IFRS 4 PROFIT REPORTING FOR SOUTH AFRICAN LIFE INSURANCE CONTRACTS

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Motivation


• Push to finalise IFRS 4 within the next year.

• Each jurisdiction faces unique challenges of IFRS 4.

• For South Africa, contractual services margin and exclusion of indirect expenses are a mind-set shift.
Background

GOAL

• Analyse the impact of the **dynamics** of the IFRS4 **building block approach** on **profit recognition** for South African life insurance contracts.

APPROACH

• Push past uncertain complexities in the exposure draft by making **necessary simplifications** which allow **meaningful comparison** between the FSV and IFRS 4 profit-reporting bases.
Agenda

- History and context
- Comparison of IFRS 4 and FSV approaches
- Dynamics explored
- Results of comparisons
- Conclusions
- Further work
History and context

- Insurance accounting project **began in 1997**.
- The standard looks to be **finalised in 2014**.

IFRS 4


- IASC sets up Insurance Accounting Steering Committee
- Draft Statement of Principles for Insurance accounting
- IFRS 4 Phase I finalised
- First IFRS 4 Phase II Exposure Draft released July 2010
- Second IFRS 4 Phase II Exposure Draft released June 2013
- Likely publication of final IFRS 4 standard

**2013 Convention**
31 Oct & 1 Nov
## Comparison of IFRS 4 and FSV

### Building Blocks of liability

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- **Minumum additional prudence vs. fully discretionary prudence.**
- **Compulsory margins vs. prescribed minimum allowance for risk on each cashflow.**
- **An adjustment that reflects the time value of money.** Discount rate can be the same for both bases (bottom-up).
- **A current, probability-weighted best-estimate of future cashflows on the contact.**
- **Best-estimate cashflows are largely the same for both bases, except for allowance for indirect or overhead expense and future options expected to be taken up.**
Comparison of IFRS 4 and FSV
Contractual Services Margin

INITIAL RECOGNITION

• Eliminates gains at inception of a contract.

• An explicit mechanism for profit deferment.

SUBSEQUENT MEASUREMENT

• Opening CSM accretes interest, reduces to earn profit on transfer of services and is adjusted for certain assumption changes.

• CSM is released over the coverage period, on a systematic basis consistent with the pattern of the transfer of services (this pattern is not prescribed and up to discretion of the insurer).

• CSM is unlocked for changes in estimates of cashflows relating to future coverage, which allows CSM to serve as a dampener for impact of assumption changes.
Comparison of IFRS 4 and FSV

Components of profit

- Release of compulsory margins
- Release of discretionary margins

FSV Profit

- Release of risk adjustment
- Release of contractual services margin
- Indirect expenses

IFRS 4 Profit

- Other components of profit under both bases can include assumption changes and experience variances.
Dynamics explored

Term Assurance

- Inherent Profitability
- Assumption Changes
- Policy options
- Discrionary margins
- Indirect Expenses

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Basis for illustrative policy

- Profitable 15-year non-taxable term assurance policy.
- 40-year old female policyholder.
- Level premium, fixed sum assured.
- Same premium, mortality, lapse, interest rate and expense (overall) assumptions.
- Projected experience as per expected basis.
- FSV approach: Compulsory margins as per SAP104. No discretionary margins.
- IFRS 4 approach: Claims plus expenses CSM carrier. Risk adjustment 6% SAM cost of capital.
TAKE-HOME:

1. IFRS 4 results in a smoother pattern of profits.
2. Under IFRS 4, the contractual services margin is the main mechanism for profit deferral.
Term Assurance
Comparison of liability profile

FSV Liability negative at inception. IFRS 4 liability zero.

Both overall liabilities become negative after payment of initial expenses.

IFRS 4 liability greater than FSV for entire policy term.
Term Assurance
Components of IFRS 4 Liability

BEL is main driver of shape of liability.

Risk adjustment is the smallest liability component, driven by mortality and lapse risk in SCR.

CSM has large decrease in first year, then runs off steadily with claims + expenses.

Best-estimate liability
Risk Adjustment
CSM

Policy Year

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Term Assurance
Comparison of profit profile

FSV realises profit at inception.

IFRS 4 profits in subsequent years greater than FSV.

IFRS 4 profit in year one less than in year two due to indirect expenses.

