General insurers should not ignore IFRS 4 Phase II

The IASB believe that they are close to finalising IFRS 4 Phase II, accounting for insurance contracts. The long germination period, conflicting priorities (such as Solvency II in Europe) and a view that there will be limited impact for general insurers, mean that many insurers in this sector have yet to begin to consider the implications of the new standard. However, we recommend that general insurance companies consider the potential impact and assess the expected scale of the implementation effort in order to avoid late surprises.

Do you write multi-year contracts? Eligibility for the simplified approach may be tougher than you think.

Are you undertaking, or planning, systems or data projects? Efficient project management should build in Phase II awareness.

Background

- A new IFRS standard for insurance contract accounting (**IFRS 4 Phase II** or 'Phase II') has been under development for 18 years and so reports of its approaching arrival might understandably be met with some scepticism.
- However, the IASB have indicated that the standard is close to finalisation and hope to issue it next year which would suggest an effective date of around 2020. The long lead time reflects the expected significance of the effort required to implement the standard.
- The majority of key decisions affecting general insurance business have been made by the IASB but there may still be lobbying opportunities whilst deliberations continue.
- A simplified model is available for pre-claims coverage on short duration contracts but the standard model (based on discounted cash flows) is required to be applied to all incurred claims and is more likely to be required for all aspects of more complex longer duration contracts (for instance Engineering, Construction and D&O contracts).
- The new standard for financial instruments, **IFRS 9**, applicable to insurers' investment portfolios, may apply earlier than Phase II (subject to finalisation and application of current proposals around deferral for insurers).
- The lobbying and implementation planning focus in the insurance industry has been primarily on the life sector given the anticipated significant financial and operational implications thereon of the new standard.
- However, some general insurers have begun to consider the impact and level of effort required and others are expected to follow.

Who should be acting now and why?

The type of business written will drive the accounting models available. This will influence the expected financial and operational impact

- Insurers will need to assess the extent to which the simplified approach can be used and, if so, whether it is the optimal choice for the insurer.
- Any general insurer writing multi-year policies may have to apply the standard Phase II model (the Building Block Approach, "BBA") rather than the simplified Premium Allocation Approach, "PAA" model. The BBA may present significant operational challenges as well as having wider financial implications.
- Even insurers applying the PAA will need to consider discounting and apply a risk adjustment for incurred claims. This is in addition to the provision of new disclosures, notably around movements in estimates from one period to the next and disclosure of the risk adjustment confidence level which will introduce a new level of transparency in insurers' reporting.
- Both the PAA and BBA will require data to be captured at a suitably granular level both on an ongoing basis and for transition purposes in order to meet Phase II requirements.

Ongoing systems and data projects should build in Phase II considerations

- Whilst it may be too early to begin building Phase II specific systems, any current or planned systems development or upgrades, or plans for new data collection or storage processes, should take into account expected Phase II requirements. This will avoid future duplicated effort or other inefficiencies.

All insurers will need to begin to plan effectively for Phase II

- Phase II may not be a significant issue for some insurers but the three year implementation period that the IASB is likely to propose is an indication that it will be a major issue for many. Insurers need establish how big a deal it is for them.
- Getting an early indication of the extent of the impact of Phase II will allow insurers to plan effectively in areas such as budgeting, resources, data collection and storage and systems development.

An overview of the standard

Measurement models for general insurers

The standard BBA Phase II model is based on a discounted cash flow model with an allowance for risk and deferral of up front profits (through the Contractual Service Margin, 'CSM'). The IASB have, however, also provided relief for companies writing short term contracts, particularly those of one year or less in duration. This relief comes in the form of a simplified PAA model that can be used if specified criteria related to contract duration and variability of expected future cash flows are met.

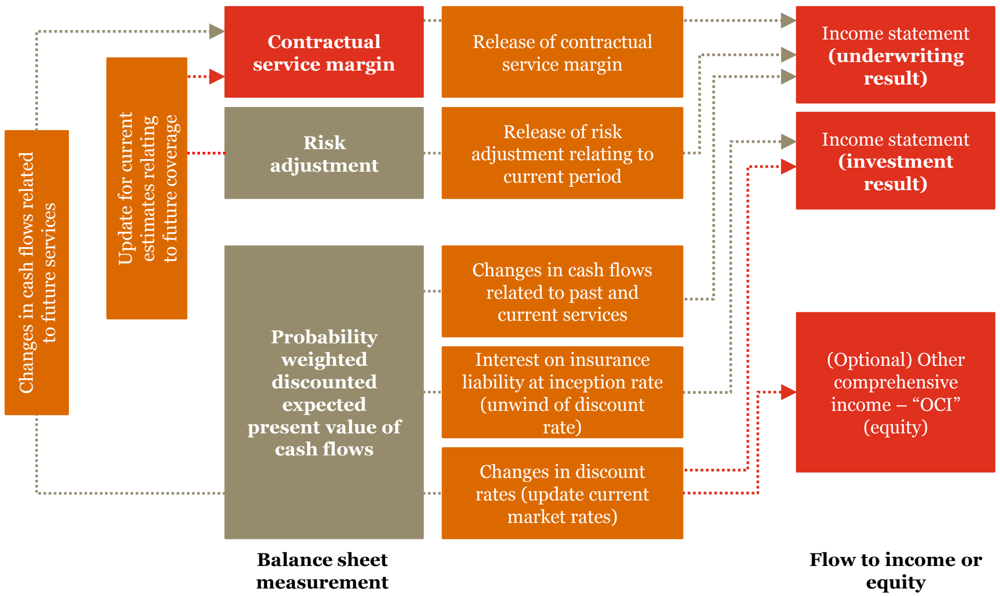
Applying the PAA to the pre-claim period may prove similar to accounting based on unearned premiums as currently applied under many GAAPs. However, the PAA relies upon premiums received and future premiums are not factored into the calculation. A BBA approach with discounting of expected claims payments will still be required for incurred claims unless it is anticipated that amounts will be settled within a year (in which case there is a further simplification allowed). The Phase II models that general insurers may apply can be summarised as follows:

