IFRS17 for practitioners – panel discussion on current hot topics

Tracey Lister, Jaco Louw, Christiaan Nel, Jac Niemand

12 May 2021

CONTENTS

Agenda
IFRS17 vs SAM
Transition
Treatment of Inflation assumptions
Investment contracts with switching option

CONTENTS

Agenda
IFRS17 vs SAM
Transition
Treatment of Inflation assumptions
Investment contracts with switching option

IFRS 17 Versus SAM

- Insurers in South Africa often want to use the SAM technical provisions for their IFRS 17 liabilities (and reinsurance assets)
- The two approaches do however differ from each other in material ways - or sometimes in the way the insurer chose to apply SAM
- **DISCUSSION: Key aspects of variation for long-term products** that insurers have been confronted with in terms of:
    - Contract boundary,
    - Cash flows,
    - Discount rates,
    - Risk Adjustment for Non-Financial Risk versus Risk Margin

IFRS 17 Versus SAM

- *CONTRACT BOUNDARY*
    - *How is the inclusion of the portfolio level contract boundary affecting insurers?*
    - *Grouped individual products: when are premium rates truly reviewable?*
    - *When do you include the cancellation notice and when not?*
- *CASH FLOWS*
    - *How are insurers dealing with the inclusion of policy loans, debtors and creditor balances?*
    - *Different expenses – directly attributable including overheads, different treatment of investment expenses*
    - *Allowance for taxes paid in fiduciary capacity*
    - *Probability weighted mean of all possible scenarios?*

IFRS 17 Versus SAM

- *DISCOUNT RATES*
  - *Can you use the Prudential Authority's discount rates?*
  - *SAM has an illiquidity premium adjustment. Can't we use this?*
- *RISK ADJUSTMENT FOR NON-FINANCIAL RISK versus SAM RISK MARGIN*

RISK ADJUSTMENT	RISK MARGIN
Ultimate horizon over full contract boundary ?	One year horizon
CSM is held and released over time	Lapse SCR impacted by release of profit up front
Only non-financial risk	Includes non-hedgeable risks
Only specific operational risk	Full operational risk
Insurer specific compensation and risk assessment	Prescribed capital level and compensation
Insurer specific diversification allowance	Prescribed diversification allowance

CONTENTS

Agenda
IFRS17 vs SAM
Transition
Treatment of Inflation assumptions
Investment contracts with switching option

IFRS17 Transition – Impracticability

- IAS 8 requires an entity to apply a change in the accounting policy retrospectively unless it is impracticable to determine the effects of the change
- Para 5 of IAS 8 states that applying a requirement is impracticable when 'the entity cannot apply it after making every reasonable effort to do so..'
- So what are the challenges that we are seeing?
  - How to justify the cost versus the benefits argument?
  - You have historical data but it is incompatible with current systems
  - Applying the risk adjustment concept historically
  - Granularity of historical assumptions, particularly expenses

IFRS17 Transition – Full Retrospective Approach

Audience question:

The full retrospective approach is a very operational intensive exercise. Which one of these challenges mostly like originates with your program?

IFRS17 Transition – Fair Value

- The fair value approach is driven by the requirements of IFRS13. That has brought a lot of challenges, in particular around:
  - The calculation approach
  - Lack of information to adopt in the calibration of the parameters
  - Auditability

CONTENTS

Agenda
IFRS17 vs SAM
Transition
Treatment of Inflation assumptions
Investment contracts with switching option

Is inflation a financial risk?

Audience question:

Should inflation be seen as a financial risk?

Is inflation a financial risk?

Audience question:

Should you distinguish between expense inflation and premium / claim inflation for purposes of the previous question?

Is inflation a financial risk?

B128: For the purposes of IFRS 17:

(a) assumptions about inflation based on an index of prices or rates or on prices of assets with inflation-linked returns are assumptions that relate to financial risk; and

(b) assumptions about inflation based on an entity's expectation of specific price changes are not assumptions that relate to financial risk;

Is inflation a financial risk?

