54 - IFRS 17: Business impacts

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2019 Valuation Actuary Symposium

Session 54 - IFRS 17: Business Impacts

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Moderator and Presenters

Moderator / Presenters	Background
 **Hélène Baril** **FSA, FCIA** **Director** **Willis Towers Watson** Montreal, QC 418.930.3479 Helene.Baril@willistowerswatson.com	■ Hélène Baril has more than 25 years of experience in the insurance industry in Canada. She joined Willis Towers Watson in 2018 as a Director with the Insurance Consulting & Technology practice. Hélène advises insurers in a number of areas, including insurance contract liabilities valuation, external peer reviews of actuarial work, external and internal audit, risk and capital management, financial projections, and mergers and acquisitions. ■ Hélène IFRS 17 related experience includes implementation support for life and health insurers, including the development of implementation roadmaps, field testing on insurance products, training, conference and presentations to clients and industry on technical issues.
 **Andrew Erman** **FSA, MAAA** **Senior Director, ALM & Hedging** **Transamerica** Baltimore, MD 443.475.3066 Andrew.Erman@transamerica.com	■ Andrew has more than 25 years of experience in the insurance industry in the United States, across a variety of companies and roles. He joined Transamerica in 2016 to manage the ALM & hedging aspects of the general account portion of the annuities & retirement for Transamerica. ■ Andrew's IFRS 17 related experience includes leading the ALM & hedging aspects of the transition to IFRS 9 and 17 across all of Transamerica's product lines. As part of a broader leadership team, he helped strategize and coordinate Transamerica's accounting policies, OCI elections, risk mitigation strategies, systems readiness, documentation planning, procedures, and related items of IFRS 9 and 17.
 **Dan Kim** **FSA, CERA, MAAA** **Director** **Willis Towers Watson** Atlanta, GA 678 684 0617 Dan.Kim@willistowerswatson.com	■ Dan is a Director with the Insurance Consulting & Technology business of Willis Towers Watson in Atlanta, U.S. Dan has consulted life insurance companies in relation to financial reporting and risk management by implementing or reviewing embedded value (EEV, MCEV), pricing and economic capital models (Solvency II, ICS, Bermuda BSCR). Dan currently leads an Economic Scenario Generation initiative for the firm's Americas Life Practice. ■ Dan's IFRS 17 related experience includes trainings, developing and reviewing guidance notes/technical papers, and financial impact analysis.

Agenda

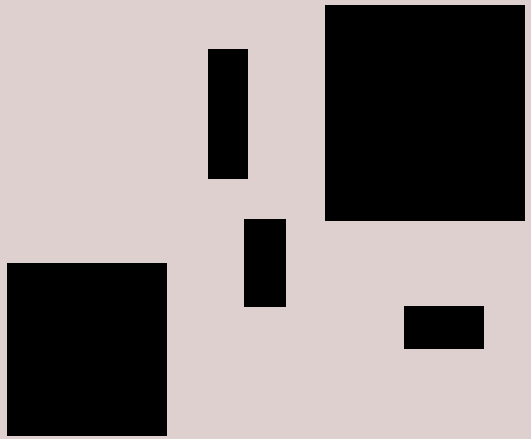
- Business Impacts of IFRS 17
  - Pervasive business impacts of change
  - IFRS 17 Implementation challenges
  - Will IFRS 17 affect your business decisions?
- Transition
  - The 3 Approaches
  - How the 3 approaches compare
  - Other Considerations
  - An approach to Fair Value
- Impacts on Financial Results
- Impacts on Valuation Process
  - Actuarial/Finance Transformation
  - Actuarial model processes must be industrialized
- Impacts on Investments, ALM, & Hedging
  - Key Impacts to Consider
  - Considerations That Overlap With Finance
  - Additional Considerations

Agenda (cont'd)

- Reinsurance Considerations
  - Impact on financial results
  - Reinsurance as a Risk Mitigation Strategy
  - Other issues related to reinsurance
- Impacts on Capital/Solvency and Risk Management
  - Potential Impact on Regulatory Capital
  - Canadian LICAT interaction with IFRS 17
  - U.S. perspectives
  - Impact on Risk Management
- Other Business Impacts
  - Impact of IFRS 17 on key insurer metrics
  - Product Strategy
  - Product Pricing
  - Tax implications
  - Impact on M&A
  - Engaging with investors
- Conclusion

Business Impacts of IFRS 17

Pervasive impacts and implementation challenges



Pervasive business impacts of change

For insurers implementing IFRS 17

Actuarial valuation change:

- Life products will no longer be measured under the current local GAAP method (for Canada, the Canadian Asset Liability Method)
- The change to the “Building Block Approach” will change the cash flows, discount rate and risk adjustments required to value actuarial liabilities

Accounting impact:

- The change in the valuation of actuarial liabilities will affect the income statement timing and magnitude for earnings
- The presentation of the income statement and required disclosures will undergo significant changes
- Accounting decisions will need to be made regarding the implementation of IFRS 9 based on the determinations made under IFRS 17

Capital Requirement:

- Changes to the valuation of products may impact capital level/ratio depending on the solvency regime

Tax perspectives:

- Policy choices under IFRS 17 will impact deferred taxes
- A changing income statement profile could impact tax planning strategies currently in place

Operational considerations:

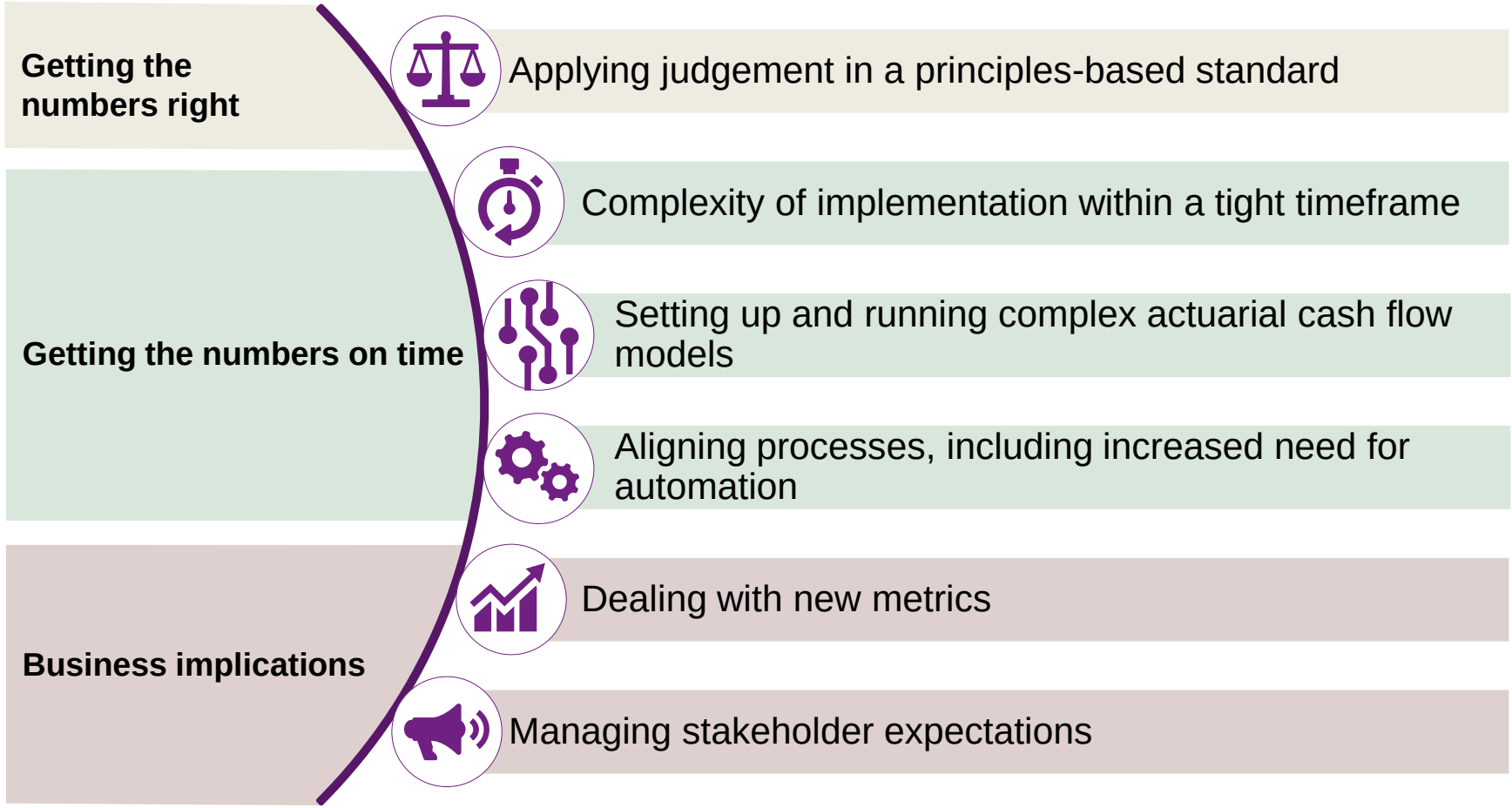
- Given the profit model revisions, pricing strategies and product development should be reconsidered
- People and resources should be assessed to determine if there is capacity to facilitate and adapt to changes required
- Key performance metrics and compensation will require evaluation

Systems implications:

- Transformation of existing system to reflect new policy data required in the actuarial calculations under the new methodology will be needed
- Updates to the existing valuation systems are required
- Integration of systems changes to ensure data flow from policy to general ledger will need to be carefully planned

IFRS 17 Implementation challenges

More than a compliance exercise



Will IFRS 17 affect your business decisions?

ALM

Reinsurance

Pricing

Dividends

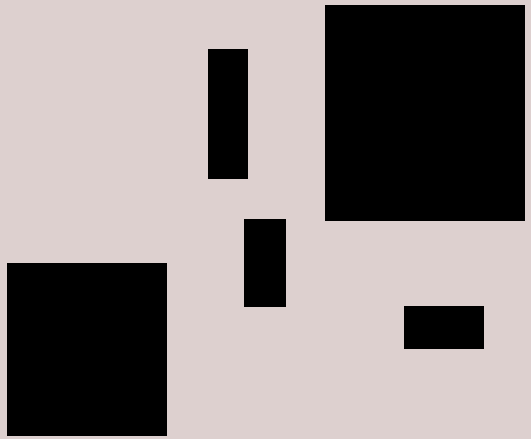
Executive compensation

M&A

Will your business model affect your IFRS 17 decisions?

Transition

Practically speaking



The 3 Approaches

At a glance

Full Retrospective Approach

- Required when historical data exists with no hindsight

Modified Retrospective Approach

- When full retrospective approach is not practicable
- Not all historical information is available, but reasonable and supportable information is available (info about historical cash flows is available or can be constructed)
- Simplification allowed
- But with no benefit of hindsight

OR Fair Value Approach

- Alternative
- Insurance liability “calibrated” to fair value

Transition – How the 3 approaches compare

Advantages and disadvantages

Each of the three methods has advantages and disadvantages:

- The Full Retrospective Approach provides the most granular level of information about current and future profitability of groups of contracts.
- The Modified Retrospective Approach provides details as close as possible to the Full Retrospective Approach, but with certain adjustments where certain information at inception of the contracts is not available or is impracticable to obtain. Certain key assumptions related to risk adjustment and discount rates, and resulting CSM are permitted to be estimated.
- The Fair Value Approach is the least granular method of the three. Historical information is generally not available, or if available, it is not reliable or not available without hindsight. This may be appropriate for older blocks of business. How to best determine the Fair Value remains an open question.

Future earnings emergence will be different between the three methods because of difference in resulting CSM, providing for varying capacity to absorb potential future losses, and difference in levels of granularity.

