# Agenda

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Insights

Eimhear McCarthy

Visit: www.menti.com
Use code: 13 9734
Variable Fee Approach (VFA)
Colin Murphy
Variable Fee Approach Overview

- **Modification to the general measurement model** for valuing insurance contracts with payments that vary with return on underlying assets.

  Treats returns on the assets underlying these contracts as part of the fee that the entity charges the policyholder for the services provided.

  *Per paragraph B104: a variable fee comprises of “the entity’s share of the fair value of the underlying items” less “fulfilment cash flows that do not vary based on the returns on underlying items”*

- **VFA** must be applied to contracts that meet the definition of a **direct participating contracts**.
Variable Fee Approach (VFA)
Participating contracts

Conditions for eligibility

1. The contractual terms specify that the policyholder participates in a defined share of a clearly identified pool of underlying items.

2. The entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns from the underlying items; and

3. A substantial proportion of the cash flows that the entity expects to pay to the policyholder should be expected to vary with the change in fair value of the underlying items

Participating contract assessment

- Assessment is made at initial recognition
- No future assessment is required, unless there is substantial modifications to the contract
Variable Fee Approach

Typical Types of Contract

1. Unit-linked with Rider benefits and/or other material insurance benefits

2. Variable annuities

3. Conventional With-profits

4. Unitised With-profits
Distinct investment components must be separated from the host insurance contract. The investment component is distinct only if both the following conditions are met:

- The investment component and the insurance component are not highly interrelated.
- A contract with equivalent terms is sold or could be sold separately in the same market or the same jurisdiction.
Reinsurance contracts either held or issued cannot be measured under the variable fee approach.

Board concluded that allowing the VFA to be used to measure reinsurance contracts would be inconsistent with its view that a reinsurance contract held should be accounted for separately from the underlying insurance contracts issued.
Variable Fee Approach

Hedging

• IFRS17 gives entities an option to exclude the impacts of risk mitigation from the CSM, if these criteria are met:
  • An entity uses a derivate to mitigate the financial risk arising from the insurance contracts;
  • An economic offset exists between the insurance contracts and the derivative;
  • Credit risk does not dominate the economic offset
• If an chooses not to adjust the CSM for risk mitigation it will have to disclose
### Variable Fee Approach (VFA)

**Comparison of VFA to BBA – Interest Rates**

<table>
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<th>Discount rates used to determine CSM adjustments</th>
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<td>• In the general measurement model, the discount rates used in the BEL and RA calculations to determine CSM adjustments are locked in at inception of the contract.</td>
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<tr>
<td>• In the variable fee approach, the discount rates used in the BEL and RA calculations to determine CSM adjustments are implicitly the current interest rate.</td>
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<table>
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<th>CSM interest rate accretion</th>
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<tr>
<td>• In the general measurement model, the interest is accreted using the rate locked in at inception of the contract.</td>
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<tr>
<td>• In the variable fee approach, the interest is implicitly accreted in the change in variable fee, using the current interest rate.</td>
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Variable Fee Approach

Other Challenges

Third Party Administrators

- Granularity of information provided. Split of cash flows by year, insurance/investment, onerous/not onerous/other.
- Must engage with TPA’s early in the project
Risk Adjustment and Discount Surveys
Carol Lynch
The General Model requires significant provisions for the reporting of risk adjustment under IFRS 17

“The compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arise from non-financial risks as the entity fulfills insurance contracts.”

• Reporting a risk adjustment (RA) as a separate balance sheet liability
• Reporting liabilities on a discounted present value basis
• Releasing the risk adjustment each period through re-measurement of the risk and uncertainty for future remaining cash flows
• Assigning a value to risk and uncertainty
  – Specific entity’s compensation for bearing risk
  – Considers all aspects of non-financial risk & uncertainty;
  – Financial risks excluded, such as investment returns (cash flows not directly tied to contract cash flows)
  – Amount that makes the entity indifferent between uncertain vs. fixed cash flows
• Reporting of liabilities gross of reinsurance and reporting an asset for ceded reinsurance risk adjustment to account for reduction of risk
Presentation of the Risk adjustment survey

