

IFRS 4 Phase II and Solvency II

Bridging the gap

Executive summary

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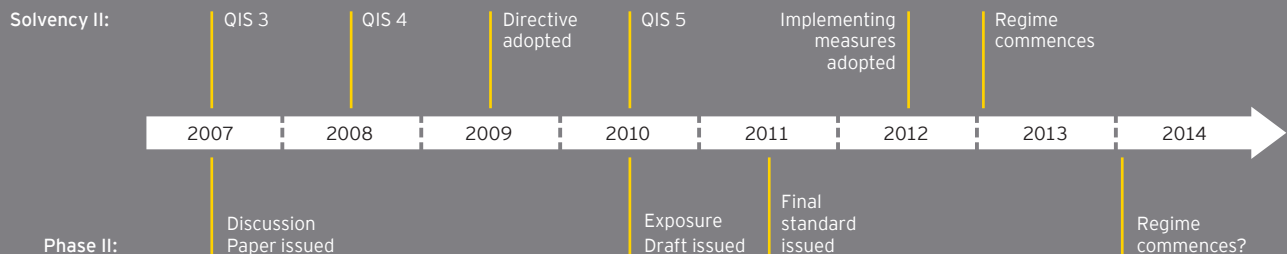
30 July 2010 was an important milestone for the IASB, with the release of the much anticipated Exposure Draft (ED). This is the most current view of the IASB's objective to provide a single global comprehensive accounting standard for insurance contracts. Following the IASB's standard framework, the ED also provides guidance on the recognition, measurement, presentation and disclosure for those contracts that contain 'significant' insurance risk.

The accounting changes set forth in the ED will fundamentally change the presentation and measurement of insurance contracts. The impact on business processes and systems will be significant, requiring careful consideration and comprehensive implementation programmes to implement Phase II alongside Solvency II, IFRS 9 and, in many instances, other current finance transformation and change programmes.

Whilst the implementation date for the new IFRS for insurance contracts is not definitive, ED and Solvency II implementation projects are expected to run concurrently. A 1 January 2014 implementation date for IFRS will require an opening balance sheet as of 31 December 2012 and comparative income statement development for reporting periods in 2013. Additionally, some regulators may require two years of comparative balance sheets. Insurers need to initiate their programmes now, as they work back from adoption in 2014 and opening comparatives in 2012 or earlier, depending on the regulator.

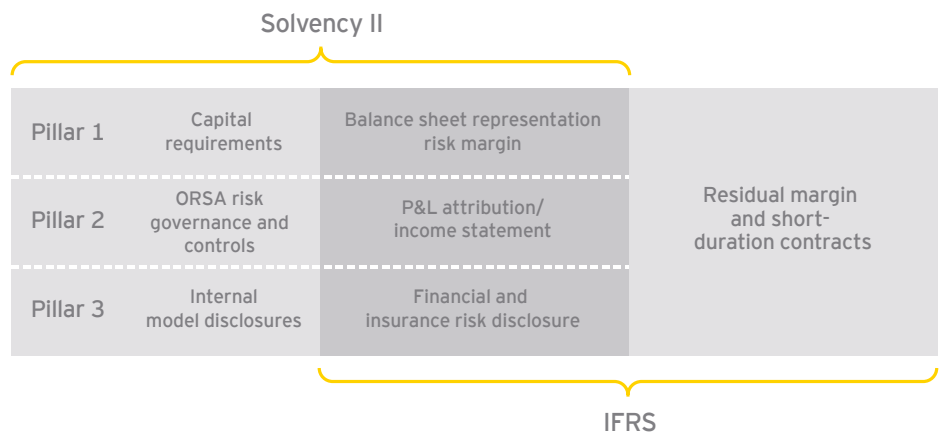
Many insurers are currently investing significantly in upgrading systems and processes to implement Solvency II, so there is a greater sense of urgency to understand and address IFRS 4 (Phase II). There are considerable similarities between the requirements for Phase II and Solvency II, creating potential implementation synergies. However, in addition to significant differences in the detail, Phase II introduces a number of requirements which go beyond the scope of Solvency II. Insurers need to take a more strategic view of the impact of these changes and build in flexibility at this stage to reduce investment in future years.

In this paper, we explore the similarities and differences between the two frameworks, where changes may be required for Solvency II projects and where synergies can be achieved by combining the two implementation programmes.