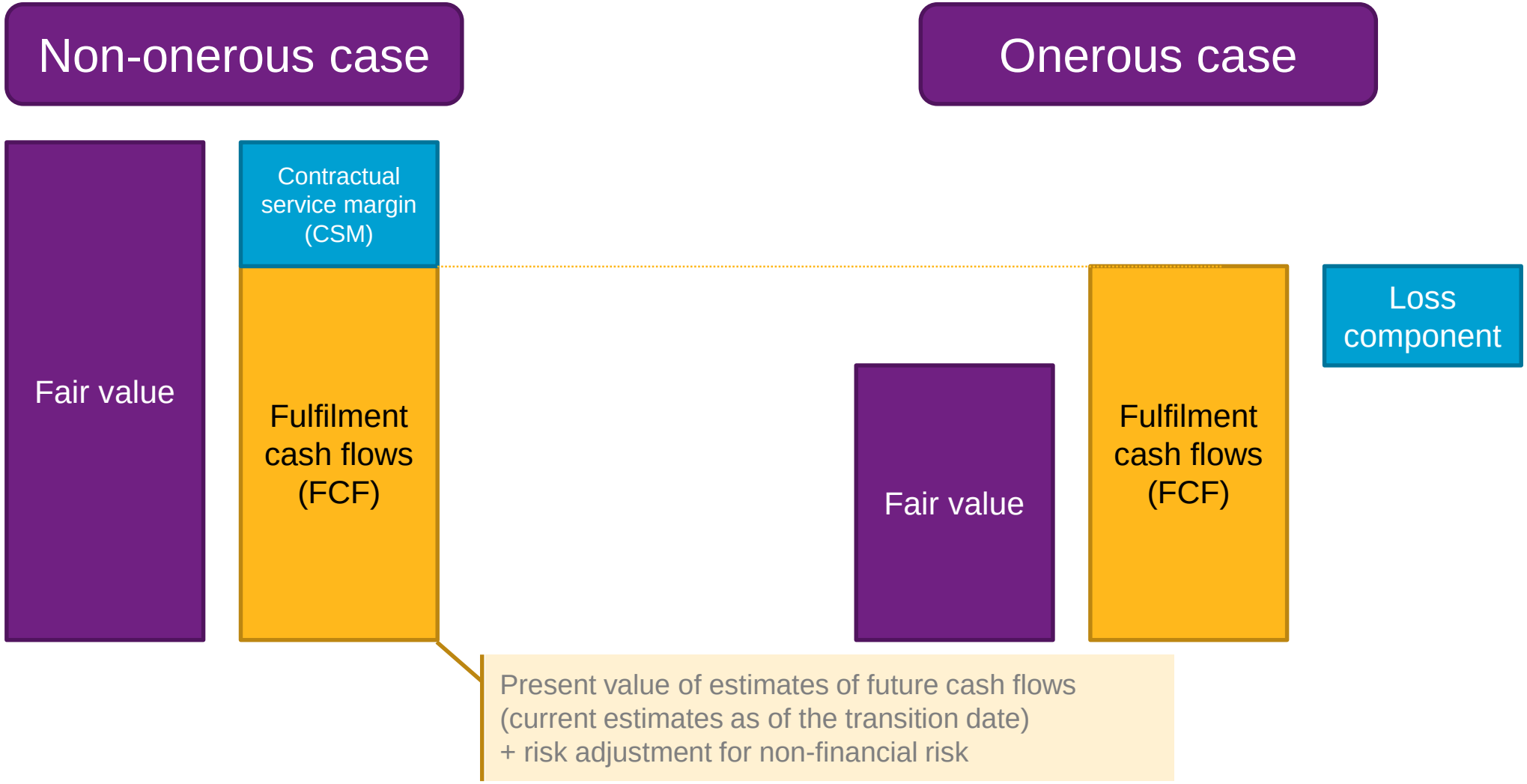
Transition – Other Considerations

From a business perspective

- Either of the two alternatives to the full retrospective approach are expected to reduce transition implementation costs, as they both will reduce the need to gather some of the detailed historical information for contracts issued many years prior.
- Insurers can use more than one approach to transition for different lines of business/products.
- However some believe that the application of either of the two alternatives will reduce comparability within and between insurance companies.
- Using alternatives to the full retrospective approach will create a disconnect between past and future performance data and may also result in a loss of the ability to track business performance at a granular level.
- As such, if the full retrospective approach is impracticable and a choice is available between the other two approaches (considering that the modified retrospective approach can only be used if the information can be gathered in the manner required):
  - An assessment of the implications of using one of the two alternatives at transition should be made, including the impact on current balance sheet and future earnings emergence, by determining if there will be a CSM at transition and what would be its level.
  - Management preference based on business strategy/business model would also need to be factored in.

Fair Value Approach

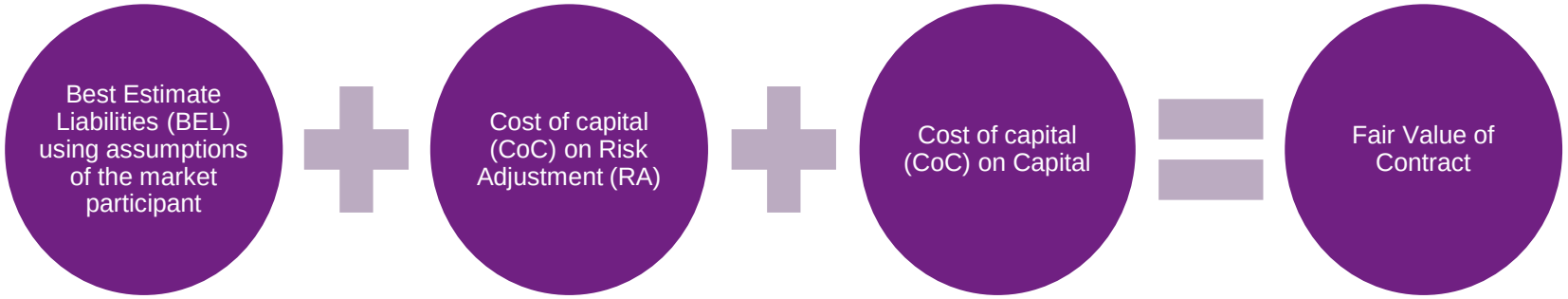
Development of contractual service margin (CSM) or loss component



An approach to Fair Value

Making use of Embedded Value

Illustrative

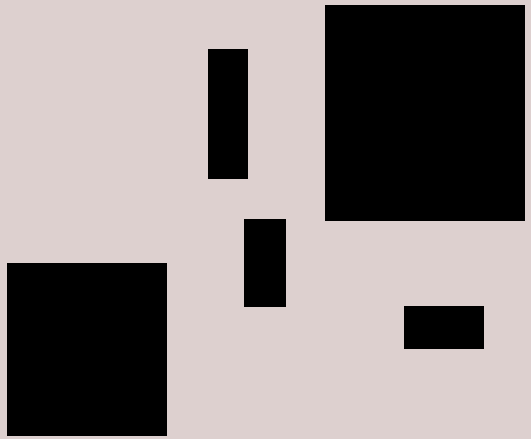


	Identical Assumptions between Fair Value and FCF	Fair Value exceeding FCF (e.g., higher claims for fair value)	Fair Value lower than FCF (market being more aggressive)
BEL	187.0	318.0	155.5
COC on RA	25.0	25.6	22.7
CoC on Capital	50.1	51.2	45.3
Fair Value of Contract	262.1	394.8	223.5
Fulfilment Cash Flows (FCF)	332.4	332.4	332.4
Loss Component	**70.3**	**-**	**108.9**
CSM	**-**	**62.4**	**-**

- Loss Component/CSM at transition depends on market assumptions relative to company assumptions (actuarial assumptions, hurdle rate, regulatory capital, taxation)
- Fair value could vary by jurisdiction
- Fair value could vary by its methodology
- Determining appropriate market assumptions could be challenging

Impacts on Financial Results

Case Study



Understanding the financials

To support financial management under IFRS 17

- How will profit emergence pattern differ under IFRS 17?
- How will any loss component be treated and how will it affect results?
- What could be the impact of different methodology choices to determine the Risk Adjustment?
- What will be the impacts of assumption changes and experience adjustments under IFRS 17?
- How will Embedded Value (EV) change under IFRS 17?
- Can contractual service margin at initial recognition inform value of new business (VNB)?

Impact Analysis: Loss Component, Risk Adjustment and Experience Variance

Case Study

- The following slides discuss analysis and considerations involving:
  - Treatment of the Loss Component
  - Methodology for Risk Adjustment
  - Impacts of shock lapse experience variance
- The analysis was based on a renewable Term 20 product:
  - Level premiums for 20 years; premium jumps for subsequent 20 year periods
  - Based on a 40 year-old male issued at the beginning of 2019
  - Initial Face Amount of $5 million
- Results are gross of any reinsurance
- Case study results and potential implications shared are applicable to the examples and circumstances only, and may vary depending on:
  - Economic environment
  - Underlying assumptions
  - The pattern of cash flows
  - IFRS 17 methodology

Treatment of Loss Component

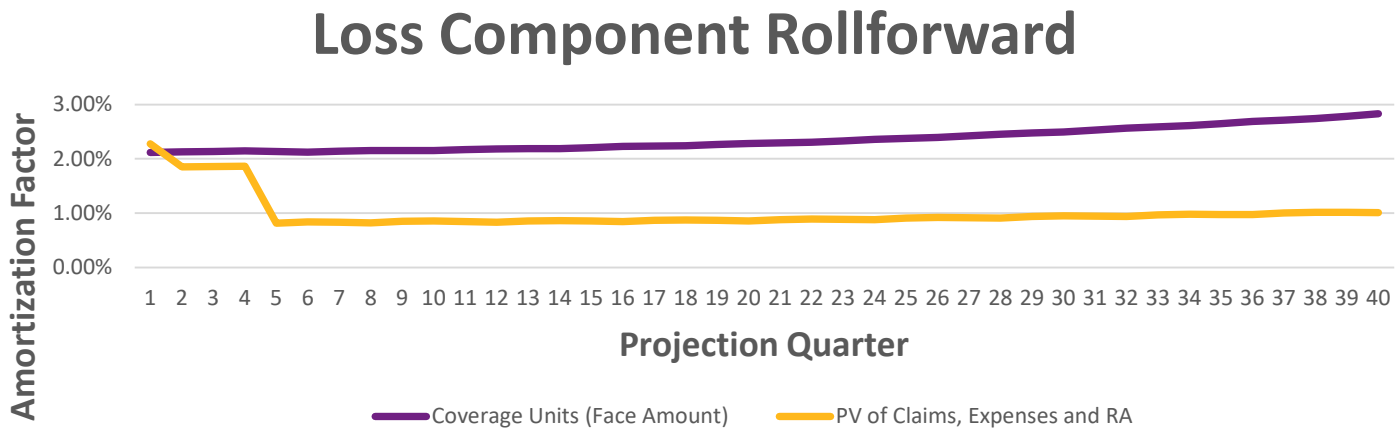
Overview

- Much discussion have taken place regarding CSM run-off
- Far less focus on the treatment of the loss component “roll forward”
- As per paragraph 50(a) of IFRS 17, the entity “shall allocate changes in fulfilment cash flows of the liability for remaining coverage specified in paragraph 51 on a systematic basis between:
  - The loss component of the liability for remaining coverage; and,
  - The liability for remaining coverage, excluding the loss component.”
- Objective is to reallocate deferred profits from revenue to recovery of past losses
  - No impact on overall earnings on best estimate basis
- There is no clear guidance on the approach to take to allocate changes in fulfilment cash flows on a systematic basis in order to run off the loss component:
  - This matters if a loss component reversal were to occur

Treatment of Loss Component

Case Study

- For an onerous Term 20 group, we tested two different loss component “roll forward” approaches, paired with a loss component reversal:
  - Coverage Units (face amount, discounted)
  - Run-off based on PV of claims, expenses and risk adjustment
- The above two approaches will result in very different loss component roll forward patterns:



- One of the key takeaway is that the loss component is sensitive to the roll forward/amortization approach similar to the CSM

Treatment of Loss Component

Case Study

- Given that a loss component exists, it may be desirable to retain it as long as possible in case of a reversal through an experience variance or assumption change resulting in a decrease in FCF.
- To illustrate this, we are applying a decrease in mortality of 10% at the end of year 6 to the onerous group.
- The following table shows how the two different approaches can affect insurance service results:

	Coverage Units (Face Amount, Discounted)	PV of Claims, Expenses and RA
Initial Loss Component	5,596	5,596
Loss Component - Start Year 6	3,828	5,005
Impact to FCF of Mortality Assumption Change	(6,972)	(6,972)
Loss Component Reversal into P&L*	3,853	5,038
CSM End of Year 6	3,119	1,934

*beginning period loss component with insurance financing expense applied

- Different treatments of the loss component may result in different financials.
  - In our case study, using the change in PV of claims, expenses and risk adjustment resulted in earlier P&L recovery in the future if a reversal takes place, relative to coverage units.
- However, some companies may want to remove loss component and build up CSM for less variable P&L
- Also the approach would have to be consistent for a portfolio/group of contracts whether onerous or not.

The Risk Adjustment

Overview

- Many challenges exist with determining the risk adjustment:
  - Methodology (e.g. cost of capital or margin approach)
  - Determination of diversification benefit
  - Establishment and calibration of confidence level
- Understanding of methodology choices:
  - Canada is familiar with the margin approach:
    - Under Canadian standards, a margin is applied to all assumptions based on the level of uncertainty in the assumption
    - Canadian standards of practice prescribe “recommended ranges” for margins
    - While not precisely the “cost for bearing uncertainty in non-financial risks”, the Canadian margins are a natural starting point for analysis
  - The CoC approach is well understood in Europe under SII as well as in many other jurisdictions such as U.S., Canada, Asia, and Bermuda, as it is used for other purposes besides IFRS.