Answer to S122 – April 2019 TRG

Paragraph B128 of IFRS 17 requires that for the purpose of IFRS 17:
(a) assumptions about inflation based on an index of prices or rates or on prices of assets with inflation-linked returns are assumptions that relate to financial risk; and
(b) assumptions about inflation based on an entity's expectation of specific price changes are not assumptions that relate to financial risk.

Therefore, <u>cash flows that an entity expects to increase with an index are considered to be an assumption that relates to financial risks, even if they are not contractually linked to a specified index</u>.

What are the practical implications?

B96 For insurance contracts without direct participation features, paragraph 44(c) requires an adjustment to the contractual service margin of a group of insurance contracts for changes in fulfilment cash flows that relate to future service. These changes comprise:

(a) experience adjustments arising from premiums received in the period that relate to future service, and related cash flows such as insurance acquisition cash flows and premium-based taxes, measured at the discount rates specified in paragraph B72(c)

What are the practical implications?

B97 An entity shall not adjust the contractual service margin for a group of insurance contracts without direct participation features for the following changes in fulfilment cash flows because they do not relate to future service:

(a) the effect of the time value of money and changes in the time value of money and the effect of financial risk and changes in financial risk.

What are the practical implications?

Audience question:

For policies with inflation-linked cash flows, such as index-linked annuities, should changes in future cash flows that adjust the contractual service margin (CSM), such as a change in longevity, be measured using a locked-in or current inflation rate?

What if we end up with the narrow interpretation?

- Greatly increase the complexity of the calculation.
- Would require tracking of some form of “shadow benefit” from inception for each group of contracts.
- How do we treat historical premium changes not due to inflation?
- For participating contracts with significant financial options and guarantees that are depending on non-financial variables, this will require locking-in stochastic scenarios.

What if we end up with the narrow interpretation?

- Greatly increase the complexity of the calculation.
- Would require tracking of some form of "shadow benefit" from inception for each group of contracts.
- How do we treat historical premium changes not due to inflation?
- For participating contracts with significant financial options and gu... his will require locking-in stochastic scenarios.

Whole different can of worms!

ACTUARIAL SOCIETY OF SOUTH AFRICA

Quantifying Risk, Enabling Opportunity.

CONTENTS

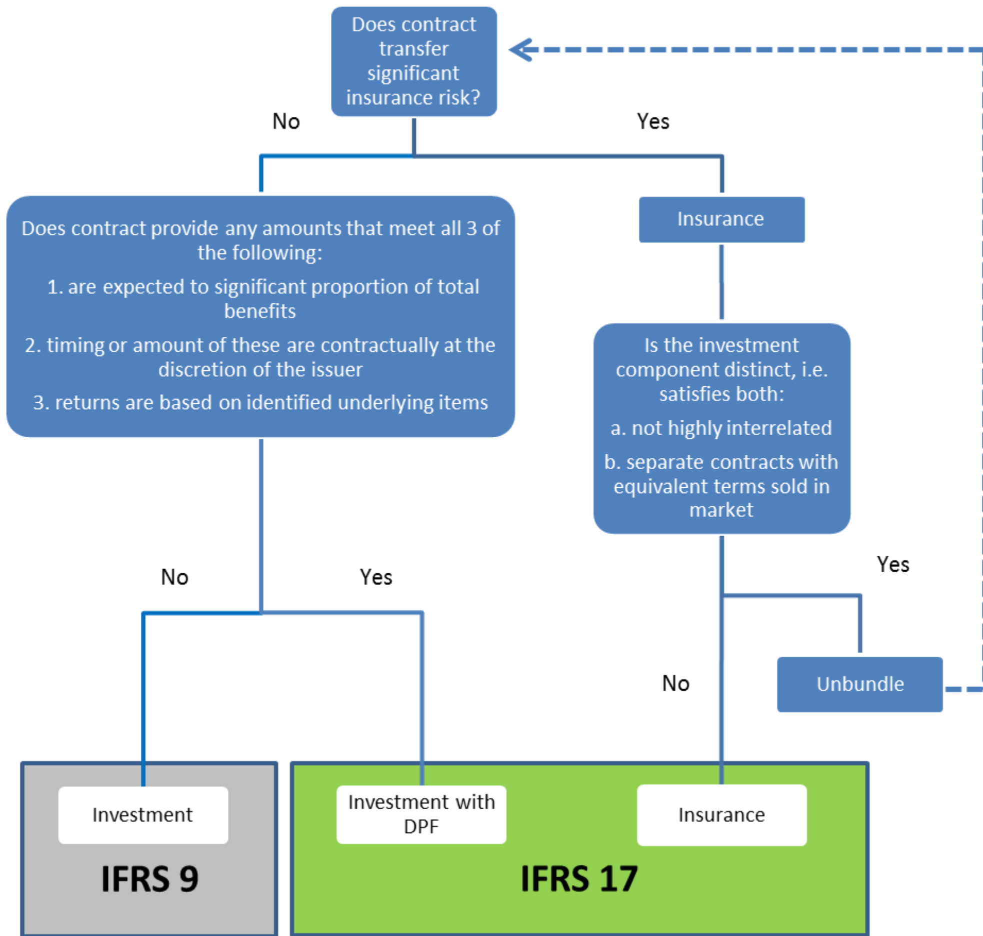
Agenda
IFRS17 vs SAM
Transition
Treatment of Inflation assumptions
Investment contracts with switching option

