SAM focus

Helping insurers understand and manage change

The International Accounting Standards Board (IASB) is planning to publish a second exposure draft setting out its final proposals for IFRS 4 Phase II in the first half of 2013.

It is important to understand what these proposals are and the implications on your SAM project for the measurement of insurance contracts.

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Most insurers have recently finalised their SA QIS2 submissions, which will give an indication of the SAM impact on their numbers. In order to help you take advantage of the parallels between SAM and IFRS 4 Phase II, we consider some of the similarities between the two frameworks in order to reduce the cost and burden of implementation. In addition we have highlighted the more important differences. This is critical to understand as it has an impact on data, systems, processes and explaining your numbers.

Measurement model

1. Both SAM and IFRS 4 Phase II base the measurement of insurance contract liabilities on the concept of a probability weighted estimate of future cash flows, the time value of money and an additional allowance for risk (i.e. the building block model). IFRS 4 Phase II includes an additional contract liability known as the residual margin to eliminate any gain on day one.
2. As a prudential regulatory regime, the focus of SAM is on the financial strength of the insurer as opposed to its performance during the year. The SAM balance sheet is intended to reflect an economic (fair) value of all assets and liabilities at the balance sheet date, hence there is no concept of a residual margin.
3. As a financial reporting regime, IFRS is focused not only on reporting the financial position, but also reporting performance in the period.
4. A key difference between IFRS and SAM will include the recognition of expected future profit on day one under SAM where expected cash inflows exceed the cash outflows. This and other differences between the two models are set out below.

Definition and scope

5. IFRS 4 includes the definition of an insurance contract and the IFRS classification depends on the level of insurance risk transferred to the insurer. In IFRS, the measurement of contracts will depend on the classification as either insurance (IFRS 4 Phase II) or investment (IFRS 9: Financial instruments), while SAM makes no such distinction. Investment contract liabilities are typically measured at fair value but can also be measured at amortised cost under IFRS.

Unbundling

6. There is a requirement to unbundle certain components of contracts and measure them under different IFRS standards, though these situations are expected to be limited.
7. Deposit elements, defined as contract components that are paid back to the policyholder regardless of whether an insured event occurs or not, should be disaggregated and presented separately. These components are still measured under the IFRS 4 Phase II model.

Contract boundary

8. The boundary of the contract represents the point beyond which any cash flows relating to a contract are no longer recognised in the measurement of the liability. The boundary in the two frameworks will be the same for many contracts however there is a risk that some differences may exist.
9. Under SA QIS II additional information has been requested to assess the impact of contract boundaries and can influence the final outcome under SAM.

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Which cash flows?

10. Estimation of future cash flows is the foundation for both frameworks. However, there are some differences that may present practical difficulties.

11. Although cash flows such as premiums and claims will be the same under both frameworks, not all the cash flows are expected to be fully aligned. For example, the inclusion of certain general overhead costs may be prohibited under IFRS 4 Phase II which will require changes in your expense allocation process and lead to two sets of expense assumptions.

12. In IFRS 4 Phase II, directly attributable acquisition expenses are included in the cash flow model and implicitly deferred through a reduction in the residual margin.

13. In IFRS, for investment contracts that include an investment management service component, there is explicit deferral of acquisition costs as an asset on the balance sheet but with a narrow definition of the costs permitted to be deferred (incremental at the contract level). There is no equivalent concept of deferring costs over the life of the contract in SAM.

Discount rate

14. For long duration products, the valuation of contract liabilities and resulting accounting profit are highly sensitive to the selection of the discount rate.

15. The discount rate in SAM is the risk free discount rate as prescribed by the regulator. Under SA QIS II a matching adjustment has been included for certain life insurance obligations that meet specified conditions. These conditions are aimed at ensuring insurers are able to earn the additional return associated with this adjustment.