Key business process and system implications

Measurement and disclosure requirements of the Phase II and Solvency II frameworks



The IASB's standard objectives are to ensure high-quality, understandable, enforceable and globally accepted principles which will improve transparency and comparability of insurers' financial statements regardless of sector, geography or products. Solvency II's goal is to establish a single common regulatory framework to maintain capital adequacy and risk management standards for those who underwrite insurance contracts within the European Economic Area. The aim under IFRS and Solvency II is to facilitate comparability and transparency from a regulatory and accounting perspective to external stakeholders, in contrast to the current divergent practices and measures which characterise insurance reporting.

Whilst there is no requirement for consistency between regulatory and financial reporting, there are significant overlaps in both the measurement and disclosure requirements between the Phase II and Solvency II frameworks.

Performance measurement

The presentation of internal and external key performance indicators will need to change to clearly communicate the levers available to manage and control business performance. Many aspects of the Phase II approach to measuring performance (including the margin-based earnings presentation and the treatment of variances between actual and expected experience on the in force book) will be familiar to insurers already using embedded value approaches.

The primary focus for Solvency II is capital adequacy rather than profitability management. Given the similarities in the measures, companies will need to improve their understanding of the differences between IFRS and Solvency II in order to effectively manage the business. Finance can help the business negotiate this challenge by presenting a clear reconciliation, with explanations of major differences, between the

Phase II summarised margins approach and the Solvency II profit and loss attribution.

Business planning and forecasting models will need to be brought into line with the new external reporting basis. Models for evaluating potential investments and acquisitions will require updating, and the earnings based component of executive incentive compensation schemes may need to be aligned with Phase II.

Informing and educating external stakeholders, including the analyst community, will be a major challenge during the transition. For example, the requirement to adjust in force future profits through retained earnings at transition will clearly impact an insurer's subsequent performance under IFRS. Clear and transparent communications that help stakeholders navigate their way through the changes to regulatory and statutory reporting will create confidence and help manage any potential adverse impacts on share prices and ratings.

Reporting and disclosure

Considerable effort will be required to ensure that the new primary statements and disclosures can be readily populated from financial systems. The proposed margin-based income statement presentation is a significant departure from the traditional revenue account presentation and the

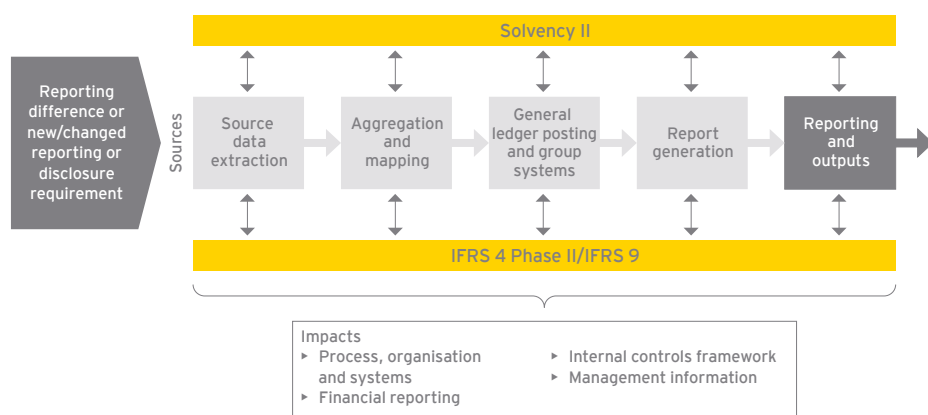
ED provides considerable information about the disclosures that will be required. The detailed Solvency II disclosure requirements have yet to be published, but some overlap is expected.

The profit and loss attribution requirements under Solvency II are similar to the 'margin analysis' -based income statement presentation. Producing the income statement under IFRS within financial reporting timeframes will create additional pressure to fully understand and analyse the results.

Complications may arise through different presentation models for short-duration contracts under the modified pre-claims liability model. There are requirements to unbundle certain elements of the insurance liability and also to show a 'traditional' view, with premiums and claims, of the movement in the best estimate liability, risk margin and residual margin. This will lead to a mixed presentation model under IFRS that requires multiple data feeds.

The use of deposit and non-deposit accounting in the single statement of comprehensive income may be confusing to analysts and investors. Automated analysis of change models, combined with bridging analysis between the different bases, will be needed to calculate, understand and explain the results to users.

Identifying the operational impact: IFRS and Solvency II similarities and differences



The ED financial and insurance risk disclosures are a carry-over from the disclosures currently produced for IFRS 4 Phase I (e.g., sensitivity, risk concentration and claims development) and IFRS 7. Similar disclosures are also required for the Pillar III Statement of Financial Condition Report.