Investment contracts with switching options

- What is the problem?
- Fees less expenses?
- A closer look at discretion
- The path to IFRS9

What is the problem?

- Generation of products sold with investment options, including unitised with-profit funds
- Focus is on investment contracts : no insurance risk
- Cannot unbundle as per IFRS4 – so end up in IFRS17!
- Platforms built for investment administration – not IFRS17 analysis



Done once!

Investment contracts with switching options

Audience question:

Given absolutely free choice, how would you prefer to account for investment contracts with discretionary participation features? The answer should relate to a product that is top of mind for you.

a) IFRS9: Fees less expenses profile or
b) IFRS17: Revenue profile determined by risk adjustment and CSM release)

Does it matter?

Are we going from Cape Town to Bellville via Cairo?

A closer look at discretion

IFRS 17 Appendix A

investment contract with discretionary participation features

A financial instrument that provides a particular investor with the contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts:

(a) that are expected to be a significant portion of the total contractual benefits;

(b) the timing or amount of which are contractually at the discretion of the issuer; and

(c) that are contractually based on:

(i) the returns on a specified pool of contracts or a specified type of contract;

(ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or

(iii) the profit or loss of the entity or fund that issues the contract.

TAKE ACCOUNT OF POLICYHOLDER BEHAVIOUR

A closer look at discretion

R100 book value

R100 market value

MVAs can apply on exit, but "Good leavers" have this waived

A SUDDEN 10% DROP IN MARKET VALUE RESULTS IN AN MVA BEING APPLIED

A closer look at discretion

R100 book value

R90 market value

”Good leaver” gets 100c of R1

“Bad leaver” gets 90c of R1

To which did ”management action” apply?

A closer look at discretion

Audience question : How do we define the quantum benefits subject to discretion?

Option A: The difference between the asset share of a contract and the ultimate benefit paid on any contingent event.

Option B: The extent to which benefits can be reduced by “management actions.”

The path to IFRS9…can be twisty!

- Set threshold – informed by fund range
- Original percentage of contracts that are subject to significant discretion
- Fund values does not help that much
- CHECK VALUE OF SWITCHING
- Track how % of contracts move over time

The path to IFRS9…WHAT TO DO WHEN YOU GET THERE

- Measurement problems persist
- Fortunately limited discretion concepts fit quite well into IFRS9
- Investigate unit of account concept as well as measurement model.
- Alternative is to have the BSAs run into equity – P&L still behaves