The Risk Adjustment

Cost of Capital Approach

The risk adjustment under the cost of capital approach is defined as follows:

$$RA = \sum_{i}^{n} SCR(i-1) \times CoC/[1+r(i)]^{i}$$

Where:

- SCR (Solvency Capital Requirement) is the projected required capital at the beginning of period i
- CoC (Cost of Capital) is the required return on the SCR in excess of the risk-free rate
- r(i) is the discount rate at time i
- n is the number of periods until the liability is extinguished

The Risk Adjustment

Case Study

For the Term 20 product, we compared the margins based on the Canadian standards of practice to a cost of capital approach (using Canadian regulatory capital requirements), excluding diversification for comparability

- Cost of capital approach
  - For SCR, we used 100% of Canadian regulatory capital for insurance risk, excluding diversification
  - For CoC, we used 6% → would be company specific
- Margin approach
  - We tested mid and high margins of the recommended range for best estimate mortality and lapse
- Judgment required for determining discount rate under the CoC method → we used the IFRS 17 discount rate under both CoC and Margin approach for consistency and comparability

The Risk Adjustment

Comparison of Margin and Cost of Capital Approaches: Case Study

- At initial recognition, the following table compares the calculation of the initial risk adjustment using the cost of capital approach and the margin approach (under various calibrations) for this specific case study:

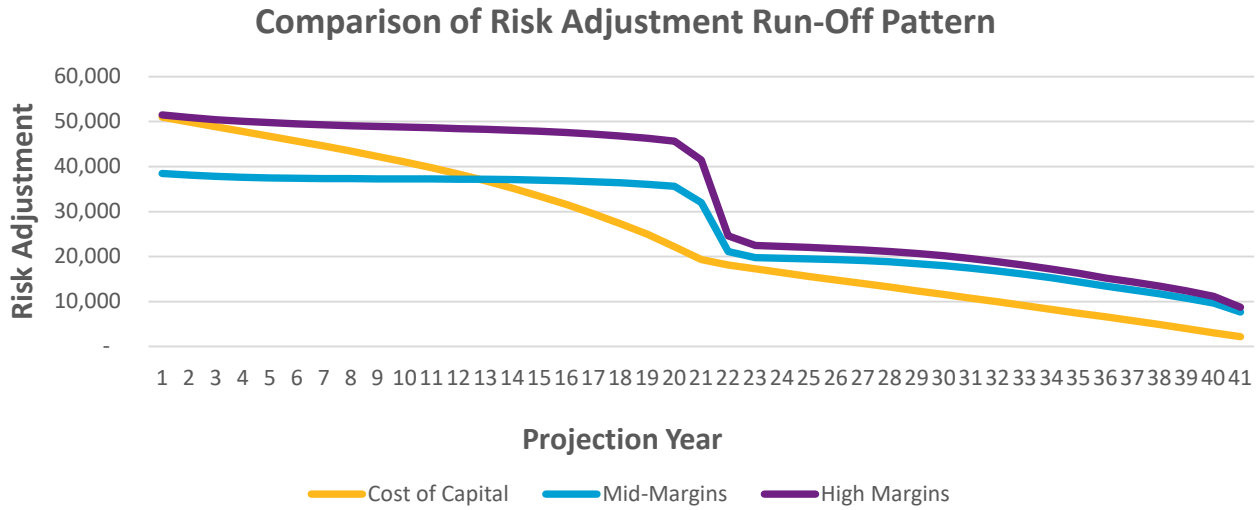
Mort Margin	Lapse Margin	RA - Margin Approach	RA - Cost of Capital Approach
9.375/ex	+/-12.5%	38,453	50,988
9.375/ex	+/-20%	43,503	
15/ex	+/-12.5%	46,884	
15/ex	+/-20%	51,506	

- Based on this case study, both approaches result in comparable levels of RA, albeit at the higher end of Canadian margin range
- Note that the confidence level under both the margin and CoC approaches have not been calibrated
- Results could vary depending on company circumstances, methodology and calibration choices
- Both approaches appear as good candidates for RA

The Risk Adjustment

Comparison of Margin and Cost of Capital Approaches: Case Study

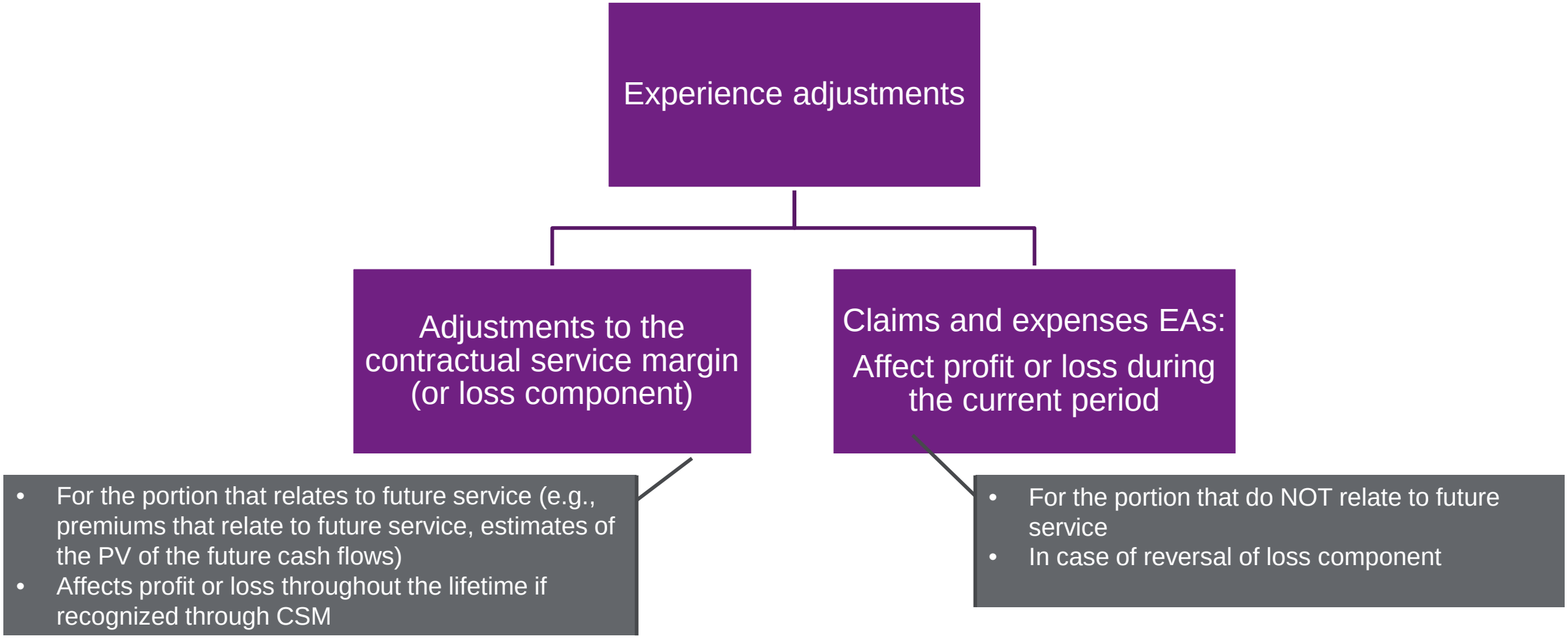
- While starting values could differ under the two methods depending on calibration, the run-off pattern should also be a consideration
- For our specific case study, the following compares run-off patterns of the mid-margin, high-margin and CoC approaches:



- In our case study, based on the assumptions we used, the CoC risk adjustment is released into profit more quickly than the margin method
- While the margin approach may be more attractive because of its simplicity (and particularly for Canadians due to familiarity), the run-off pattern of the risk adjustment may differ, so an impact analysis would be useful to make an educated decision.

Impact of experience adjustments

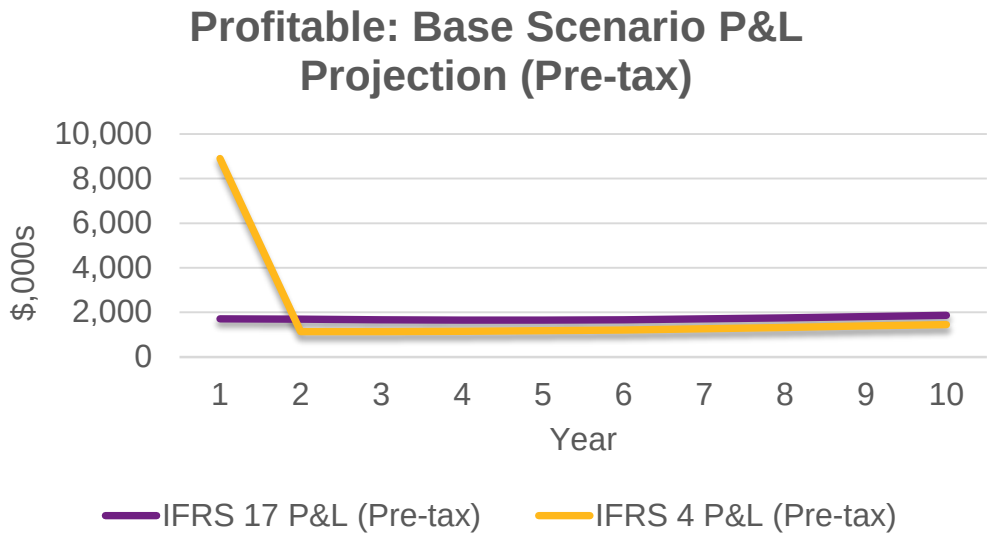
Overview

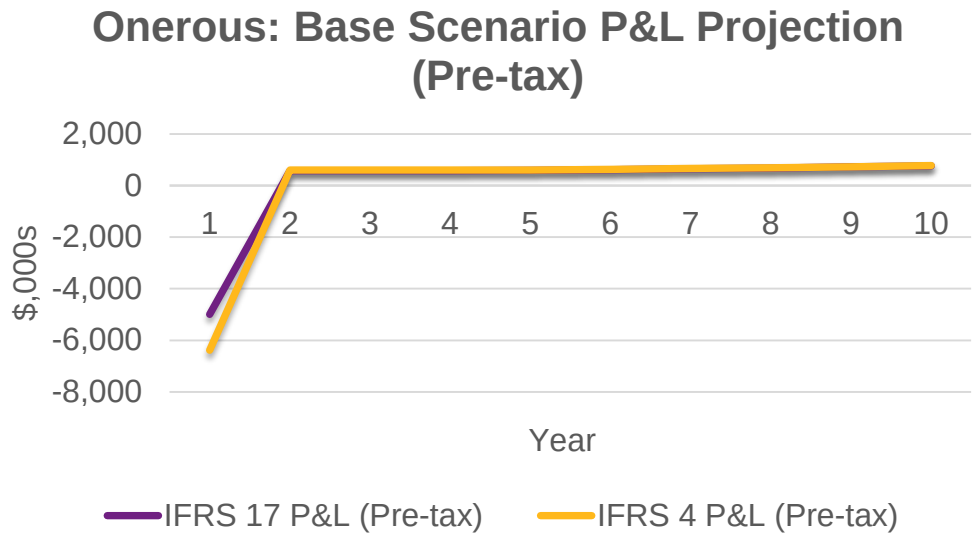


Experience Variance

Profitable and Onerous Groups: Case Study

- For a profitable and onerous Term 20 group, we tested the impact of a 20% shock lapse under Canadian IFRS 4 and IFRS 17
- The graphs below compare the base scenario, where experience is as expected, under IFRS 4 and IFRS 17
- The IFRS 17 discount rate was used to discount the IFRS 4 cash flows to remove economic assumption impacts

