IFRS 4 Phase II
Comparison with Solvency II and MCEV

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In this briefing note we compare the proposed accounting standard for insurance contracts, IFRS 4 Phase II, with Solvency II and MCEV.

INTRODUCTION

The International Accounting Standards Board (IASB) continues to work on phase II of the Insurance Contracts project. The accounting standard being developed within this project, IFRS 4: Insurance Contracts (IFRS 4 Phase II) will replace the current version of this standard. The IASB is still considering some key aspects of the standard, and deliberations are expected to continue over 2015, with the final standard following once this has been completed. Mandatory adoption of the proposals is currently foreseen to be three years after the issue of the final standard.

In this article, we will compare the current draft of the IFRS 4 Phase II standard (based on the 2013 exposure draft and any tentative decisions to date) with the following regimes:

- Solvency II: The new EU insurance regulatory regime for assessing solvency
- Market-consistent embedded value (MCEV): An economic measure of existing business based on the European Insurance CFO Forum Market Consistent Embedded Value Principles.[1]

The IASB continues to deliberate on some aspects of IFRS 4 Phase II. In particular, the measurement model for participating contracts has not yet been agreed upon. This briefing note therefore focuses on the proposed approach for non-participating contracts.

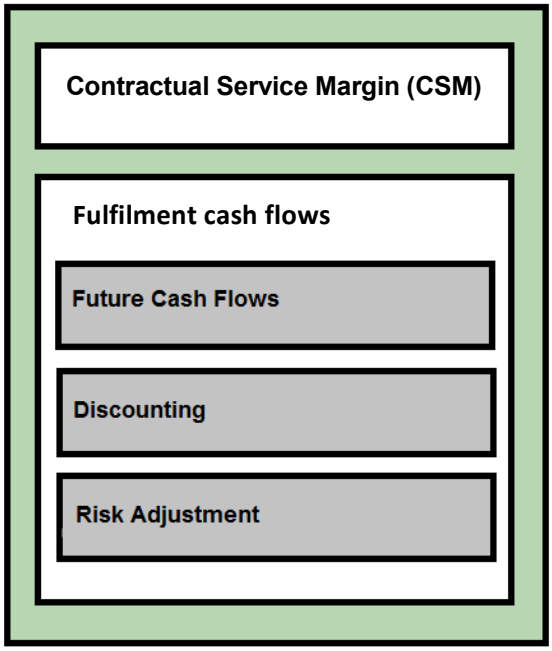
BACKGROUND

Listed companies in the EU have been obliged to report using IFRS since 1 January 2005. The original standard for insurance contracts (IFRS 4 Phase I) allowed companies to continue to use their existing accounting regime to value insurance contracts. This was intended only as an interim standard until the completion of IFRS 4 Phase II.

In July 2010 the IASB issued an exposure draft of IFRS Phase II. In June 2013 a second exposure draft was issued outlining the draft standard and focusing on key areas for consultation.

The current draft of the IFRS 4 Phase II standard measures non-participating insurance contracts using the building blocks[2] shown in the following illustration:

IFRS 4 Phase II – Measurement of non-participating contracts



We will first look at the contracts in scope of IFRS 4 Phase II and how this compares to the other regimes (Solvency II and MCEV). We will then compare each of the building blocks of IFRS 4 Phase II measurement to the corresponding building blocks of the other regimes. IFRS 4 Phase II only deals with the liability side of the balance sheet, and so we will

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[2] For certain short-duration contracts, a premium-allocation approach may be used instead of the building block approach. The premium-allocation approach is similar to unearned premium methodology.

focus our comparison on the measurement of insurance liabilities under the three regimes. Finally, we will look at the key differences relating to the presentation of results.

SCOPE

There are some differences in scope between the three regimes.

IFRS 4 Phase II applies to all contracts that meet the definition of an insurance contract, which depends on whether significant insurance risk is transferred. This definition is largely unchanged from the original standard.

Solvency II applies to the entire business of an insurance undertaking. Therefore, some contracts which are in scope for Solvency II may not be in scope for IFRS 4 Phase II, e.g., unit-linked contracts with little or no additional death benefit above unit value.

