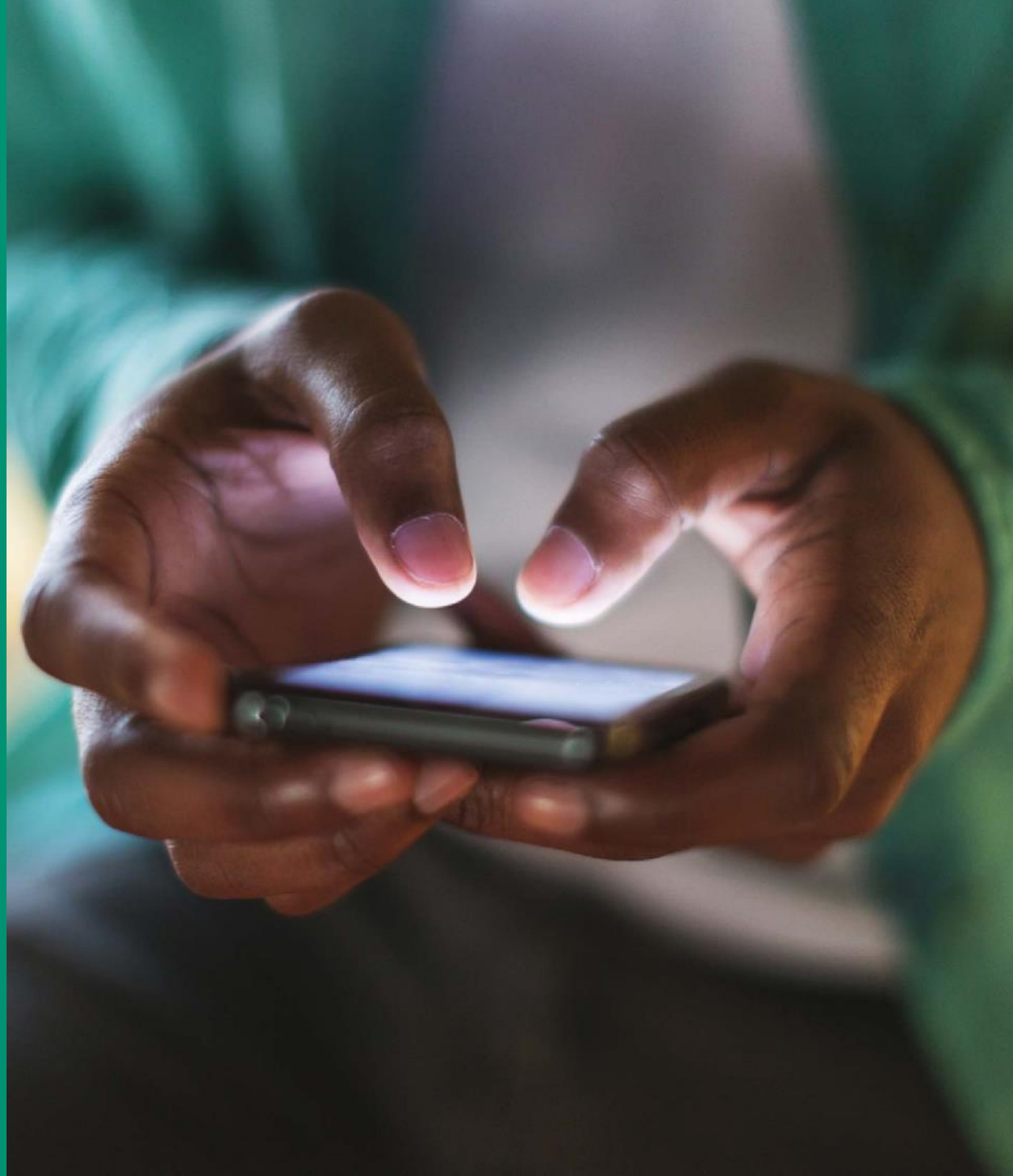
- This isn't just about locating old assumptions …
- … you need the policy data that would have been in effect at the time …
- … and possibly most difficult of all – the models

- I always use the term “reimagining” …
- … you can’t just pick up and use old information …
- … you have to put yourself into the mindset applied at that time

- Start collecting data and storing models today …
- … it will take away some of the pain come 2020/2021

- What if you have already distributed profits that you now have to hold back?

Governance and Connectivity



Why governance?

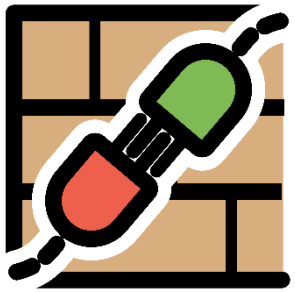
- Solvency II, ComFrame …
- … the risk-based regimes have explicit governance framework requirements

- On paper, IFRS 17 is a calculation regime …
- … governance matters because the actuaries have to work with the accountants on this …
- … and the accountants say it matters

- Accountants want to see process and governance around their numbers …
- … actuarial mathematics is of little interest to them

- But this is actually great news for many actuaries …
- … everything we did for these risk-based regimes works for IFRS 17 too

Why connectivity?