	Current IFRS/GAAP	BBA throughout	PAA	PAA and undiscounted incurred
Unexpired risk	Unearned Premium Reserve (UPR) less DAC	Contractual Service Margin Risk adjustment Discounting Best estimate of fulfilment cash flows	Akin to premium (less acquisition costs) unearned	Akin to premium (less acquisition costs) unearned
Expired risk	Undiscounted reserves for past claims (including IBNR)	Risk adjustment Discounting Best estimate of fulfilment cash flows	Risk adjustment Discounting Best estimate of fulfilment cash flows	Risk adjustment Best estimate of fulfilment cash flows

Building block approach

General insurers writing multi-year contracts with greater variability in expected future cash flows are expected to be required to use the BBA throughout a contract's life cycle. Even those who write contracts which are eligible for the PAA may choose to use the BBA instead to seek consistency with discounted cash flow measures used elsewhere (for example, under regulatory bases such as Solvency II) or to provide richer financial information and insights. Please refer to our publication "Ready or not, here it comes? Status of IASB re-deliberations on the IFRS for insurance contracts and where we go from here – October 2014[1]" for a comparison between Phase II and Solvency II requirements.

The BBA model can be summarised as follows in terms of performance reporting:



PAA eligibility
Tougher than it looks…

The ability to use the PAA is determined by criteria which are likely to require some judgement to be applied. Whilst annual contracts with coverage periods of one year or less will automatically be eligible for the PAA, multi-year contracts will require assessment as to whether the PAA will provide a reasonable approximation of the BBA. This is likely to be difficult for more complex lines of business with greater variability in the expectation of future cash flows. Reinsurance arrangements will also need to be separately assessed.

The following diagram summarises the assessment that will need to be applied based on our current interpretation of the requirements:

Factors to consider	Decision tree		Typical lines of business affected
Contract boundaries under IFRS 4 Phase II (different to current accounting and Solvency II)	Is the coverage period one year or less? (Yes →) / No ↓	PAA is automatically applicable	All annual insurance contracts
Variability in your expectation of the present value of future cashflows	Is the PAA a reasonable approximation to the BBA? At contract inception, is it reasonably likely that expected present value of future cashflows will vary significantly in the period before a claim is incurred? (Yes →)	May be possible to construct an argument that PAA is applicable	Property damage type multi-year policies of 2 to 3 years
No definition of 'reasonable approximation'	Other considerations to determine whether the PAA is a reasonable approximation to BBA (? →)	More difficult to construct an argument that PAA is applicable	Construction, energy, engineering, A&H, D&O, credit, surety and long duration property damage type multi-year policies

What should general insurers be doing now?

- General insurers should **familiarise themselves with the Phase II project**, its status and expected content and should continue to **monitor developments**, notably around the expected effective date of the new standard.
- Entities currently **undergoing or planning systems development work** or data collection or storage projects should seek to understand the operational implications of Phase II on these projects. Phase II requirements should be incorporated where feasible or a means of considering their implications should at least be built into project management procedures.
- The level of implementation effort anticipated and the financial impact of the new standard are likely to be significantly affected by the particular accounting model applied under Phase II. Accordingly, an early area of focus should be around establishing the extent to which the PAA can be applied to contracts written through a **PAA eligibility assessment**.
- Having carried out such an assessment, **decisions around whether the PAA option would be utilised** when available should be considered. It is possible that operational, communication or consistency concerns may undermine the perceived benefits of its simplicity resulting in wider scale use of the BBA than initially anticipated.
- Early consideration of Phase II **project planning** will allow projects to kick off effectively and efficiently at the appropriate point in time.
- Where **IFRS 9** is expected to be effective before Phase II (subject to current IASB and EU deliberations on deferral for insurers), initial classification and measurement options under that standard will need to be assessed for insurers' investment portfolios. The implications of applying Phase II to an insurers' liabilities should form part of this assessment. Related Phase II policies such as the ability to use OCI for discount rate changes will need to be given consideration in this regard.

Contact us for further information

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