Unique disclosures required under Phase II include the confidence intervals used for the calculation of risk margin and reconciliations of contract balances for insurance liabilities. These provide a detailed analysis of changes and methods, as well as inputs used to develop the measurements to estimate the liability. Unique disclosures will also be required under Solvency II and are expected to be extensive.

Systems and data

For insurance groups, the content and structure of data captured from business units to support group statutory and regulatory reporting will change significantly. This will require major changes to group financial consolidation and reporting systems. In addition, changes to the primary financial statements and disclosures will impact the general ledger and chart of accounts at both the group and business unit level.

Insurers will also need to define solutions to support parallel reporting of Phase I and Phase II results during the transitional period and provide Solvency II, local GAAP and local regulatory reporting on an ongoing basis as required. This will necessitate an assessment of the capability of corporate and business unit general ledgers to support multiple GAAP conversions.

The data requirements for Phase II are similar to Solvency II and address many of the potential data gaps in Phase I (e.g., data to model future premiums, participation benefits, options and guarantees). Solvency II also requires insurers to invest in data quality, control and management; however, there are differences in the detail, e.g., regarding the definition of a portfolio, contract boundaries and unbundling. A key challenge will be to ensure that these different types of data

are available and that systems have the flexibility to accommodate differences in the inputs to cash flows between Solvency II and Phase II.

General ledger cost hierarchies and account postings may need to be changed to separate those costs which are incremental at a contract or portfolio level. Cost allocation systems will need to be updated to provide incremental acquisition costs at a portfolio level and to separately identify the overhead element of ongoing maintenance costs.

Insurers issuing short-duration contracts will need to design systems to track the amortisation of the modified pre-claims liability and accrue interest on the balance.

People

Educating finance staff and management on the key changes from Phase I and the similarities between Phase II and Solvency II will require a major investment in training. With the release of the ED, initial awareness sessions should begin immediately.

Experience from Phase I and other GAAP conversions demonstrates the need for formal governance structures and strong project management, particularly since introducing the new Phase II standard must take place alongside Solvency II and IFRS 9. Implementing change has become a core competency for finance functions. Therefore, experienced finance change managers with knowledge of insurance reporting and Phase I or Solvency II conversions will be at a premium.

In addition, resource management will be critical. There will be a significant draw on many of the same core resources to input into developing IFRS and Solvency II requirements, whilst balancing ongoing demands of business as usual processes and potentially other in-flight projects. The importance of retaining and effectively leveraging knowledgeable and valuable resources should not be underestimated.

Governance, policies and procedures

Significant work will be required to revise and update policies and promulgate guidance for implementation. This will include policies for setting discount rates and risk margins and any deviations from Solvency II. Accounting policies and manuals must be updated to reflect the new standard. For example, under Phase I, each entity within an insurance group retained its local GAAP for measuring insurance liabilities; however, under Phase II, policies will be standardised across international insurance groups.

The processes developed to report under the new insurance accounting standard will need to be auditable. Pillar II governance and control frameworks have raised the benchmark in terms of governance and quality of documentation (e.g., policies, assumptions, data sources and calculation methods) required to facilitate a smooth audit sign off.

Managing volatility

The move to a market-consistent measurement basis for Solvency II is expected to lead to closer matching between assets and liabilities to reduce capital requirements. The introduction of Phase II is expected to increase the income statement volatility for those companies who are not matching assets and liabilities. Combining asset and liability management strategy for Solvency II with Phase II will provide an opportunity for an insurer to manage volatility both from a balance sheet and profit and loss perspective.

An insurer may elect to use the amortised cost basis under IFRS 9 for assets backing those components under Phase II which do not reflect changes in market assumptions (i.e., the residual margin). This needs to be measured against the cost and effort of having the same assets measured at fair value under Solvency II.

Uncertainty over the timing for adoption of the new IFRS standard for financial instruments will make IFRS 9 critical for all insurers to avoid a mixed accounting model which will complicate their implementation strategy. Clearly, the cost of implementation, as well as considering the impact on the results, would be managed more effectively if adoption dates are identical. However, assuming different dates, management should be assessing the impacts of adopting an IFRS 9 strategy that will align with the expected IFRS 4 implementation. Otherwise, a short-term investment classification solution may need to be implemented, resulting in additional work.