The covered business under MCEV is long-term life insurance business. Short-term life insurance and long-term accident and health insurance may also be included in MCEV covered business.

FUTURE CASH FLOWS

The first building block of IFRS 4 Phase II is an unbiased, probability-weighted estimate of future cash flows within the boundary of the insurance contracts, i.e., the expected value of future cash flows. Best estimate assumptions are used and are updated at every reporting date. The cash flows should reflect observable market data, where available. For data not available in the market, company-specific cash flows are used. Only cash flows directly attributable to fulfilling portfolios of contracts should be included. This includes fixed and variable expenses that can be linked to fulfilment efforts at portfolio level. General overhead expenses that cannot be directly attributed to portfolios of insurance contracts are not included in the fulfilment cash flows.

Portfolio of insurance contracts

Portfolios of insurance contracts include insurance contracts that provide coverage for similar risks and are managed together as a single pool.

Solvency II and MCEV require the use of best estimate assumptions for modelling future cash flows also. In Solvency II and MCEV, all maintenance expenses allocated to the in-force business should be included in the cash flows. Therefore, it is possible that some difference in cash flow may arise due to the treatment of general overhead expenses in IFRS 4 phase II.

DISCOUNT RATES

The second building block in IFRS 4 Phase II is the discounting of the cash flows. A principle-based approach is used to determine the yield curve for discounting cash flows. The discount rates can be estimated using a bottom-up or a top-down approach. In both cases, the purpose is that the discount rates only reflect the characteristics of the insurance contracts (such as duration, currency and illiquidity). In the bottom-up approach, a risk-free yield curve is increased with an illiquidity premium appropriate for the insurance liabilities. The starting point for the top-down approach is the expected return on a reference portfolio. The return is adjusted for duration mismatches, expected credit losses and unexpected losses. In the top-down approach, it is not necessary to explicitly determine an illiquidity premium.

For Solvency II, the method of setting the discount rates is prescribed and is generally set equal to an adjusted risk-free curve based on swap rates. Under very strict conditions, it is possible to use a matching adjustment which adjusts the discount rates based on the expected return of matching assets held. In other situations, the risk-free rate may be adjusted depending on the spreads available on currency-specific and country-specific reference portfolios (volatility adjustment).

MCEV uses a principle-based approach to determine the discount rates. A bottom-up approach is used. The discount rates used for MCEV are generally based on a risk-free curve with an addition for illiquidity premium. If market swap rates are not available to determine the risk-free rates, robust alternatives such as government bond yields can be used.

CONTRACT BOUNDARIES

Under IFRS 4 Phase II, cash flows are within the boundary of an insurance contract when the company can compel the policyholder to pay the premiums or has a substantive obligation to provide the policyholder with coverage. In particular, a contract boundary is set if the company has the right or the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those

risks. A right to reassess the premium or a right to change the benefits only determines a contract boundary if the premium paid to date does not take into account risks related to future periods.

Under Solvency II there is a broadly similar definition to determine contract boundaries. In 2014, 'Guidelines on contract boundaries' for Solvency II were published. These guidelines specify that the boundary condition, determined by the company's ability to reassess premiums to fully reflect the risk, can be determined at portfolio rather than contract level. In some cases, insurance and investment components of contracts may need to be separated and different boundaries may apply.

Within MCEV, the concept of contract boundaries does not apply. Instead, all cash flows related to contractual renewal premiums or foreseeable recurrent premiums are included when valuing the contract.

RISK ADJUSTMENT

The risk adjustment (RA) in IFRS 4 Phase II is the compensation that a company requires for bearing the uncertainty about the amount and timing of cash flows. IFRS 4 Phase II does not prescribe the method to calculate the RA, and therefore a company can apply its own specific view on insurance risk. However, the disclosure of the confidence level corresponding to the RA is mandatory in order to enhance comparability between companies. The RA can be determined at a portfolio level and can incorporate diversification benefits that may exist.

Fulfilment cash flows

Under IFRS 4 Phase II, the present value of future cash flows within the contract boundary plus the risk adjustment is known as the fulfilment cash flows.