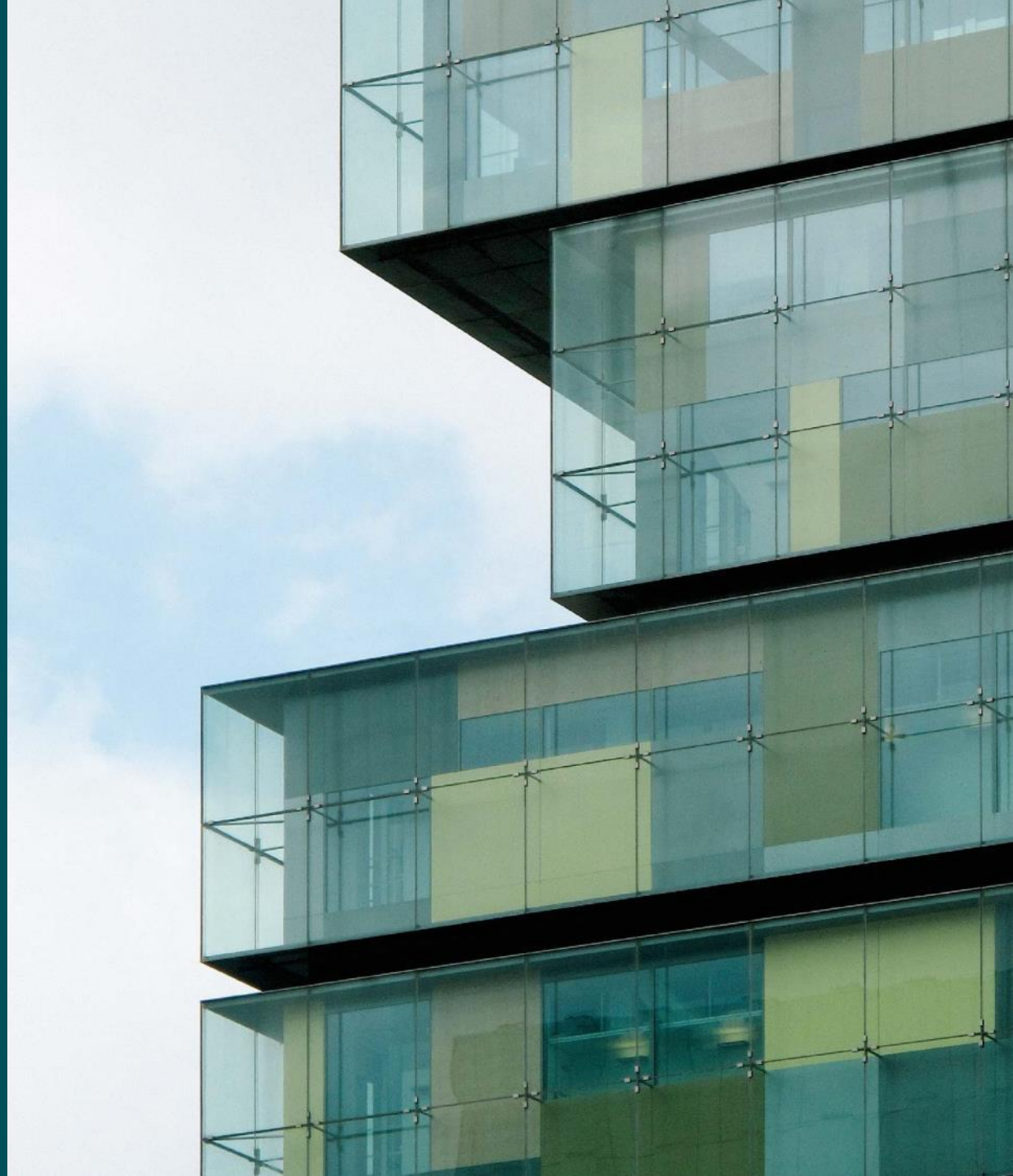
- Again, it's all about co-operation between actuaries and accountants

- Actuarial calculation results will need to be consumed by accounting systems …
- … on a greater scale than under previous regimes

- Accountants have the concept of "Priority 1 systems" …
- … if it feeds into the Accounts, it's a Priority 1 system …
- … if it feeds data into a Priority 1 system, then it must meet standards of a Priority 1 system

- It's not just that data flow between systems must be facilitated …
- … data flow will also need to be automated and controlled

Conclusion



Conclusion

- We have time …
- … about four years from final text to official implementation date

- There is a lot of work to do …
- … experience so far is that everything takes longer than expected

- Make sure you leverage everything you've got …
- … systems, models, assumption setting, governance, process management

- **Own it!**

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