



Deloitte Finance Club
The community for Financial
Controllers and senior financial
executives

Wednesday, 19th November 2014



Deloitte Finance Club

A few facts

- Established in **May 1997** as the *Financial Controllers' Club*, and renamed **Deloitte Finance Club** in 2013
- Provides an **annual programme of technical updates and hot topic briefings**
- Connects our members to relevant experts as well as over **2,200 members** across the country

Deloitte Finance Club

Upcoming programme

- [Holiday finance checklist 2014](#)

Wednesday, 10 December 2014 – 8:30am-10:30am (arrivals from 8am)

2015 programme to be released soon

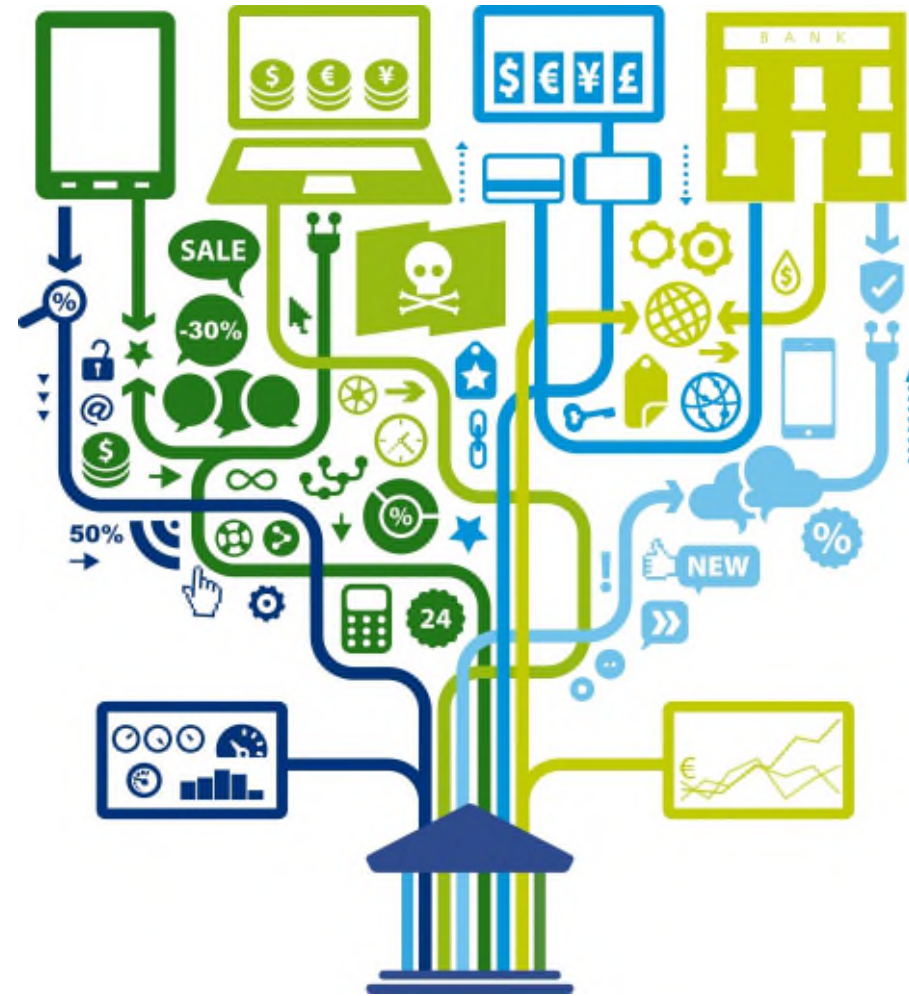
Key trends and developments in UK insurance

Agenda

- **Alex Arterton** – opening remarks
- **Peter Evans** – Insurance disrupted
- **Kush Patel** – IFRS 9
- **Derek Haynes** – IFRS for Insurance Contracts