A similar concept called the risk margin exists under Solvency II. The risk margin is defined as the amount, in addition to the present value of future cash flows, which would be required by another insurer to take over and meet the insurer's obligations. A cost of capital (CoC) methodology is used to determine the risk margin. The CoC is the net present value of the cost of holding the solvency capital. The CoC rate is set to 6% of the non-hedgeable solvency capital.

In MCEV a cost of non-hedgeable risk (CNHR) is required to allow for non-hedgeable financial and non-financial risks. Companies can choose the methodology to use to determine the CNHR but a comparison to the CoC methodology must be disclosed. Therefore, many companies choose to use the CoC approach. But unlike Solvency II, the CoC rate is not prescribed.

Risk adjustment

The methodology to determine the risk adjustment is not prescribed under IFRS 4 Phase II. The IFRS methodology used should reflect the companies' perception of risk. One possibility is that companies would use a cost of capital methodology to allow for comparability with Solvency II and MCEV. Alternatively, as the equivalent confidence level must be disclosed, using a confidence level approach may be considered more efficient. A company might prefer using the same method as used in pricing.

CONTRACTUAL SERVICE MARGIN

Under IFRS 4 Phase II, insurance contract profits are spread over the duration of the contract using a contractual service margin (CSM). The CSM requires a measurement of fulfilment cash flows at initial recognition of the insurance contracts.

Fulfilment cash flows – Initial measurement

The fulfilment cash flows used for initial measurement also includes directly attributable acquisition costs that can rationally be allocated to the portfolio of contracts.

The CSM recognised at initial recognition is an amount equal to the opposite of the initial measurement of the fulfilment cash flows. For any onerous portfolios, the CSM is set to zero. The CSM is recognised in profit and loss (P&L) over the duration of the contracts in a systematic way that best reflects the remaining transfer of services that are provided under the contract. The CSM must be unwound at the discount rates that were locked in at the inception of the contract.

If assumptions with respect to future services change, the CSM is unlocked to allow for the changes to the extent that it can absorb the

changes—the CSM cannot become negative. The impact of changes in the assumptions is spread over the remaining duration of the contracts.

When the CSM is depleted, additional losses from changes in assumptions are recognised immediately. Profits from changes in assumptions should then first be used to compensate previous losses before a positive CSM can be built up again. Acquisition costs which are not directly attributable to the portfolio of contracts are also recognised immediately.

All acquisition costs are recognised immediately in Solvency II and MCEV. Additionally, future profits relating to existing business are recognised immediately in Solvency II and MCEV. There is no comparative CSM mechanism under these regimes.

Contractual service margin (CSM)

The CSM is a key difference in IFRS 4 Phase II compared with Solvency II and MCEV. The CSM allows for the spreading of profits on insurance contracts over the duration of the contracts.

PRESENTATION OF THE RESULTS

IFRS 4 Phase II results will be presented in the company's Statement of Comprehensive Income. The IASB proposes an earned premium approach for presenting the results under IFRS 4 Phase II. Under this approach the proportion of premium relating to future obligations is not accounted for as income, rather it is held as a deposit to pay future claims and expenses. Any portion of premium related to profit for the company is spread over the duration of the contracts using the CSM. This approach has the advantage that it is applicable not only for longer-duration contracts but also for shorter-duration, mostly non-life, contracts. Furthermore, the Earned Premium Approach is in line with the IFRS 15 'Revenue from Contracts with Customers' standard.

Companies must recognise insurance contract revenue and expenses in the P&L. The release in the CSM and the RA are also recognised in the P&L.

The additional impact of changes in current discount rates may be recognised in the P&L or in other comprehensive income (OCI). The company is required to develop an accounting policy and make sure that the same policy is used for groups of similar portfolios. Furthermore, the company is required to develop guidance for changes in the accounting policies based on the requirements of IAS 8.