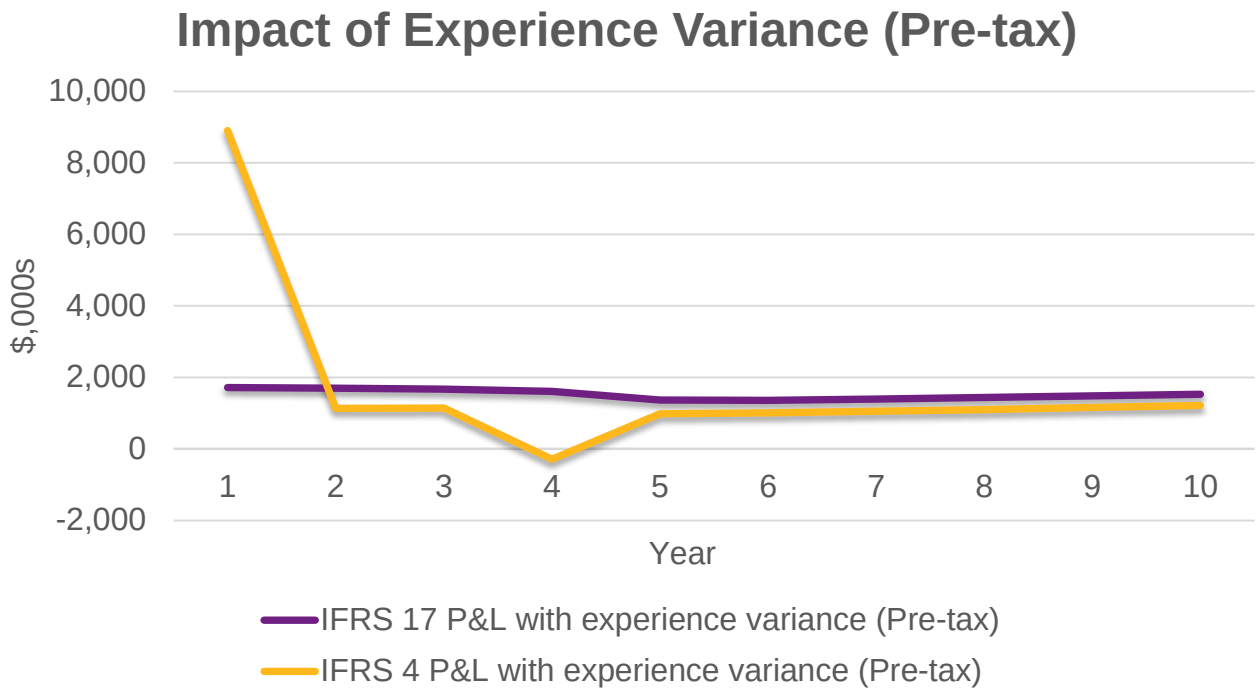




Experience Variance

Profitable Group: Case Study

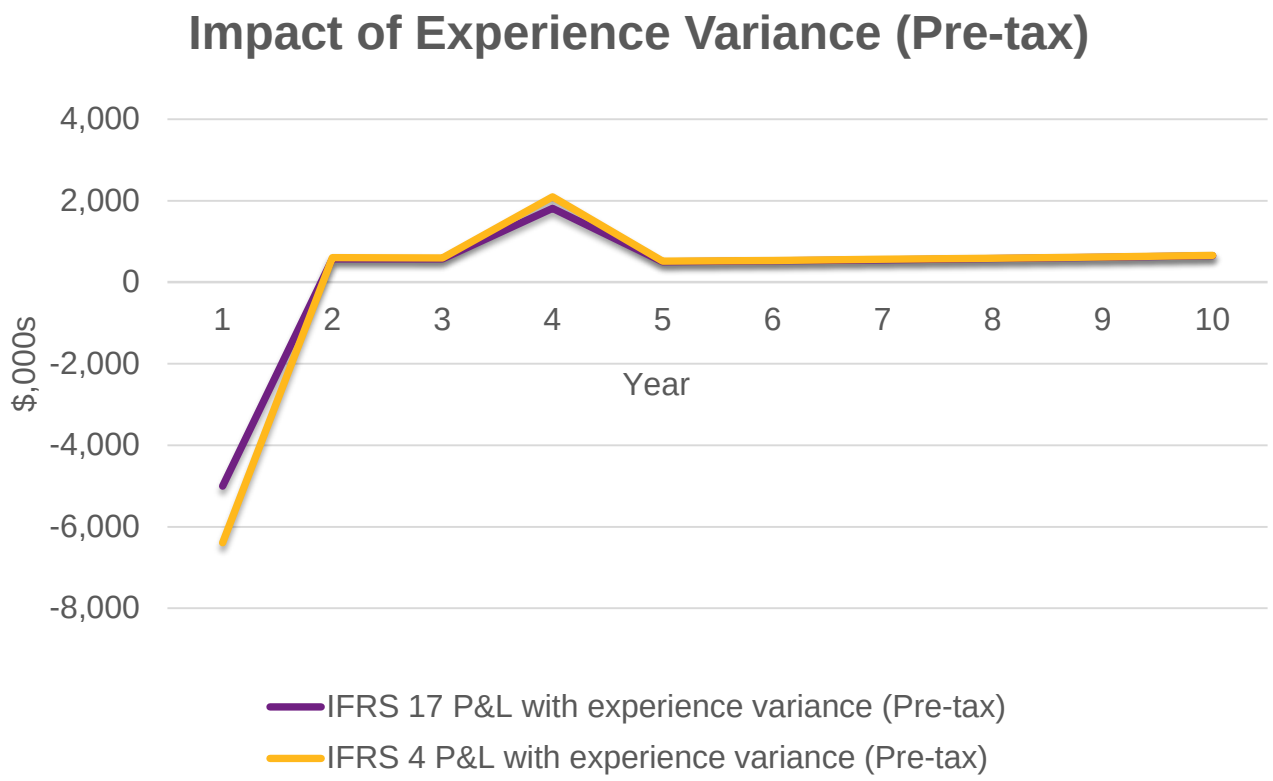
- The experience variance (20% shock lapse) occurs at the end of year 4. Thus, there is no adjustment to the cash flows in that period.
- Comparing the results on an IFRS 4 and IFRS 17 basis we see that:
  - There is a larger profit at inception under IFRS 4 than under IFRS 17
  - There is a loss at the end of year 4 under IFRS 4 due to the experience variance (goes directly to P&L)
  - Results under IFRS 17 are smooth, with impact from the experience variance flowing through to the P&L over lifetime of group (as the CSM absorbs the experience variance)



Experience Variance

Onerous Group: Case Study

- The experience variance occurs at the end of year 4. Thus, there is no adjustment to the cashflows in that period.
- Comparing the results on an IFRS 4 and IFRS 17 basis we see that:
  - Initial losses are recognised at time zero under both IFRS 4 and IFRS 17
  - While the initial loss and profit on release of positive reserves is slightly lower under IFRS 17 than IFRS 4, the P&L under IFRS 4 and IFRS 17 behave in a similar fashion for onerous contracts



Case Study

U.S. Perspectives

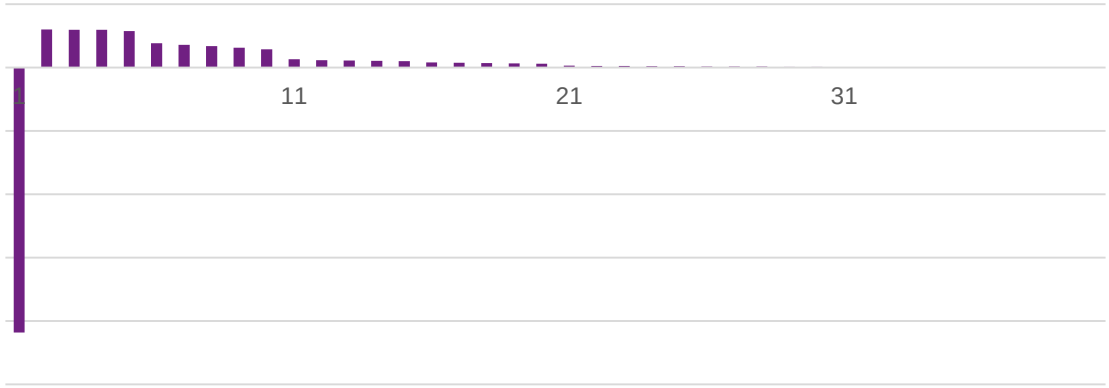
- Profit emergence comparison between IFRS 17 vs. US GAAP vs. US Statutory profits
- Embedded Value (EV) under IFRS 17 and US Statutory basis
- Contractual service margin (CSM) at initial recognition and market-consistent value of new business (VNB)

Case Study

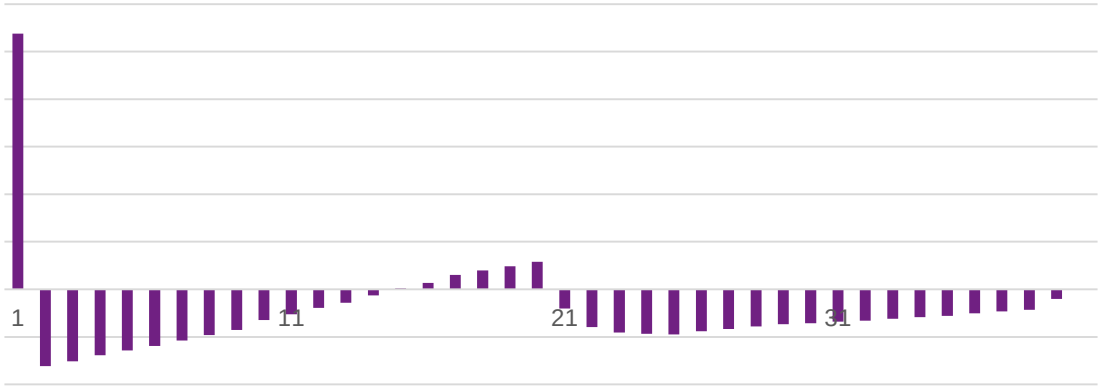
Tested products

- Two products are selected to illustrate different cash flow patterns

Single Premium Immediate Annuity
(Liability net cash flows by projected year)



Renewable 20 year-term
(Liability net cash flows by projected year)

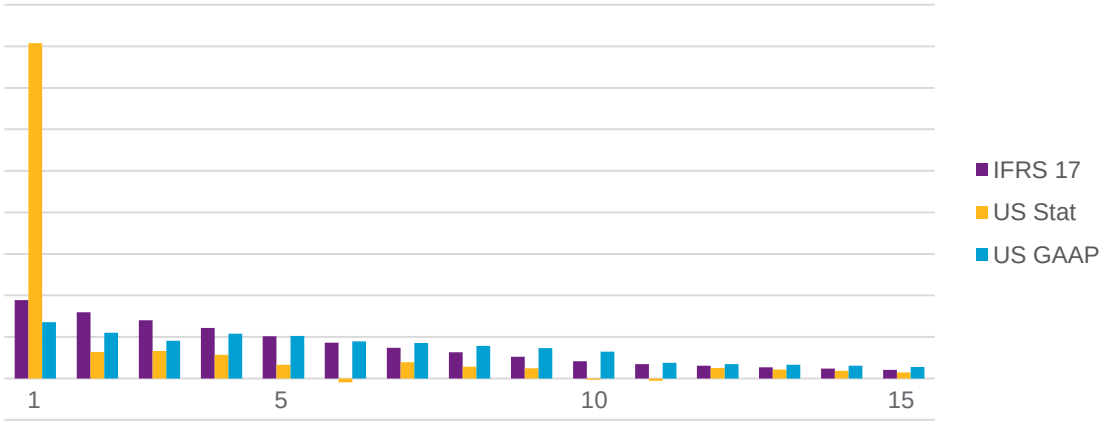


- Case study results and potential implications shared are applicable to the examples and circumstances only, and may vary depending on:
  - Economic environment
  - Underlying actuarial assumptions, asset portfolio and investment strategy
  - The pattern of cash flows
  - IFRS 17 methodology

How will profit emergence pattern differ under IFRS 17?

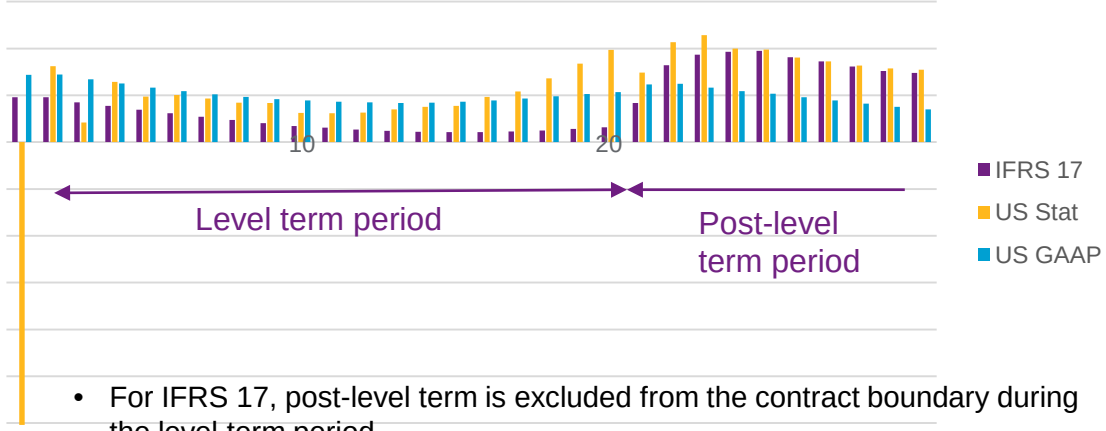
IFRS 17 vs. US statutory vs. US GAAP

SPIA
Profit or loss (before tax)



- IFRS 17 coverage unit: PV of benefits

Term 20
Profit or loss (before tax)



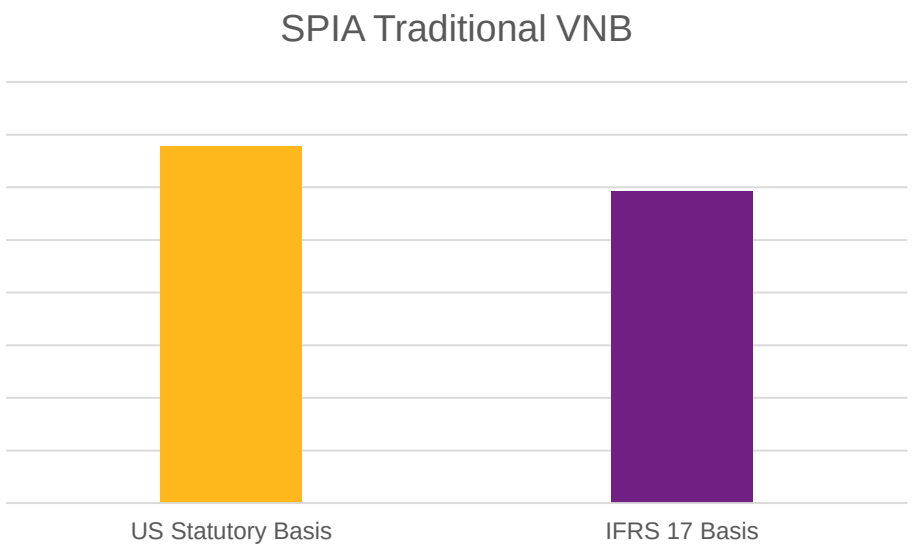
- For IFRS 17, post-level term is excluded from the contract boundary during the level term period
- IFRS 17 coverage unit: face amount

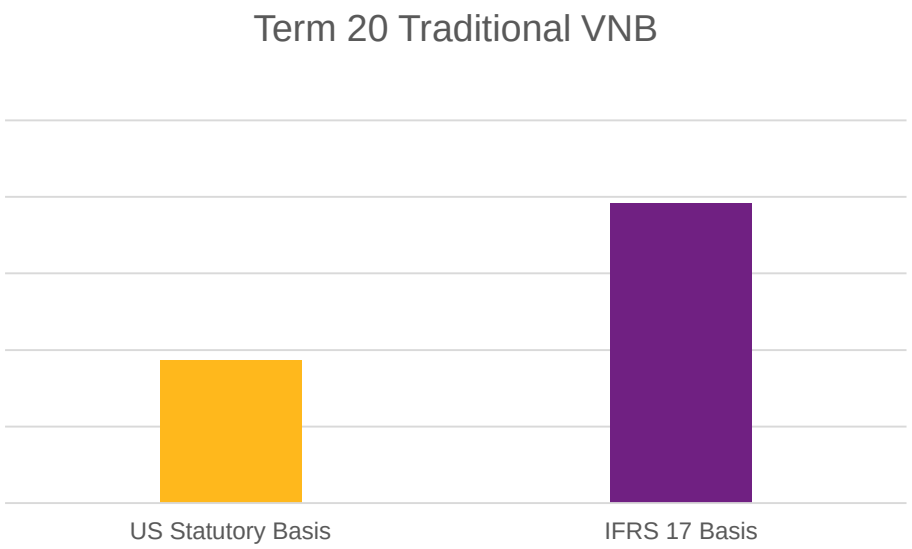
- The lifetime profits are the same while emergence pattern (or timing) differs depending on the reporting framework
  - IFRS 17 and US GAAP smooth the profit over period (within contract boundary)
  - The statutory accounting has no mechanism to smooth the profit over the period

•Projected profits are shown as expected basis (no assumption change, nor experience adjustments after the inception)
•For both of the products, we assumed non-onerous for IFRS 17, no premium deficiency reserve for US GAAP at initial recognition
•Note that the IFRS 17 profit emergence pattern will differ depending on product type, IFRS 17 methodology, assumptions and decisions including, but not limited to, level of aggregation, coverage unit, contract boundary, onerous vs. non-onerous, level of discount rates

How will Embedded Value (EV) change under IFRS 17?