We constructed a **Risk Adjustment Survey** based on IFRS 17 projects performed by Deloitte for other clients in the world to **get a picture of their current state regarding the Risk Adjustment topic.**

Although all the companies **are within the journey** of defining the Risk Adjustment principles, approach, process and tools, this survey allows us to **identify any current orientations.**

**The survey covers more than 25 insurance companies**

- **By region:**
  - EMEA: 39%
  - Global: 30%
  - APAC: 22%
  - The EMEA region is the most represented with almost 40%, followed by the APAC region 30%.

- **By activity:**
  - Life: 26%
  - Non Life: 47%
  - Life & Non Life: 21%
  - Breakdown by main activity of the actors surveyed. The sample covers all sectors of activity.

- **By size (Md €):**
  - GWP < 5: 23%
  - 5 < GWP < 15: 45%
  - 15 < GWP: 32%
  - Breakdown by turnover. The sample shows a good diversity in size of companies.

- **Use of Internal Model for Capital computation:**
  - YeS: 26%
  - No: 74%
  - A quarter of the respondents surveyed have an internal model for calculating the SCR.
Survey – General Methodology for the RA

**Question:** Have you opted for a general methodology for RA?

- Cost of Capital: 48%
- Quantile based on assumption choices: 22%
- Quantile based on stochastic scenarios: 22%

**Question:** Do you plan to take into account group diversification?

- Yes: 30%
- No: 48%
- Not defined: 22%

**Question:** Do you believe that RA will be a significant P&L steering component under IFRS 17?

- Yes: 35%
- No: 65%
## Risk Adjustment: Practical implications

### RA must be available at the granularity required for the contract test

RA being part of the onerous contract test and bundling of contracts

### RA is an integral part of the AoC * and therefore the construction of the IFRS 17 P&L

The analysis of the variations will require to calculate the adjustment for the risk several times for the various stages:

- Release of risk
- Changes in non-economic assumptions
- Changes in economic assumptions
- Release of risk adjustment on old contracts
- Experience gaps

### The critical path of the fence and the RA

The option to have a calculation of the risk factors out of the critical path of the closing process will have to be considered: Consider sensitivity of the quantile...

- Study of the stability of technical risks
- Consideration of sensitivity of the quantile...
Survey – General Methodology for the RA

**Question:** Do you plan to calculate the RA for each step of the IFRS 17 Analysis of change required to produce the P&L and the CSM?

**Survey results**
- No: 4...
- Multiple steps: 26%
- Not defined: 30%

**Question:** From a process perspective, do you expect to use current period data or previous period data? (ex. SCR of the closing or SCR of the previous closing)

**Survey results**
- Actual data: 48%
- Previous data: 17%
- Not defined: 35%

**Question:** For RA calculation you might expect either to re-use existing tools or to set up a new dedicated tool. Have you defined any system orientation for RA measurement?

**Survey results**
- Maximise the re-use of existent tools: 13%
- Develop new specific tools: 87%
Discounting: Different approaches under IFRS 17

**Top-Down Approach**

- **Yield rate deduced from a real or a fictive assets portfolio**

**Bottom-up Approach**

- **Risk free discount rate**

The liq premium can be deduced using:

1. Market derivatives like CDS
2. Historic data or Merton model
3. Volatility Adjustment *
4. Matching Adjustment*

- It is required to use market data when possible

**IFRS 17 Discount Rate**

The reference portfolio can be:

1. fictive
2. real

- The actual portfolio may be based on the investment portfolio in front of the insurance liabilities. Techniques such as replicating portfolios can be used to build a fictive portfolio.

We deduce the part of premium that is not related to the characteristics of the insurance contracts:

- The risk premium deducted from the performance of the reference portfolio must correspond to the performance of the asset that does not reflect the characteristics of the liability.