Example Company – Changes in Discount Rates Recognised in OCI

Statement of Comprehensive Income
Example Company, €m

Expected claims & expenses over period	3,500
Release of risk adjustment	200
Release of CSM	300
Revenue & expenses	4,000
Actual claims & expenses over period	3,100
Underwriting result	900
Interest expense	-4,000
Interest income	4,100
Interest income	100
Profit and loss for period	1,000
Other Comprehensive Income	700
Total Comprehensive Income	1,700

Unwind of discount rates on locked-in rates

Movement in asset and liability may be recognised in OCI

Changes in discount rates

Companies are required to separately identify the impact of:

- ***The change in discount rates***
- ***The unwind of discount rates that were locked in at inception***

This requires that companies store and re-use the discount rates that applied at inception for all cohorts of contracts. The company will need to decide on the granularity used to define cohorts.

Quantitative Reporting Templates are used to report Solvency II information. These templates focus mainly on balance sheet and capital items. They include an analysis of movement in excess assets which have some similarities to the requirements of the Statement of Comprehensive Income in IFRS 4 Phase II.

Under MCEV, the changes from the start of the year to the end of the year are outlined using an analysis of change methodology. This shows the expected return, the value of new business, the deviations from the expected return and the changes due to changes in assumptions. There are some similarities with this approach and the proposed approach for IFRS 4 Phase II, e.g., reporting actual and expected cash flows separately. However, it is expected that many companies will require significant developments to their reporting systems in order to facilitate the requirements of IFRS 4 Phase II.

CONCLUSION

There are many similarities between IFRS 4 Phase II, Solvency II and MCEV. These include using best estimate cash flows to value policyholder liabilities, using market-consistent discount rates and the existence of similar concepts to measure the uncertainty in timing and amount of cash flows.

However, there are also many differences. A key difference in IFRS 4 Phase II is the use of the CSM to spread profits over the duration of the contracts, whereas profits are recognised immediately in Solvency II and MCEV. Additionally, Solvency II requirements are more prescriptive than IFRS 4 Phase II or MCEV. The less prescriptive nature of IFRS 4 Phase II could lead to the company choosing approaches which are different to the other regimes, such as the calculation of the risk adjustment or differences in setting discount rates. The presentation of the results is also very different under IFRS 4 Phase II.

As a result, the introduction of IFRS 4 Phase II may bring some challenges for companies. Some of the questions which companies should be asking right now are:

- Are our calculation systems robust enough to calculate the fulfilment cash flows and the CSM?
- Do our reporting systems need to be redesigned to allow for the IFRS 4 Phase II reporting requirements?
- Will our systems allow for storage and access of historical interest rates to calculate the roll-forward of the CSM?
- What are the strategic business implications of IFRS 4 Phase II on our company?

For some companies, significant system developments may be required before the implementation of IFRS 4 Phase II. We recommend that companies begin to plan for these now.

HOW MILLIMAN CAN HELP

Milliman is a leading global advisor and has consultants working internationally on understanding and assessing the impact of the IASB's latest proposals for insurance contracts.

Milliman consultants can assist in understanding the proposals including:

- The areas of consultation highlighted by the IASB
- Systems implications and design
- The influence that the exposure draft may have on your business, including new business impact

Milliman also has extensive expertise of industrialisation of reporting processes. Integrate™ is Milliman's unique, holistic system which gives an approach to automation and governance of actuarial reporting processes.

Built around MG-ALFA®, Milliman's industry-leading financial modelling system, and powered by Microsoft Windows Azure, Integrate represents a reimagining of the relationship between people, processes and technology. Launched in 2012, it is the first industrialisation solution that is proven to manage risk, maximise efficiency and unlock the full potential of the actuarial staff.

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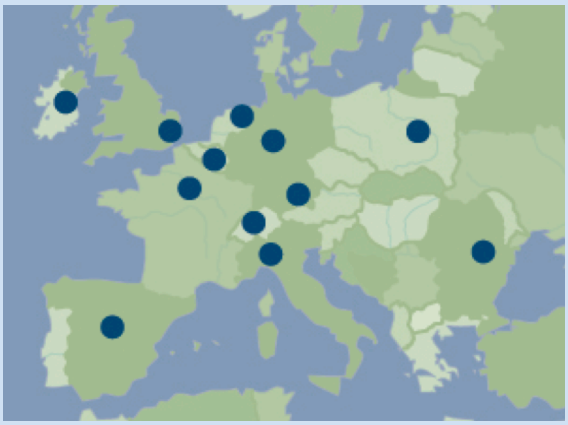

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