Profit emergence and value of new business (VNB)

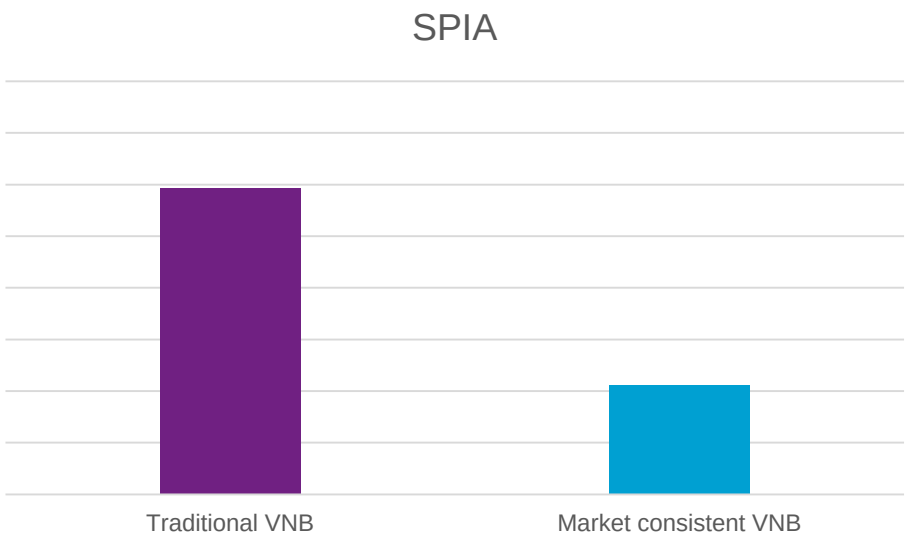


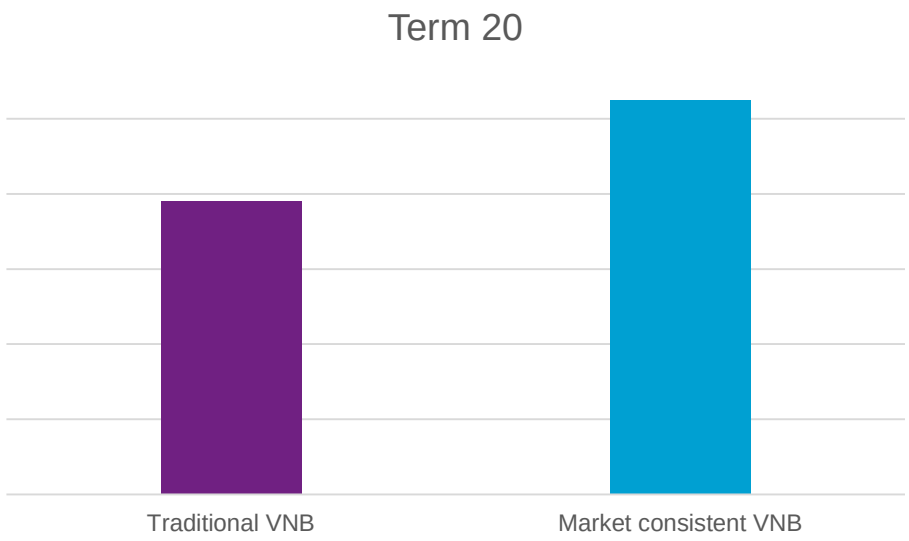


- The charts compare traditional value of new business (VNB) discounting the profits at 7% using US statutory earnings or IFRS 17 earnings as a basis
- Traditional VNB allowing for cost of capital and tax
- The value of new business will differ depending on the profit emergence pattern
  - The value will be larger if the profit is recognized earlier

How will Embedded Value (EV) change under IFRS 17?

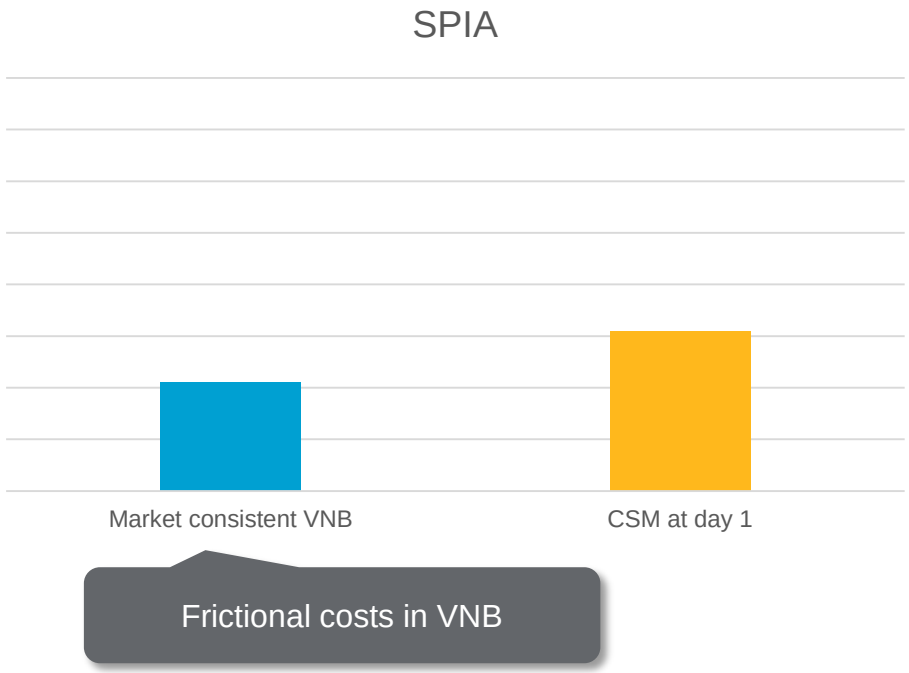
Traditional vs. market consistent VNB

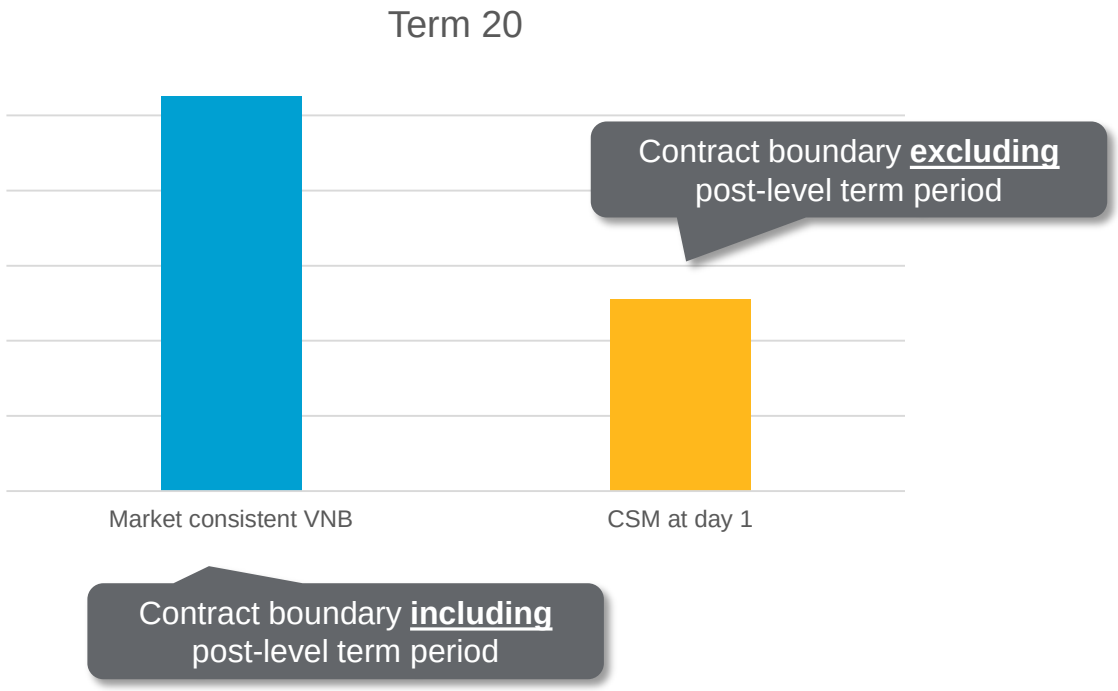




- The charts compare value of new business using IFRS 17 profits
  - Traditional VNB uses 7% to discount realistic profits
  - Market consistent VNB uses the same discount rate as the IFRS 17 discount rate at inception for the comparison purpose
- Traditional and market consistent measures may be different depending on the relative impact of economic assumptions (e.g., investment income, discount rates) and risk allowances – similar considerations for EV measure under statutory earning basis

Can contractual service margin inform Value of New Business (VNB)?