16. In IFRS 4 Phase II, the approach to the discount rate is principal based and it must reflect the characteristics of the liability (which could, for example, reflect asset dependency for participating contracts). However, it is proposed that the impact of all changes in the discount rate over time to be presented in Other Comprehensive Income (OCI) rather than through profit or loss.

17. The approach will require the contract liability to be measured based on both the current and 'locked-in' (at inception) rates. There is no equivalent concept in SAM.

Risk adjustment

18. The concept of an explicit risk adjustment is pertinent in both SAM and IFRS 4 Phase II.

19. In SAM, the allowance for risk is determined following a 'cost of capital' approach with a prescribed calibration of the assumed cost.

20. In IFRS 4 Phase II there is no prescribed method and the calibration must conform to a principle, namely 'the compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the contract'.

21. Within a SAM environment it is likely that insurers will want to make use of the cost of capital model. However there is the potential in IFRS to have a different cost of capital calibration from that used in SAM. In addition, IFRS will require the disclosure of the confidence level that the risk adjustment equates to, if an approach different to the confidence level approach is used.

Residual margin

22. The residual margin is a concept with no direct comparison in SAM. As a result insurers will need to develop a new model or separate system to determine this element of the liability and its release to profit or loss during the lifetime of the contracts.

23. The residual margin is determined at a portfolio level. The release of the residual margin is over the period in which the service is provided and there is no prescribed unit of account. In addition, the residual margin is increased for interest at each reporting period at the day one locked in rate.

24. Changes in estimates of future cash flows are not recorded in profit or loss, but are offset in the residual margin (unlocking), subject to the residual margin not becoming negative.

25. Changes in the valuation of options and guarantees, discount rate and risk adjustment are not offset against the residual margin and recognised in profit or

loss. The requirement to unlock the residual margin and charge interest introduces greater complexity and more granular data requirements.

Participating contracts

26. The basic definition of a participating feature is similar in SAM and IFRS 4 Phase II. All participating contracts (including Investment DPF contracts) issued by an insurer are expected to be in the scope of IFRS 4 Phase II.

27. In IFRS, the cash flows relating to the policyholders participation are measured and presented mirroring the measurement basis of the underlying assets in which the policyholder participates, so at the cost or fair value (through OCI or profit or loss); while options and guarantees are measured at their current value. There is no equivalent concept of mirroring in SAM as all assets are measured at economic value.

Non-life and short duration contracts

28. A modified measurement model, the Premium Allocation Approach (PAA) is permitted by IFRS 4 Phase II as an alternative to the building block model; where either the period of cover is one year or less, or it produces measurements that approximate the results produced under the building block model. There is no equivalent option under SAM.

Transition

29. IFRS 4 Phase II will require retrospective application on transition. This is particularly challenging as insurers must estimate, on a 'best endeavours' basis the residual margin, when insufficient objective data is available for certain years. The residual margin on transition will require an assessment of contract profitability at the outset of the contract which is then reassessed up to the current date.

30. Although the transition proposals need to be finalised under SAM it is expected that, as SAM is a full prospective measure, there is limited additional complexity.

What should you do?

31. The timelines for SAM and IFRS 4 Phase II are not aligned. SAM's expected go live date is 1 January 2015, with a required parallel run in 2014. IFRS 4 Phase II is unlikely to be mandatory until 2017/8.

32. The potential for early adoption of IFRS 4 Phase II provides the opportunity for considering to aligning the projects together with the aim of avoiding unnecessary duplication of efforts.

33. The priorities should include the closer collaboration between the risk, actuarial and finance functions and making sure that the measurement models being developed for SAM are flexible enough to be adapted for IFRS 4 Phase II, given some of the similarities.

34. This can only be achieved if the significant differences in the detailed requirements between SAM and IFRS 4 Phase II are proactively considered as part of the SAM process and system design.

35. Insurers need to consider as part of their implementation plans how differences between IFRS and SAM will be reconciled and explained to their boards, the regulator and stakeholders.

If you wish to discuss how we can help you, please call your regular contact or alternatively:

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