Key liability measurement issues

CEIOPS and the IASB have arrived at a similar approach to the measurement of insurance liabilities. At the heart of both models is the requirement to use current unbiased estimates for all future cash flows. This reflects the time value of money and the inclusion of a risk margin to deal with the uncertainty around those cash flow estimates - the three building block approach. These components are re-measured each reporting period to reflect changes in assumptions and estimates of the cash flows, as well as the uncertainty associated with those cash flows.

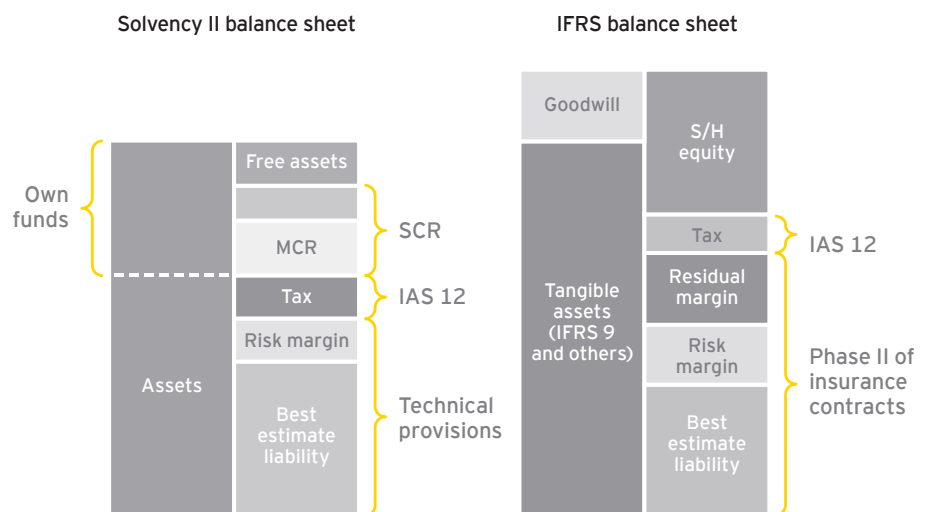
Differences in the level of expenses and the level at which diversification for the risk margin can be considered will lead insurers to build additional flexibility into their actuarial models to simultaneously calculate the differing measures. Additional systems, over and above those being developed for Solvency II, will be required to address:

- ▶ The inclusion of a residual margin to offset day one profits
- ▶ A modified reserve for short-duration contracts
- ▶ The requirement to unbundle certain elements of insurance liabilities
- ▶ Continuing differences in the measurement of investment contracts

The implications are that models may need to be enhanced to:

- ▶ Provide flexibility to accommodate changes between Solvency II and Phase II
- ▶ Ensure capacity to update assumptions more frequently
- ▶ Handle varying cash flows for different reporting bases

Companies will need to consider whether their current environment is sufficient in terms of flexibility, capacity, performance, data control and management to support Phase II alongside Solvency II.



Risk margin

Whilst IFRS permits three methods for the risk adjustment calculation, it is likely that insurance companies under Solvency II will adopt the Cost of Capital approach to better align the methodology between IFRS and Solvency II. Although this seems to bring consistency, key differences will exist at the level at which diversification benefits can be obtained for lines of business. Solvency II sets this at the legal entity level, whereas IFRS only allows diversification within a portfolio of contracts.

Phase II also requires the calculation of separate risk margins for reinsured business versus the net calculation permitted by Solvency II. Insurers need to make sure that their systems can accommodate all the new data requirements. They also need to explain to investor communities the differences in the level of risk margin between both frameworks.

Expenses

Solvency II's aim is to protect policyholders and fully reflect in the measurement of the liability all costs which the insurer is expected to incur. The objective of IFRS is to provide information on the performance of the company. Overhead expenses represent the cost of managing the business

and are expected to be covered by profits as they emerge. Phase II, therefore, requires only the costs related to managing the insurance contracts to be included within the liability measurement.

This treatment of expenses will impact actuarial models, expense management and identification, as well as future profitability. Separate cash flows will be required within the underlying actuarial models to concurrently identify and measure maintenance expenses and overheads. Appropriate systems will also be needed to identify the maintenance expenses within the general ledger to ensure these are not included in the income statement. Future overheads will be paid for through the release of the residual margin.

One area related to expenses that seems inconsistent and may lead to confusion from financial statement users is the transition provision for the residual margin. Companies will not compute a residual margin for existing business upon adoption, leading to the appearance of potentially significant future losses as overheads are charged to expense with no offsetting margin release.