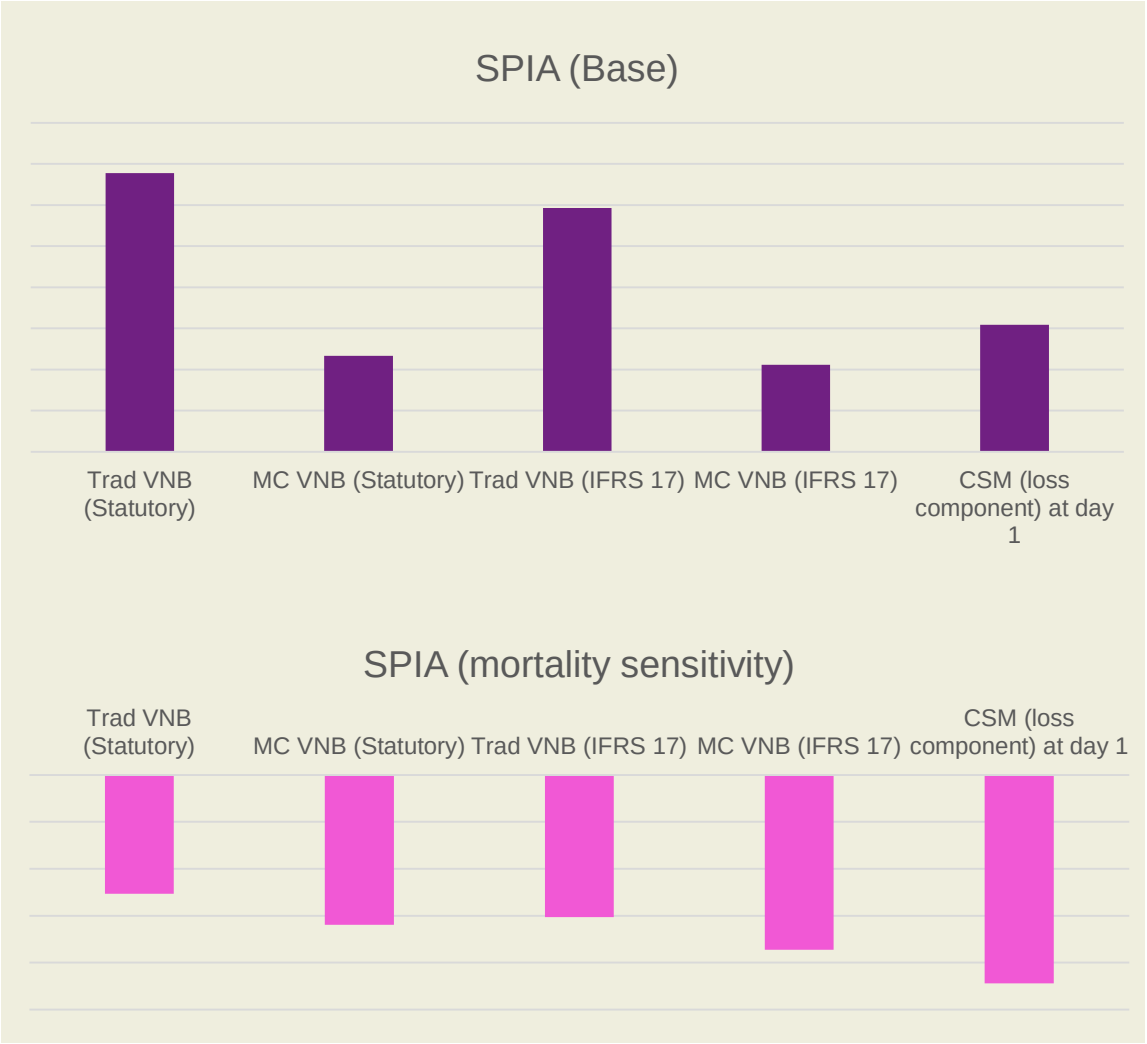


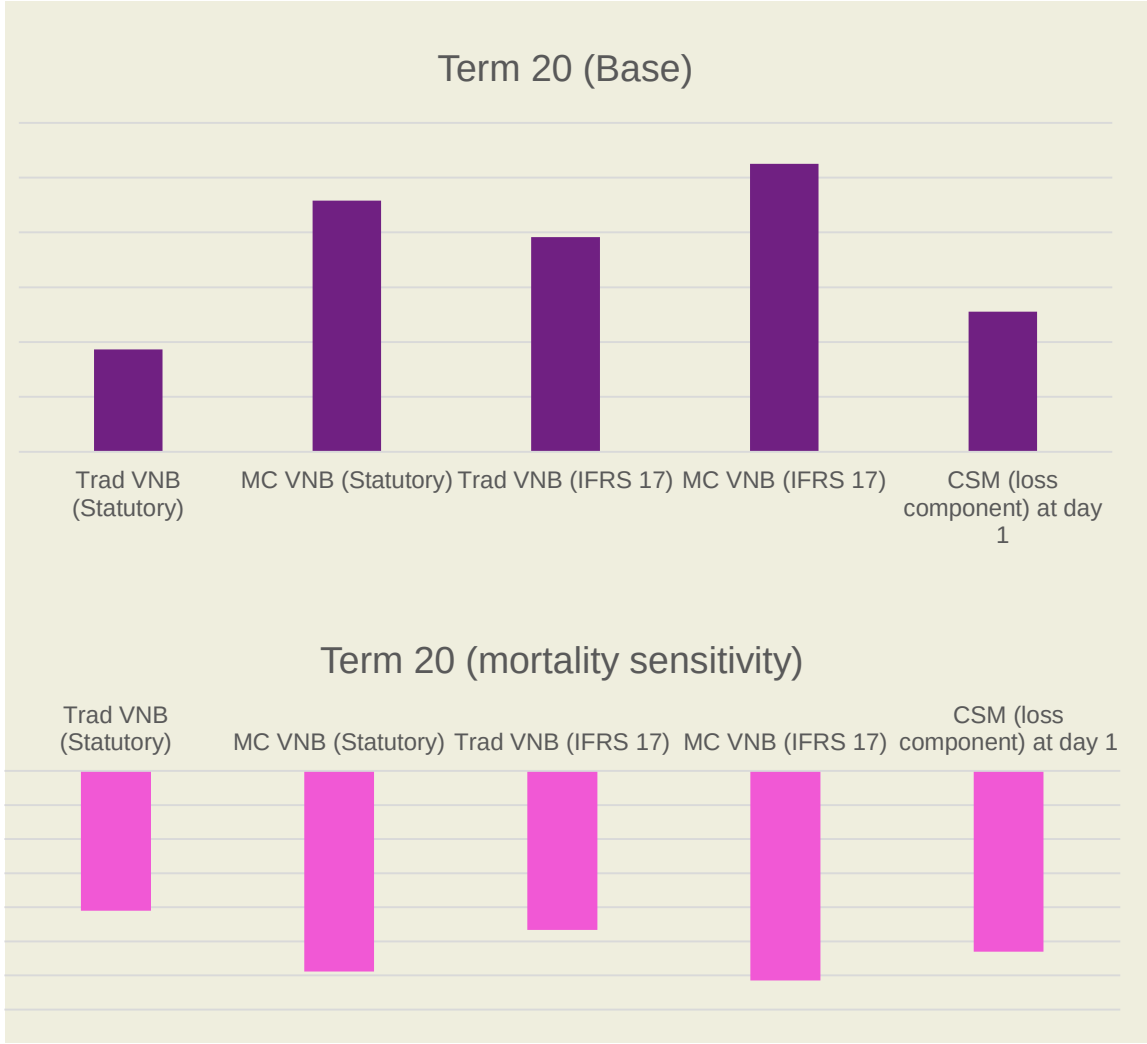


- Market consistent VNB can be different from CSM
  - Frictional costs (tax, investment expenses on required capital)
  - Difference of contract boundary definition (VNB can use definition appropriate for management)
  - Discount rates do not need to be the same, while the case study used the same discount rate
  - Difference in allowances for risks (cost of non-hedgeable risks for market consistent VNB vs. risk adjustment for IFRS 17)
  - Onerous group of contracts? Level of aggregation?

Can contractual service margin inform Value of New Business (VNB)?

What will be your main metric?



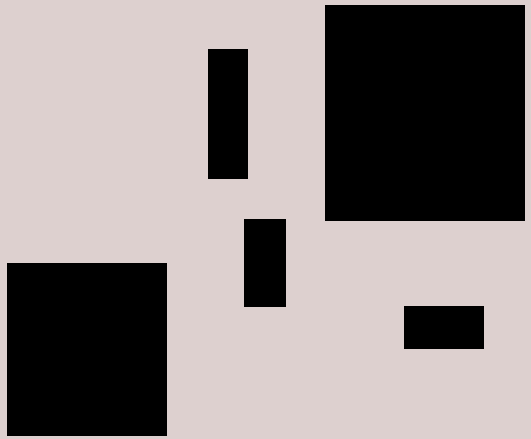


IFRS 17 financials in general

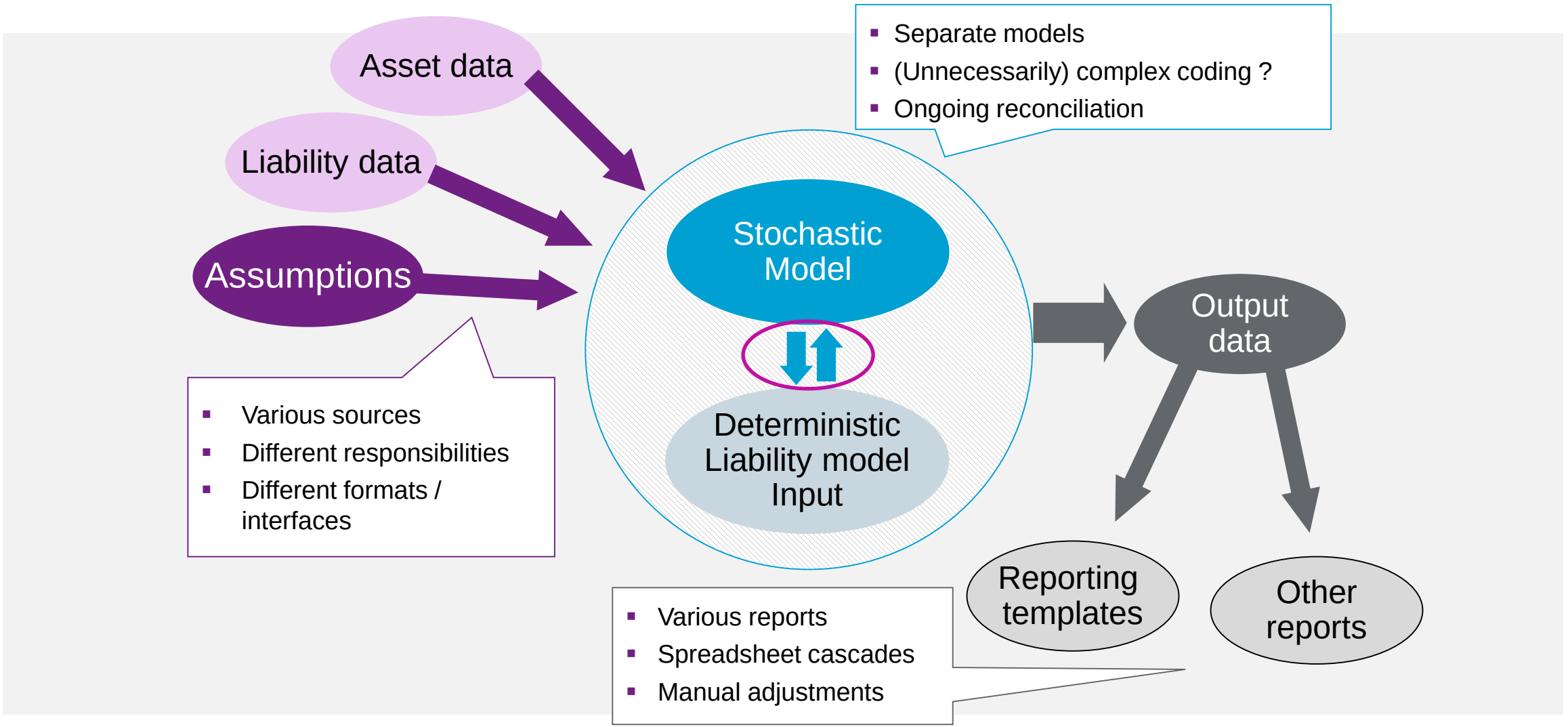
- The IFRS 17 P&L is unique and much different to other accounting basis (e.g., IFRS 4, US statutory, US GAAP)
  - The complexity may arise due to CSM (or loss component for onerous group of contracts)
  - Reinsurance will add to the complexity in IFRS 17 profit emergence pattern and its reporting
- In general, IFRS 17 will result in increased volatility in the P&L
  - The impact of assumption and experience changes may be smoothed out by CSM
  - Asset and liability matching is another aspect that would affect the IFRS 17 income statement volatility
- Detailed financial impact analysis is needed to understand the overall profit emergence pattern and collateral impacts on B/S, retained earnings, financial metrics, embedded value (VNB and VIF)
- An impact study will help make educated IFRS 17 policy decisions, for example:
  - Transition
  - Risk adjustment methodology
  - Basis to roll forward loss component
  - Level of aggregation
  - Coverage unit definition

Impacts on Valuation Process

From transformation to automation



Actuarial model processes must be industrialized



Actuarial/Finance Transformation

Opportunities brought by IFRS 17

- Effectively managing transformational change from IFRS 17 can make organizations better able to face a complex and highly regulated future
- Given the volume and complexity of the calculations required, automation will go a long way towards being able to do calculations fast, but also with the required confidence that they are right the first time
- IFRS 17 will also add to the future computing demands, so companies will need to think about scalability and cost effectiveness as part of their IFRS 17 programs
- There are five areas that everyone beginning IFRS 17-related transformational change needs to think through in advance before they apply innovation
  - Using more staff is never the answer
  - Get your heads in the right place
  - Select your team carefully
  - Communication is more than an article on the intranet
  - ‘I’m going to lose my job’ is a common refrain

IFRS 17 offers a unique opportunity to bring greater efficiencies and job transformation into corporate life

Impacts on Investments, ALM, & Hedging

SOCIETY OF ACTUARIES®

Key Impacts to Consider

ALM and Hedging programs need to be re-examined

- On general account side, the changing discount rate will require careful attention to manage the income statement volatility
  - Background: For most companies, discount rate will generally be the risk-free rate plus an illiquidity premium
  - It starts with the risk-free rate… And how do we think about a concurrent transition from LIBOR to SOFR?
  - ALM departments would typically be a key stakeholder in setting the illiquidity premium
  - For companies with long liabilities (ULSG, LTC, etc.), need to consider how to handle extrapolation after the last liquid point
  - Companies with shorter asset durations may see OCI volatility increase dramatically and even change direction versus today!
  - Managing OCI volatility may become increasingly important in our new worlds… And IFRS 9 does not (practically) allow liability hedges to flow to OCI, so choices are more limited
- IFRS 17 broadly moving to market consistent may require re-thinking current hedge programs for liabilities currently under SOP 03-1
  - May include GMIB and GMDB
  - Current SOP based hedge programs may need to be unwound
  - Implement newer (and bigger for some companies) hedge programs for IFRS 17… Think through impacts of using CSM as a buffer to reduce need for hedging program
  - May impact liquidity and collateral management (roughly at same time as Reg IM is impacting us) and may impact hedge costs
  - Currently have a program that borrows from FHLB and invests in long assets to help manage rho? These may not qualify for risk mitigation (in more colloquial terms, they won't work) under IFRS 17

Considerations That Overlap With Finance

Collaboration with finance is always key…

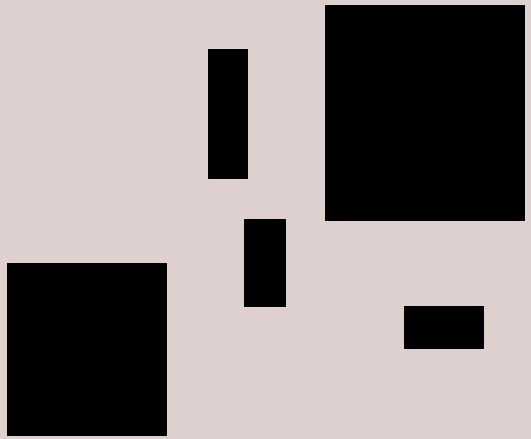
- Implementing risk mitigation and working with the finance side
  - Companies with more sophisticated hedge programs may need multiple risk mitigation factors for each Greek
  - And how to handle Theta? It's just passage of time, and you can't really hedge time, so what would the risk mitigation % be for theta?
  - Attributions are more complex under IFRS 17 and require even greater coordination between hedging department, actuarial valuation, and finance
  - Like other areas of the company, disclosures are more complicated under IFRS 17 for hedging
  - And if your company is upsizing hedge programs from IFRS 4 to IFRS 17, don't forget to set those risk mitigation percentages very carefully on the transition, because you likely won't buy all the extra hedges on the first business day of the transition
- Core earnings or underlying earnings?
  - Many companies highlight a portion of net income with investors and analysts
  - Each company needs to take a view of the extent to which this will be desirable to investors, given the comparability of information that IFRS 17 will provide… Will "core" earning still matter in the new world?
  - If continuing such an approach, will need to re-define what counts as "core" earnings under IFRS 17
  - Whatever philosophy your company takes, it can also be very helpful to articulate revised tolerances for P&L volatility, OCI volatility, and core earnings volatility (as applicable) to help guide development of ALM & hedging strategies

