Love it or loathe it, IFRS 17 is on its way

Understanding the new reporting standard for insurance contracts

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Agenda

- Overview of standard
- Calibration and ALM implications
- Product development and reinsurance
- Q&A
# Overview of measurement

<table>
<thead>
<tr>
<th>Measurement model</th>
<th>Criteria</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building Block Approach (BBA)</td>
<td>• Cash flows are independent of underlying investment strategy</td>
<td>• Conventional non-profit annuities</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Protection business</td>
</tr>
<tr>
<td>Variable Fee Approach (VFA)</td>
<td>• Clear pool of underlying items</td>
<td>• Conventional and unitised with-profit contracts</td>
</tr>
<tr>
<td></td>
<td>• Substantial portion of cash flows vary with underlying items</td>
<td>• Unit-linked contracts</td>
</tr>
<tr>
<td></td>
<td>• Policyholders receive a substantial share of the returns</td>
<td></td>
</tr>
<tr>
<td>Premium Allocation Approach (PAA)</td>
<td>• Short duration</td>
<td>• Reinsurance contracts held</td>
</tr>
<tr>
<td></td>
<td>• No embedded options / guarantees</td>
<td>• General insurance contracts</td>
</tr>
<tr>
<td></td>
<td>• Measurement is a good approximation to the BBA</td>
<td>• Group protection contracts</td>
</tr>
</tbody>
</table>
Liability components

1. Future cash flows
   - Claims, benefits, premiums and expenses estimated using up-to-date information
   - VFA: projected assets less charges plus cost of guarantees

2. Discounting
   - Market consistent interest rate
   - Top down or bottom up approach
   - Assets need not be held

3. Risk adjustment
   - An assessment of the future uncertainty of amount of future cash flows
   - Similarities to the Solvency II risk margin

4. Contractual Service Margin
   - Represents the unearned profit of an insurance contract
   - A liability held on the balance sheet
## Comparison of the CSM

### Contractual Service Margin

<table>
<thead>
<tr>
<th>Assumption</th>
<th>Building Block Approach</th>
<th>Variable Fee Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Changes in past claims / claims incurred</td>
<td>CSM <strong>not</strong> recalculated. Impact flows through to P&amp;L</td>
<td></td>
</tr>
<tr>
<td>Changes in non-financial assumptions impacting future cash flows</td>
<td>CSM recalculated to reflect the impact on the change in profit</td>
<td></td>
</tr>
<tr>
<td>Changes in financial assumptions, such as interest rates</td>
<td>CSM <strong>not</strong> recalculated. Impact feeds through to P&amp;L or OCI</td>
<td>CSM recalculated as interest rate changes affect the cash flow projection</td>
</tr>
</tbody>
</table>
### Initial measurement - Example

Discount rate: 5%

Risk adjustment measured using the cost of capital method

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Best estimate CFs</td>
<td>1,000</td>
<td>800</td>
<td>400</td>
<td>100</td>
</tr>
<tr>
<td>CoC</td>
<td>100</td>
<td>70</td>
<td>30</td>
<td>10</td>
</tr>
</tbody>
</table>

**BEL:** £2,106  
**Risk Adjustment:** £193  
**Acquisition costs:** £100  
**Total:** £2,399  
**Premium:** (£2,600)  
**CSM:** £201
## Subsequent measurement - Example

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>PV at t=1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Best estimate CF</td>
<td>1,000</td>
<td>800</td>
<td>400</td>
<td>100</td>
<td>1,211</td>
</tr>
<tr>
<td>Updated BE CFs</td>
<td>1,000</td>
<td>850</td>
<td>450</td>
<td>150</td>
<td>1,347</td>
</tr>
</tbody>
</table>

### CSM at t=0

<p>| | |</p>
<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>CSM at t=0</td>
<td>£201</td>
</tr>
</tbody>
</table>

### CSM at end of t=1:

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<tr>
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<th></th>
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</thead>
<tbody>
<tr>
<td>CSM at end of t=1</td>
<td>£75 - £19 = £56</td>
</tr>
</tbody>
</table>

### PV at t=1

<p>| | |</p>
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<thead>
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<th></th>
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</thead>
<tbody>
<tr>
<td>PV at t=1</td>
<td>£1,211</td>
</tr>
</tbody>
</table>

### Impact of assumption changes:

\[
(\text{Value of CSM before allocating to period}) - \text{Value of CSM before adjusting for interest} = \£136
\]

### Value of CSM before allocating to period:

\[
\£201 + 10 - 136 = \£75
\]

### Allocation of CSM to current period:

\[
\frac{\£75}{4} = \£19
\]

### Interest added

\[
\£10 = \£201 \times 5\%
\]
Transition

• Need to create an IFRS17 balance sheet for business already on the books
• Items relating to the current standard will disappear (e.g. DAC)
• CSM will have regard to conditions at inception
• If full retrospective approach unpractical:
  – “Modified retrospective approach”
  – “Fair value approach”
ALM considerations

Diagrams are not to scale
Economics of products is not changing

Aggregation of contracts will drive profit signatures
- Greater transparency of loss-making contracts may lead to pressure on pricing teams

Gender-neutral pricing

Reinsurance contracts reported as separate portfolios
Other considerations

- Making judgements in areas of discretion
- Optimising impacts at transition
- Developing new systems and processes
- Educating and training stakeholders
- Aligning remuneration packages
Questions
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Thank you