Many possible choices for a risk free discount rate:

1. EIOPA’s discount rate without VA (ie 6 months swap rate risk-corrected)
2. Swap rate
3. EONIA rate

- Choice went for EIOPA’s risk free rate without VA ➔ there is a need to review EIOPA’s assumptions (LLP, UFR and extrapolation method)
Discount Rate under IFRS 17 – Survey Results
Profile of the Respondants

[Diagrams showing business and geographical distribution with percentages]
**Question:** At which granularity are you defining a discount rate?

**Survey results**
- 45%
- 44%
- 11%

- Per business line (usually reporting lines because liquidity is assessed to be the same between products within the same LoB)
- Ongoing discussions

- Per cohort (each cohort has a different liquidity characteristics therefore it should be projected with a specific DR)

**Question:** For cashflows that do not vary based on returns on underlying items, which methodology are you planning to use?

**Survey results**
- 67%
- 33%
- 0%
- 0%

- EIOPA’s methods (MA or VA) mix between top-down and bottom-up
- Bottom-up
  - Top-down
  - EEV Liquidity Premium
  - Other

**Question:** If the bottom-up approach is selected which risk free rate will you use?

**Survey results**
- 17%
- 17%
- 33%
- 33%

- EIOPA’s risk free rate (without VA) but after reviewing UFR and LLP
- Swap rate
- OIS rates
- Local government interest rates
**Survey - Discounting**

**Question:** What would be the key objectives when defining an IFRS 17 compliant discount rate methodology? (Multiple choices possible)

- Maximise CSM
- Reducing P&L volatility
- Optional impact at transition
- Process efficiency
- Other

**Survey results**

- Maximise CSM: 32%
- Reducing P&L volatility: 10%
- Optional impact at transition: 32%
- Process efficiency: 21%
- Other: 5%

**Question:** Which techniques do you use to calibrate illiquidity premium for liabilities in the case that you use a bottom-up approach?

- Solvency II techniques (MA, VA): 56%
- CDS: 22%
- Covered Bonds: 11%
- Matching adjustment: 11%
- Other: 2%

**Survey results**

- Solvency II techniques (MA, VA): 60%
- CDS: 20%
- Covered Bonds: 20%
- Matching adjustment: 0%
- MCEV liquidity premium: 0%
- Other: 0%
IFRS 17 Implementation Roadmap
Carla Dunne
Where to start?

- Program Governance (summary of sponsor, workstreams, SteerCo)
- Hold workshops with key program resources
- Define critical path activities
- Assign resources to understand true impact and constraints
- Finalise Project Charter
Critical path to IFRS 17 go-live

H2 2019

- Mobilise
- Impact assessment
- Policy & Interpretation
- E2E solution
- High level design
- Communication

2020

- Requirements
- Design, build, test
- Dry-runs

2021

Go-live (IFRS 17 and IFRS 9)
First half year IFRS 17 financial statements published (if applicable)
First IFRS 17 full financial statements published

2022

Cut-off for 1st opening balance

2023

* Illustrative for entities with 31 December year-ends

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Next Steps
What are the ground rules?

Why?
- Because you have to, i.e. Compliance only
- Because you want to, i.e. Transformational agenda

What?
- Start right to left
- What disclosures need to be populated?
- What do you need to populate from your systems?
- What do you need to do to your chart of accounts?
- What do you need to do to your performance metrics?
- What data do you need to enhance versus what is actually missing?
- What do you build versus what do you buy?

Centralised versus Decentralised
- Impact of regulatory asks in each jurisdiction you operate in?

Where?

How?
- How do you assess impacts to existing systems?
- How do you define the data required to deliver compliance?
- How do you deal with ambiguity in technology options, i.e. end-to-end insurance package?
- How do we deal with key dependencies of IFRS17?

When?
- Difficulty in dealing with a deadline that is 30 months away
- Ability to generate midpoint deadlines to drive momentum?
- Ability to capture detailed planning to a reliable level of accuracy
Next Steps

- Prepare roadmap to 2022
- Prepare detailed plan to end of 2019 with deliverables and owners
- Validation workshops with key program resources
- Align next steps and governance
- Lock down 2019 plan and roadmap’
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