ACTUARIAL SOCIETY OF SOUTH AFRICA

QUANTIFYING RISK, ENABLING OPPORTUNITY

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IFRS 4 Phase II Update & Discussion

Key Objectives

1. Provide a recap based on latest proposals
2. Summarise the main issues for short-term insurers
3. Consider the PAA relative to the BBA
4. Get your views/discuss your questions…

Why do we need a new standard?

- IFRS 4 Phase I is an interim standard
- Lack of transparency in reporting
- Comparability is an issue?
    - *Margins for prudence*
    - *Allowance for expenses*
    - *Discounting & inflation*

Phase II focuses on enhancing the comparability of financial reporting for insurance contracts between different insurance entities, jurisdictions, etc.

Proposed measurement model

	Current IFRS/GAAP	BBA throughout	PAA	PAA and undiscounted incurred claims
Unexpired risk	UPR less DAC	Contractual Service Margin Risk adjustment Discounting Best estimate of fulfilment cash flows	Premium (less acquisition costs) unearned	Premium (less acquisition costs) unearned
Expired risk	Undiscounted reserves for past claims (including IBNR)	Risk adjustment Discounting Best estimate of fulfilment cash flows	Risk adjustment Discounting Best estimate of fulfilment cash flows	Risk adjustment Best estimate of fulfilment cash flows

Is it the same as SAM?

Similarities

- Mean cashflows
- Inflate & Discount
- Add a margin for risk

Differences

- No day 1 profit
- Objective of the risk adjustment
- Contract Boundary

Technical Provisions

Main issues for short-term insurers

Contract Boundary for SAM vs. Phase II

Latest Phase II proposals define boundary as being the point where*:*

*"has right or practical ability to reassess risk of particular policyholder and can re-price; **OR** where both of the following are satisfied:*

- *Entity has right **OR** practical ability to reassess risk of portfolio of insurance contracts and can re-price.*
- *Pricing of premiums up to reassessment of risks does not take into account future risks."*

Unit of Account: Significant impact on data & modelling requirements

- Objective of standard is to measure at individual contract level but can aggregate if objectives are met
- On initial recognition, onerous contracts should not be aggregated with profit making contracts
- Portfolio definition no longer refers to contracts that are priced similarly relative to the risk taken on
- The determination of portfolios will be a significant area of judgement and debate

Main issues for short-term insurers

Calculation of Risk Adjustment

- Risk adjustment objective is:

  'the compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contracts.'

- Disclosure of confidence level required….
- No limitation on techniques or prescribed level of diversification.
- SAM risk margin adopts a prescribed cost of capital method. If a cost of capital method is adopted for IFRS then there is the potential for a different calibration to SAM.

Cost of capital	Confidence level	Conditional tail expectation
Cost of setting up the economic capital required for the lifetime of the portfolio. **No prescribed capital or percentage cost.**	Value at risk; used to measure the expected loss on the portfolio at the specified confidence level over specified time horizon. **Disclosure may lead insurers to 'target' a certain level?**	Tail value at risk; used to measure the expected loss on the portfolio as an average of outcomes occurring above the specified confidence level over the specified time horizon. **Appropriate for long-tailed/volatile lines of business?**

PAA vs. BBA?

Requirements for using PAA

Paragraph 35 of the exposure draft states:

"An entity may ….using the premium-allocation approach set out in paragraph 38-40 if:

> *a) doing so would produce a measurement that is a **reasonable approximation** to those that would be produced when applying the requirements in paragraphs 18-32 (i.e. the BBA)*
>
> *b) the coverage period of the insurance contract at initial recognition (including coverage arising from all premiums within the contract boundary determined in accordance with paragraphs 23-24) is one year or less."*

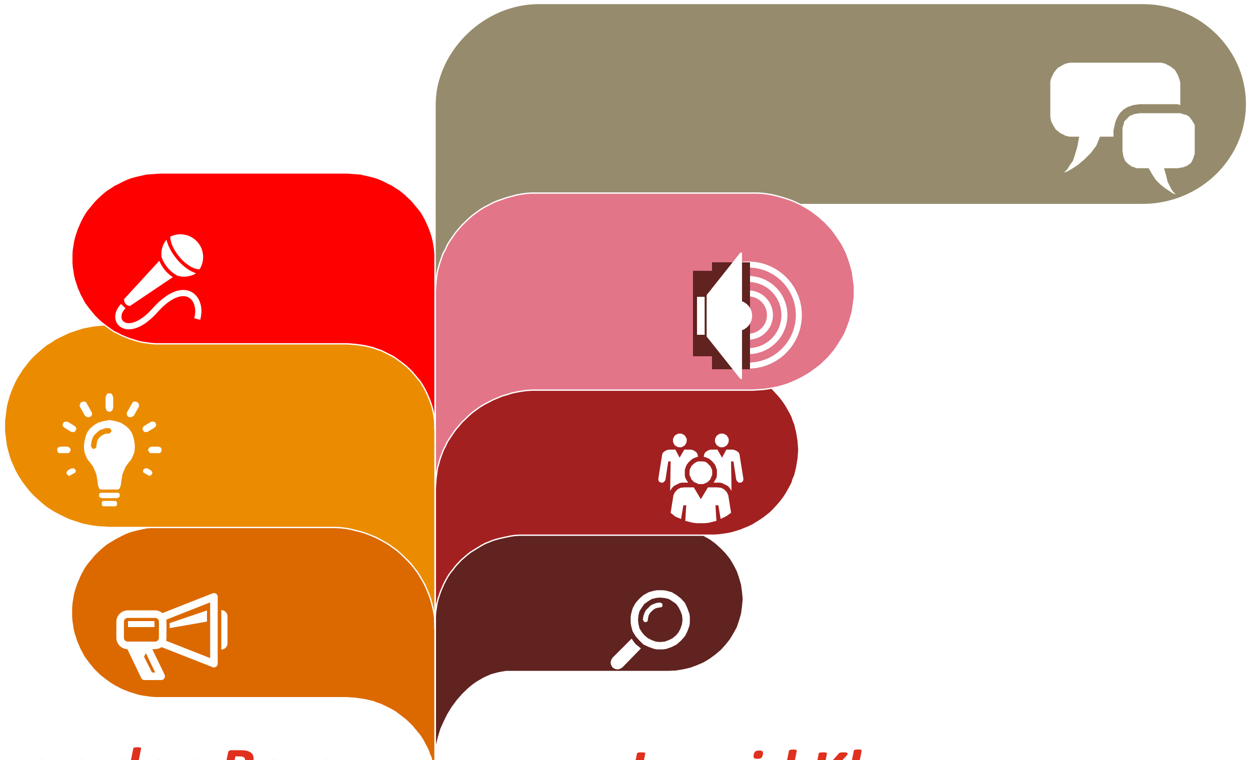
Paragraph 37 further explains:

"The application of the premium-allocation approach in paragraphs 38–40 ***cannot produce a reasonable approximation*** *to the measurements that result from the requirements in paragraphs 18–32 if, at contract inception,* ***the entity expects significant variability, during the period before a claim is incurred****, in the fulfilment cash flows that are required to fulfil the contract.*

PAA vs. BBA for longer duration contracts...

1. **Claims Experience**
2. **Discount Rates**
3. **Claims + Discount Rate**
4. **Revenue Recognition**
5. **Release Pattern**

Any other thoughts?



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