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Dynamics explored

**TAKE-HOME:**

1. For unprofitable contracts, IFRS 4 results in a lower liability than under FSV for entire contract term.
2. For profitable contracts, IFRS 4 liability is greater than FSV liability for entire contract term.
Low Profitability
No CSM at inception

Loss at inception under IFRS 4 smaller than under FSV. Due to risk adjustment being smaller than compulsory margins.

Subsequent IFRS 4 profits lower than FSV.
High Profitability
No discretionary margins

FSV realises significant profits at inception.

IFRS 4 profits more level throughout and larger than FSV (more profit deferment under IFRS 4)
Dynamics explored

TAKE-HOME:
Under FSV discretionary margins can result in a variety of profit profiles.
High Profitability
Discretionary margin - zeroise negative reserves

Zeroisation results in zero FSV profit at inception and loss in first year.

Once liabilities turn positive, FSV profits decrease significantly.
High Profit - Extra Mortality Margin
40% Increase in mortality rate

Using a discretionary margin applicable over entire policy period produces FSV profit pattern similar to IFRS 4.
Dynamics explored

**TAKE-HOME:**
1) Higher proportion of indirect expenses results in higher CSM at inception.
2) Indirect expenses can be indirectly allowed for in CSM releases (with appropriate carrier).
Indirect Expenses
Varying proportion of direct initial expenses

Consequence of more indirect expenses is higher initial CSM and hence future profit.

More indirect expenses result in greater loss in first year (insufficient liability release to cover initial expenses).

Policy Year

- 100% Direct
- 80% Direct (base)
- 50% Direct

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Indirect Expenses
Impact of CSM carrier on indirect initial expenses

- Larger CSM release in the first year means subsequent year releases of CSM are smaller.
- CSM carrier which includes expenses dampens loss due to indirect expenses.
- Indirect expenses are indirectly allowed for via releases of CSM if carrier includes expenses.
Dynamics explored

**TAKE-HOME:**

FSV and IFRS 4 treat policyholder options differently: IFRS 4 takes full allowance for all future policyholder options.
Policy options
Voluntary increase premium and sum assured (yr 5)

IFRS 4 recognises all future policy option profits at inception and adds to CSM.

FSV recognises profits from policy options on occurrence and capitalises profits immediately.

Profit

Policy Year

IFRS4 Voluntary Escalation  IFRS Base  FSV Voluntary Escalation  FSV Base

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Dynamics explored

Assumption Changes

Term Assurance

Inherent Profitability

Discretionary margins

Indirect Expenses

Policy options

**TAKE-HOME:**
Under IFRS 4 the CSM dampens profit impact of assumption changes and spreads it over time.
Demographic assumption change
Small mortality rate increase (yr 5)

No change in profits before assumption change.

FSV realises full future loss due to assumption change.

IFRS4 has minimal change in profit due to CSM absorption.

Subsequent year IFRS4 profits lower due to lower CSM release.
Demographic assumption change
Large mortality rate increase (yr 5)

Both FSV and IFRS4 realise loss as a result of significant assumption change.

IFRS4 loss smaller because of CSM absorption as only excess assumption change results in loss.

IFRS4 profits subsequent to change are very small as no CSM remains.
Demographic assumption change
Mortality rate decrease (yr 5)

FSV capitalises future profits as a result of assumption change.

IFRS4 sees minimal impact on profit as CSM absorbs the change.

Subsequent IFRS4 profits much higher due to higher CSM release.
Conclusions

- IFRS 4 results in a **smoother** pattern of earnings than FSV:
  - No profits allowed at inception.
  - Dampening effect of the CSM for **assumption changes**.
  - **Policy options** are treated differently under IFRS 4 and FSV.

- For **profitable contracts**, IFRS 4 **liability greater** than FSV liability.

- For **unprofitable contracts**, IFRS 4 results in **lower loss up front** and less prudent liability going forward.

- Existing FSV **discretionary margins** may mean that existing profit profile is more or less similar to profit profile under IFRS 4.

- **Indirect expenses** and **CSM carrier** are important.
Further work

• This investigation looked at **illustrative contracts** and focussed on the **dynamics of building block approach**.

• Important, but uncertain issues such as the use of **other comprehensive income**, **mirroring** and **presentation of revenue and expenses** are not considered here.

• Although the final IFRS 4 picture is likely to be more **complex**, these results are a good indication of the **overall shape** of earnings under the new standard.
QUESTIONS