Additional Considerations

Some other things to keep in mind… And there's a whole lot more

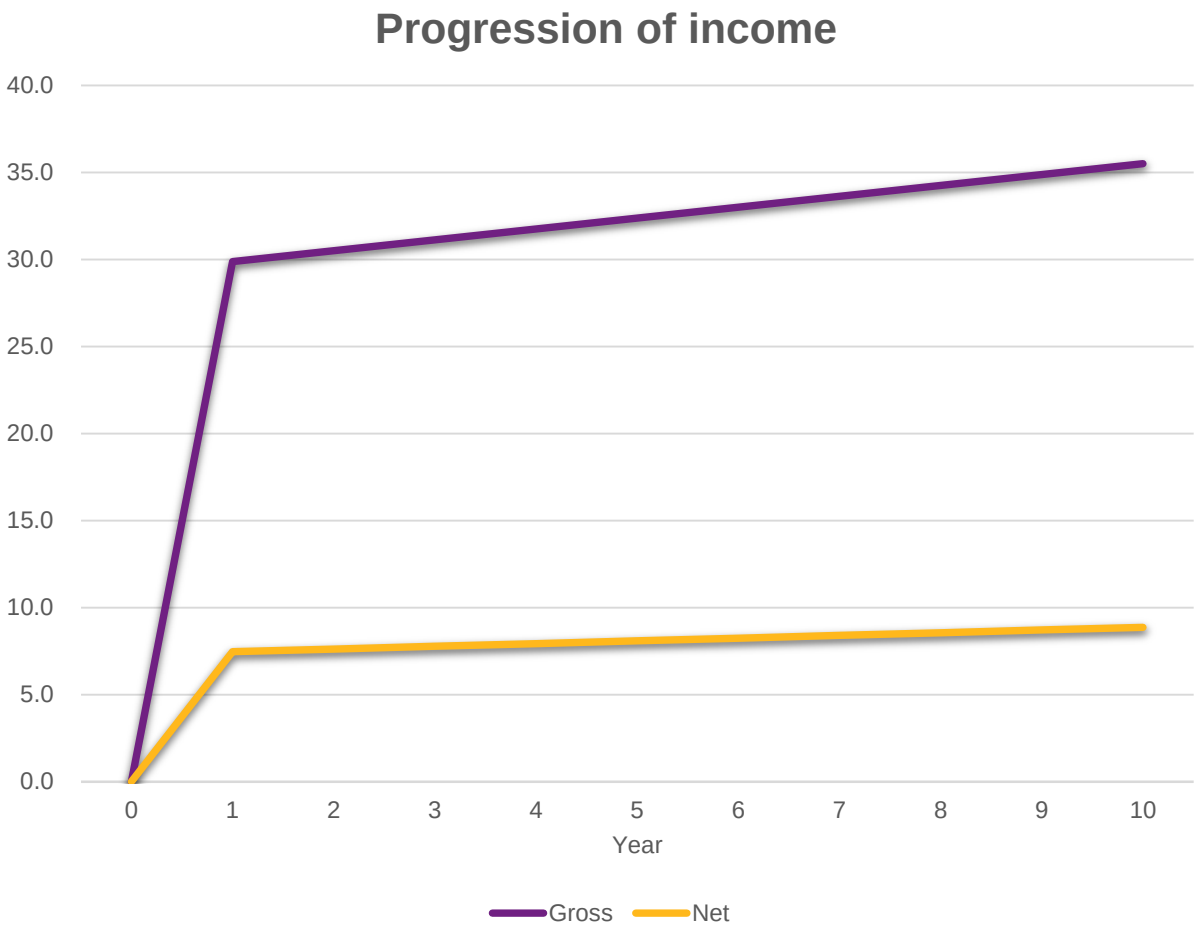
- Hedge targets in the year where comparative statements are being produced (2021)
  - Background: IFRS 17 goes into effect 1/1/2022 but comparative statements are required for the year prior
  - What will companies hedge in 2021?
  - If hedging to IFRS 4 targets, then comparative statements will likely have more volatility
  - If hedging to IFRS 17 targets, then earnings released to the street are likely to have more volatility
- Asset portfolio true-ups
  - Today, many companies true-up their asset portfolios to align with stat reserves, and this works well today because, generally, stat reserves ≥ net GAAP liabilities for most (or all) products so the assets are covering the liabilities on either accounting basis
  - Under IFRS 17, certain product lines (like LTC and ULSG) are likely to have IFRS 17 fulfilment value + CSM much bigger than stat reserves
  - So, for these products, truing up assets to align with stat reserves will lead to a "shortfall" of assets (and their related investment income) when looking at product line financials on IFRS 17 basis
- Documentation challenges should not be overlooked… And you'll probably want to finish in 2020
  - Risk mitigation documentation
  - Derivative program documents
  - Risk strategies
  - To apply risk mitigation in the comparative period (2021), such documents may need to be in place at the beginning of the year

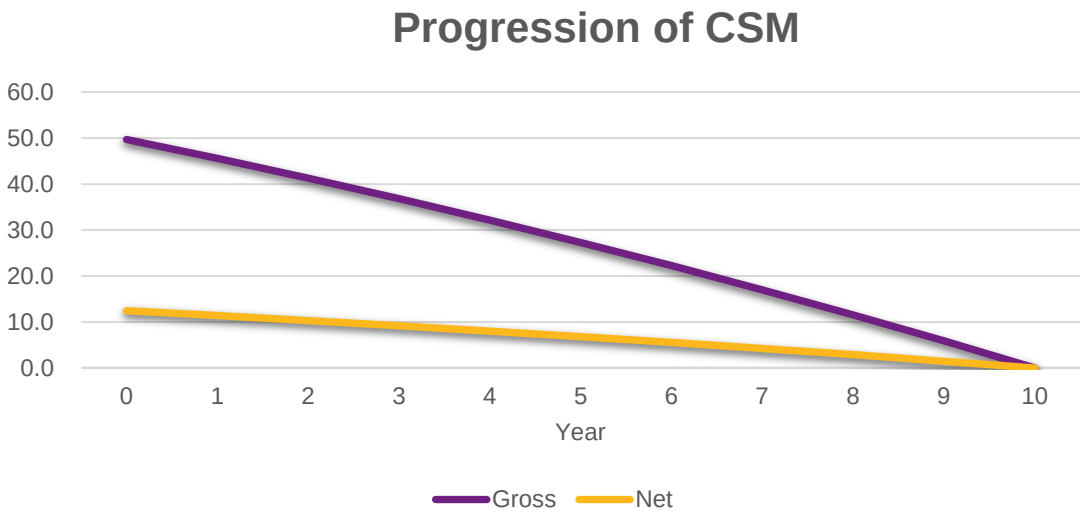
Reinsurance Considerations

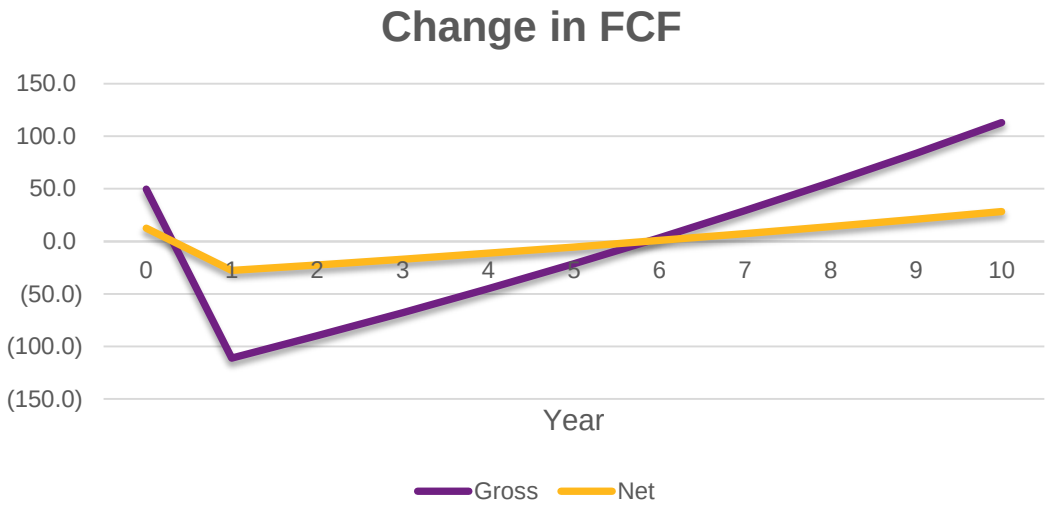


Impact on financial results

Case Study – Profitable Contract with 75% proportional reinsurance

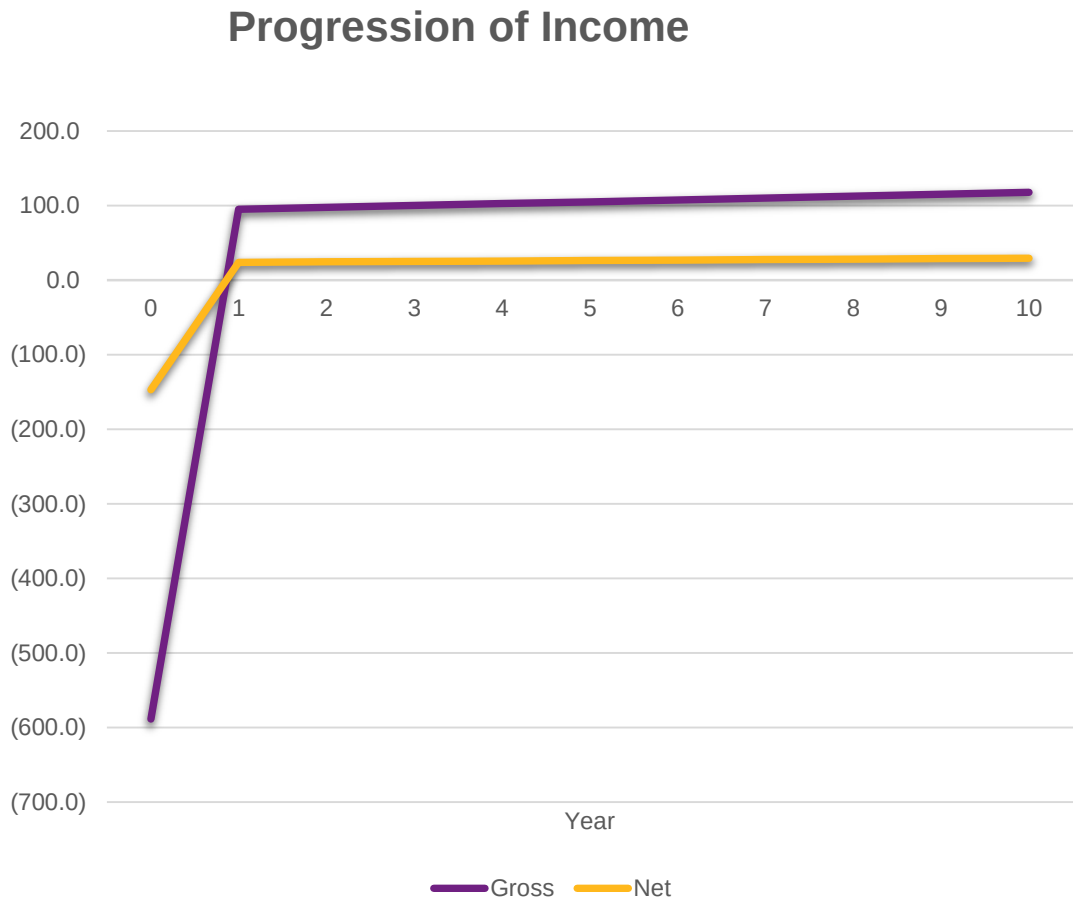


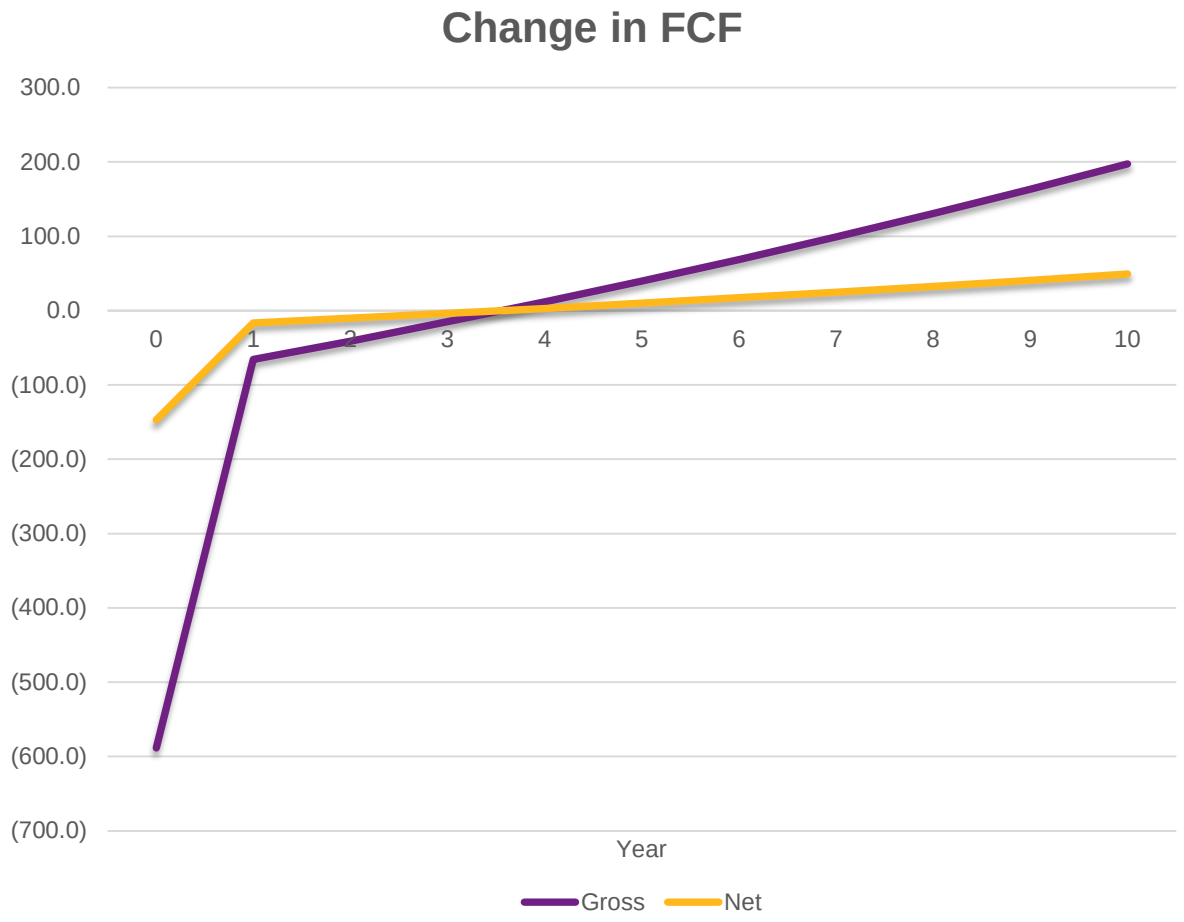




Impact on financial results

Case Study – Onerous Contract with 75% proportional reinsurance (based on proposed Exposure draft change)