Residual margin

The residual margin has been introduced by the IASB to defer and amortise profit at inception over the coverage period of the contract. The level of residual margin is directly impacted by the cash flows included within the three building block approach. Allowance is made for incremental acquisition expenses within the cash flows, thus reducing the level of the residual margin.

This measurement principle is unique to Phase II and requires the measurement at inception and subsequent tracking of changes to be recorded at the cohort level of contracts. As a result, a methodology is needed to allocate the risk margin to underlying cohorts of contracts and new systems must be developed to capture and amortise the residual margin.

As the residual margin is effectively measured on an amortised cost basis, insurers need to consider whether a matching portfolio of assets can be identified and measured at amortised cost to reduce accounting mismatch.

Short-duration contracts

Phase II mandates a premium allocation method for short duration contracts, which is similar but not identical to the unearned premium methodology currently used for non-life insurance liabilities. Whilst this represents a different measurement approach from the proposed building block methodology, it has the benefit of being similar to existing reporting for non-life contracts.

This methodology differs from that used for Solvency II for the same contracts. Insurers will need to modify existing systems to track the amortisation of the premium and ensure that systems developed for Solvency II for claims liabilities can separately identify those claims associated with earned and unearned premium, and also separately identify the pre- and post-claim cash flows. In addition, insurers will need to accrue interest on the liability over the coverage period.

The onerous contract test required by Phase II will also force the insurer to apply the three building block approach, reducing the operational benefit of the premium allocation method.

Unbundling and scope of insurance risk

IFRS measurement requirements are based on the characteristics of the contract, rather than the nature of the legal entity as under Solvency II. Contracts that do not transfer insurance risk will continue to be measured as financial instruments or service contracts under IFRS. The ED introduces mandatory unbundling requirements for components of the insurance contract which are not considered to be 'closely related' to the insurance coverage (i.e., account driven contracts, such as unit-linked contracts and embedded derivatives). This means that the presentation and measurement of all future management fees and charges expected to be earned over the life of the contract will be excluded from the measurement of the investment component.

Insurers will need to develop their underlying systems to facilitate a robust reporting process to track, measure and map the different components between Solvency II and Phase II balance sheets.

Discount rate and liquidity premium

Phase II and Solvency II require an insurer to explicitly take account of the time value of money by discounting at the risk-free rate, whilst taking account of the liquidity premium. The latest Quantitative Impact Study (QIS 5) prescribes the discount rate and liquidity premium to be applied.

Whilst debate continues regarding whether the risk-free rate should reflect a swap rate adjusted for a credit spread as in QIS 5 or a government bond yield and how to calculate the level of liquidity premium, insurers will need to consider if the same rates or a different approach is required to measure the liabilities under Phase II.

Next steps and conclusion

Planning is essential to develop an understanding of the complexity and scale of change for a particular organisation and the critical path to implementing IFRS 4 Phase II. Based on experience from previous conversion exercises, the first step is to conduct a high-level impact assessment to identify the key accounting and disclosure changes, system and business impacts and scope the major areas of work required to implement the change. With many organisations at a critical stage of their Solvency II programmes, there is a small window of opportunity to understand the potential synergies with Phase II and adapt existing programmes to manage the change in the most cost-effective manner.

First steps should include awareness training on ED content that addresses the potential impact on targeted audiences: audit committee, CFO, chief actuary or other senior finance and actuarial management, followed by developing an initial view on accounting impacts and differences, impacts on processes and IT (aligned to Solvency II impacts) and financial impact analysis, looking at the changes to the balance sheet and income statement due to the new standard.

As insurers begin implementing the IFRS Phase II and Solvency II programmes, there will be challenges in meeting the proposed timeframes. Recognising differences and similarities in key business processes and systems will require flexibility and change. Those companies that start now will realise benefits and a reduction in their investment in future years.

Glossary

Cohort – contracts within a portfolio with similar date of inception and similar coverage

Coverage period – the period during which the insurer provides coverage for insured events

Incremental acquisition expenses – the costs of selling, underwriting and initiating an insurance contract that would not have been incurred if the insurer had not issued that particular contract, but no other direct and indirect costs

MCR – minimum capital requirement

ORSA – Own risk and solvency assessment

Portfolio of contracts – insurance contracts that are subject to broadly similar risks and managed together as a single pool

SCR – solvency capital requirement

Short duration contract – a contract with a coverage period of approximately 12 months or less

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