Reinsurance as a Risk Mitigation Strategy

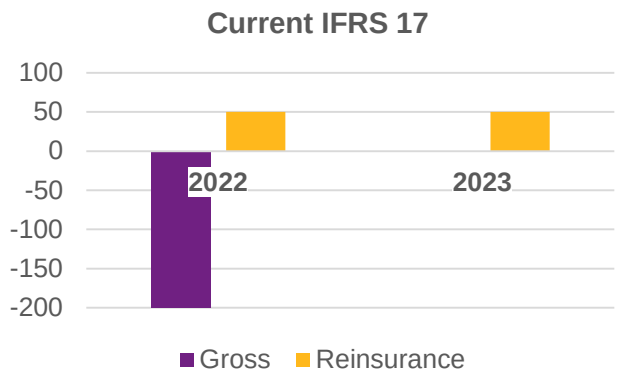
What you need to know and consider

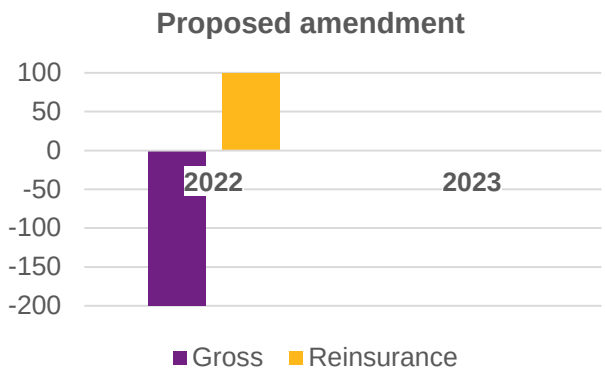
- Another amendment proposed would require an entity that recognizes losses on onerous insurance contracts at initial recognition to also recognize a gain on reinsurance contracts held. This very welcomed proposed change will have a significant impact on the results of insurers with onerous contracts which are covered by proportionate reinsurance contracts.
  - Insurers should begin to assess which contracts are impacted. This change may require insurers to develop new systems and processes to account for these contracts. In practice, reinsurance contracts are likely to cover multiple groups and even portfolios, with a mix of onerous and profitable. Aligning granularity will be a complex task.
  - Cedants should review their current reinsurance programmes and revise, if appropriate. There may also be some opportunities for constructing new reinsurance structures to benefit from this change.

Illustrative

Underlying onerous insurance contract: 2 years – expected net cash outflows: 200

Reinsurance: 50% Quota share



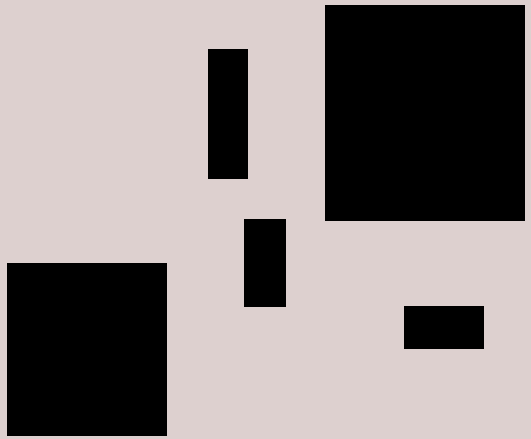


Issues related to reinsurance

Reinsurance can be complicated

- Reinsurance of onerous contracts
  - Initial gain is recognized only for the reinsurance covering the losses of the underlying contracts on a proportionate basis
- Level of aggregation (granularity)
  - Separate and explicit evaluation for reinsurance contracts held
- Contract boundary
  - Open-ended contracts (extension of original contracts vs. new contracts)
  - Initial recognition
- Risk adjustment and risk of non-performance
- Variable fee approach not allowed for reinsurance
- Group consolidation (may depend on the reporting level)
  - Internal reinsurance - eliminating intra-group reinsurance contracts at a group level

Impacts on Capital/Solvency and Risk Management



Potential Impact on Regulatory Capital

- Transition will impact Day 1 B/S and Retained Earnings
- Where the country adopts IFRS 17 as its regulatory framework, regulators may need to make changes to their regulatory capital formula in light of the new accounting regime
- On an economic basis, there should not be any changes to company solvency level
- On an accounting/regulatory basis, some companies will be in better position and some will show worse results
- However, the level of capital for the whole industry in a specific geography could remain relatively stable depending on the approach adopted by the regulator (e.g. scalar factor used in Canada)

Canadian LICAT interaction with IFRS 17

Life Insurance Capital Adequacy Test

- Canadian regulators are trying to minimize effect of IFRS 17 on industry capital level (trying to keep LICAT unchanged to the extent possible)
- Discount rate – IFRS 17 does not consider entity specific asset returns in determining actuarial liabilities; however LICAT has been structured in a way that will provide relief to companies who still operationally apply an asset-liability management strategy
  - Market risk (interest rate risk) aspect of LICAT has charges for asset mismatch
- As the company re-evaluates its product mix and pricing given profit emergence, the new products may attract capital charges or relief under LICAT

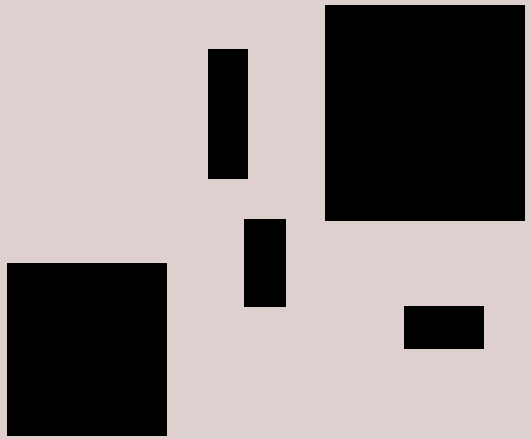
U.S. perspectives

- US RBC remains unaffected by IFRS 17
- Multinationals may use US RBC, Solvency II, Insurance Capital Standard, economic capital, etc., depending on the solvency regime applicable to its group reporting
- Rating agency capital is another consideration
- Need to consider all relevant capital metrics (e.g., targets, constraints)

Impact on Risk Management

- Under IFRS 17, companies will need to understand how their existing risk management protocols are impacted (e.g. Pricing, ALM, Reinsurance)
- On one side, IFRS 17 will result in increased risk across an organization
  - Calculations are more complex
  - Considerably more data required to be accessed and stored
  - More interaction between actuarial systems and accounting systems
  - Enhanced reporting requirements with tight deadlines
- On the other side, IFRS 17 affords companies the opportunity to reduce risk
  - Update and modernize actuarial systems through governance, automation and overall performance
  - Use the vast amount of data to better manage the business
  - Leverage increased interaction between actuarial systems and accounting systems

Other Business Impacts



Impact of IFRS 17 on key insurer metrics

Metric	Impact
Profit	▪ IFRS profit top metric for many insurers ▪ Will become more complex under IFRS 17
Distributable cash flow	▪ Top priority for investors ▪ Impact of IFRS 17 on dividend paying capacity unclear; may vary by country
Value	▪ P&C insurers currently use IFRS equity; Life insurers use mix of IFRS, EV & Regulatory Capital/Solvency II Own Funds ▪ Increased use of IFRS equity as Value starting point
Capital	▪ For insurers in Europe and multinational, current focus on Solvency II and ICS ▪ Impact of IFRS 17 on available capital ▪ No direct impact of IFRS 17 on required capital but maybe some indirect impacts

Product Strategy

Considerations

- Will you need to change any product design? If any, which product and why?
- Which products may lead to big difference between current local GAAP net profit and IFRS 17 net profit?
- Which products may be onerous under IFRS 17?
- Are there any disadvantages for some products under IFRS 17?
- Will there be some influence on product strategy in order to manage IFRS 17 profit (as a KPI)?

Product Pricing

Considerations

It is challenging to anticipate the impact on pricing if IFRS 17 profit is adopted as the pricing measure - there are many key issues/considerations as follows:

- Discount rate will be a key consideration under this market-consistent valuation approach
- Emergence of profit will differ significantly from what we are used in the current accounting regime
- Products with rich options and guarantees may lead to lower profitability
  - Under IFRS 17, options and guarantees will be measured consistent with observable market prices
- Explicit risk adjustment with no methods prescribed under the IFRS 17 may differ from current margins
- Interpretations on applying GMM vs VFA for certain products (e.g., UL, variable annuities) will have an impact
- The option to use OCI for a systematic split of the investment result may be a consideration
- Investment strategy will also be an important part of the pricing consideration
- Operational considerations
  - Increased accounting complexity will lead to additional resource requirements (automation could help)
  - Planning and investment in people/systems will be needed
  - Controlled, stable and robust deterministic and stochastic cash flow projection models will be needed
  - Education will be required for decision-makers, boards, investors

Impact on M&A

- There are multiple considerations in M&A
  - The main drivers are typically strategic and economic, although this differs by company
  - Some companies put more weight on GAAP/IFRS earnings
- The initial recognition in IFRS 17 will lead to zero impact on the day 1 balance sheet due to either the CSM or goodwill
  - Fulfilment cash flows and fair value will need to be calculated to determine CSM or goodwill
  - Possible challenges in defining and calculating the fair value
    - Industry practice has not developed yet
    - Will fair value equal actuarial appraisal which is typically based on a real world approach or will fair value be more similar to a market consistent approach?
    - If fair value is based on real world actuarial appraisal then this could lead to more goodwill because fulfillment cash flows may be more likely to exceed initial consideration
- Possible strategic considerations (either buy or sell) may include:
  - Operational aspects
    - Resource constraints including people, software, etc.
    - Entities with solid IFRS 17 infrastructure in place will have relative advantages in understanding IFRS 17 implications, and can make decisions faster
  - Key metrics
    - Key management metrics influence strategic decisions; key metrics may include IFRS 17 measures
    - Less likely for U.S. domestic insurers

Tax implications

Who knows?

- The profit emergence pattern will be changing
  - Companies will need to re-evaluate their existing tax planning strategies
  - Consider impact of day one losses on onerous contracts through P/L and retained earnings
  - Consider future profit patterns
- IFRS 17 has policy choices available
  - If the regulators/auditors allow or impose certain policy choices such as use of OCI for certain items, tax treatments may need to be revisited
- However, we have no idea how tax agencies will react and what changes they will consider

Tax department should be involved throughout the implementation program to monitor the impact of results on tax planning and utilization strategies

Engaging with investors

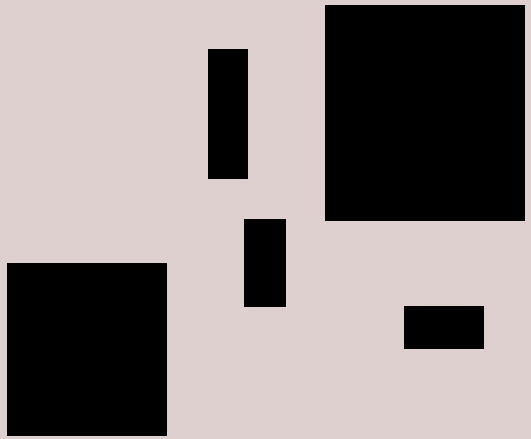
One of the biggest investor communication challenges we have ever seen

Statement of Comprehensive Income	
	20X
Insurance contract revenue	X
Insurance service expenses	(X)
Insurance service result	X
Investment income	X
Insurance finance expense	X
Net financial result	X
Profit/Loss	X
Discount rate changes on insurance liability (optional)	X
Total comprehensive income	X

Revenue excluding deposits

Plan the investor communication – the earlier the better!

Conclusion



Key takeaways

01

Focus on business

02

Transition outcome

03

Opportunity for Transformation and Automation

04

Collateral impacts

More than just accounting: significant business impacts likely

The different equity and profit emergence and revised presentation requirements should lead insurance companies to review or revise:

1. **Key metrics used**
2. **Asset-liability management**
3. **Capital and risk management**
4. **Product strategy and pricing**
5. **Investor engagement**

Thank you !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