Insurance disrupted

How technology is changing the traditional UK general insurance model

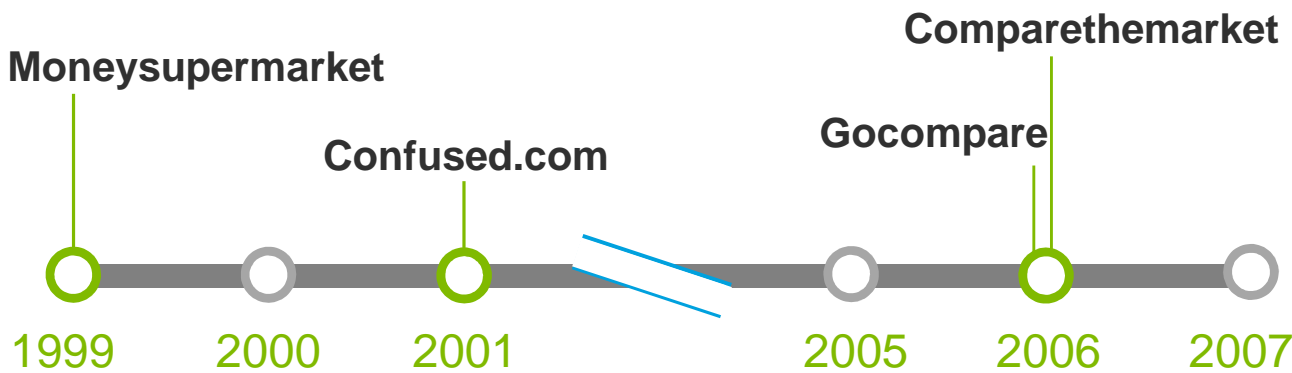


Insurance disrupted

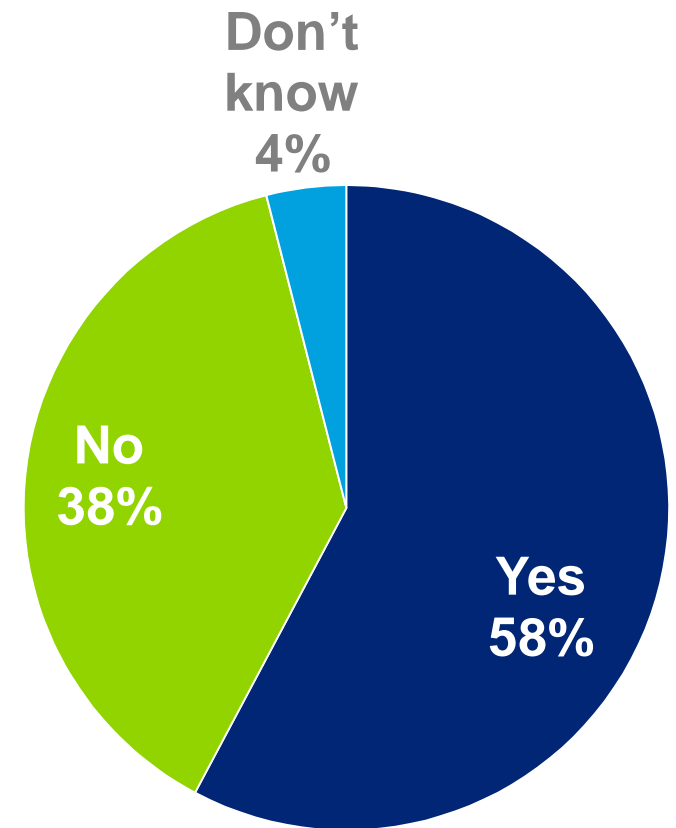
Key messages

- The internet causes major disruption to business models
- Price comparison websites have eroded profit margins...
... creating big issues for the CFO
- Customers continue to rely on the phone to communicate with their insurers, they will move to the internet
- Is telematics the future?

The use of price comparison websites (PCWs) has grown rapidly



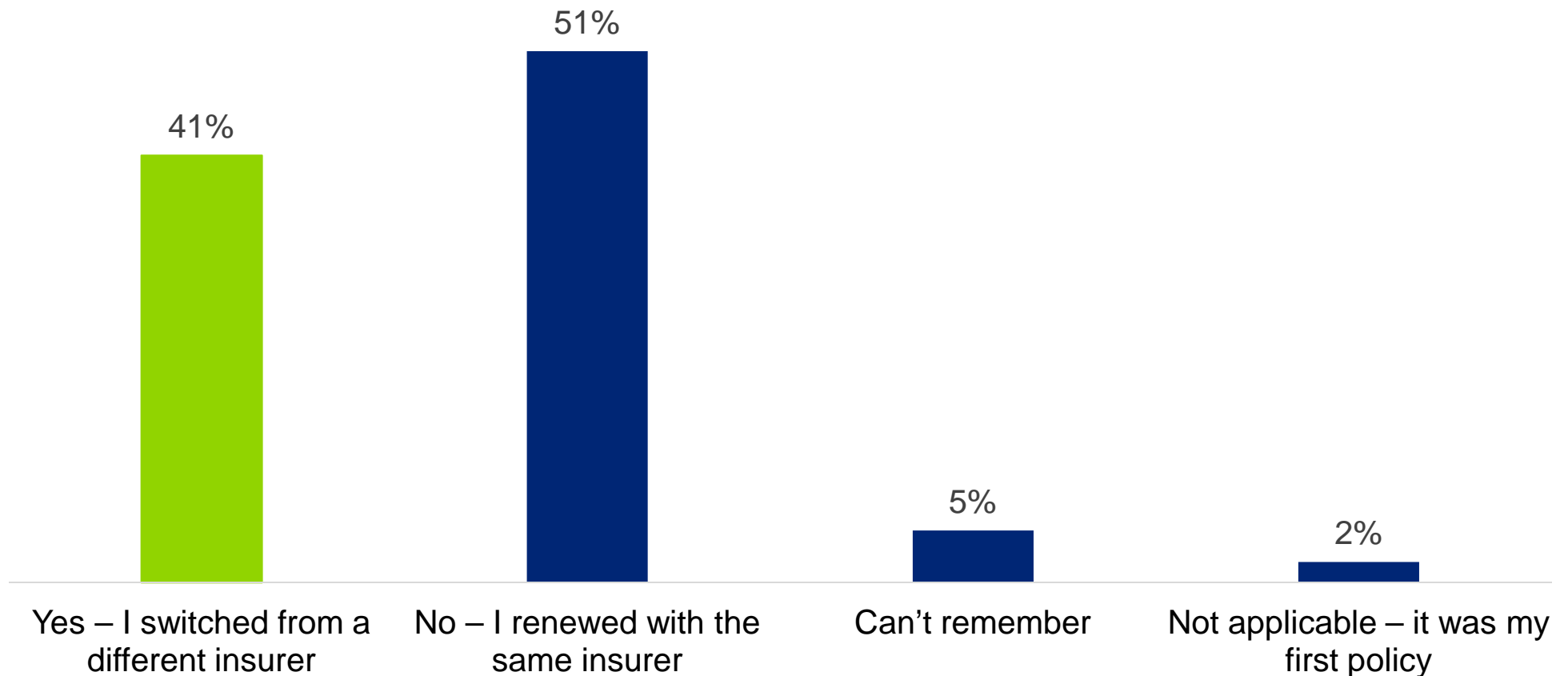
% customers who use price comparison websites



Source: Deloitte Insight/YouGov, 10-16 April 2014. Sample: 2,849

Customers switch general insurer frequently

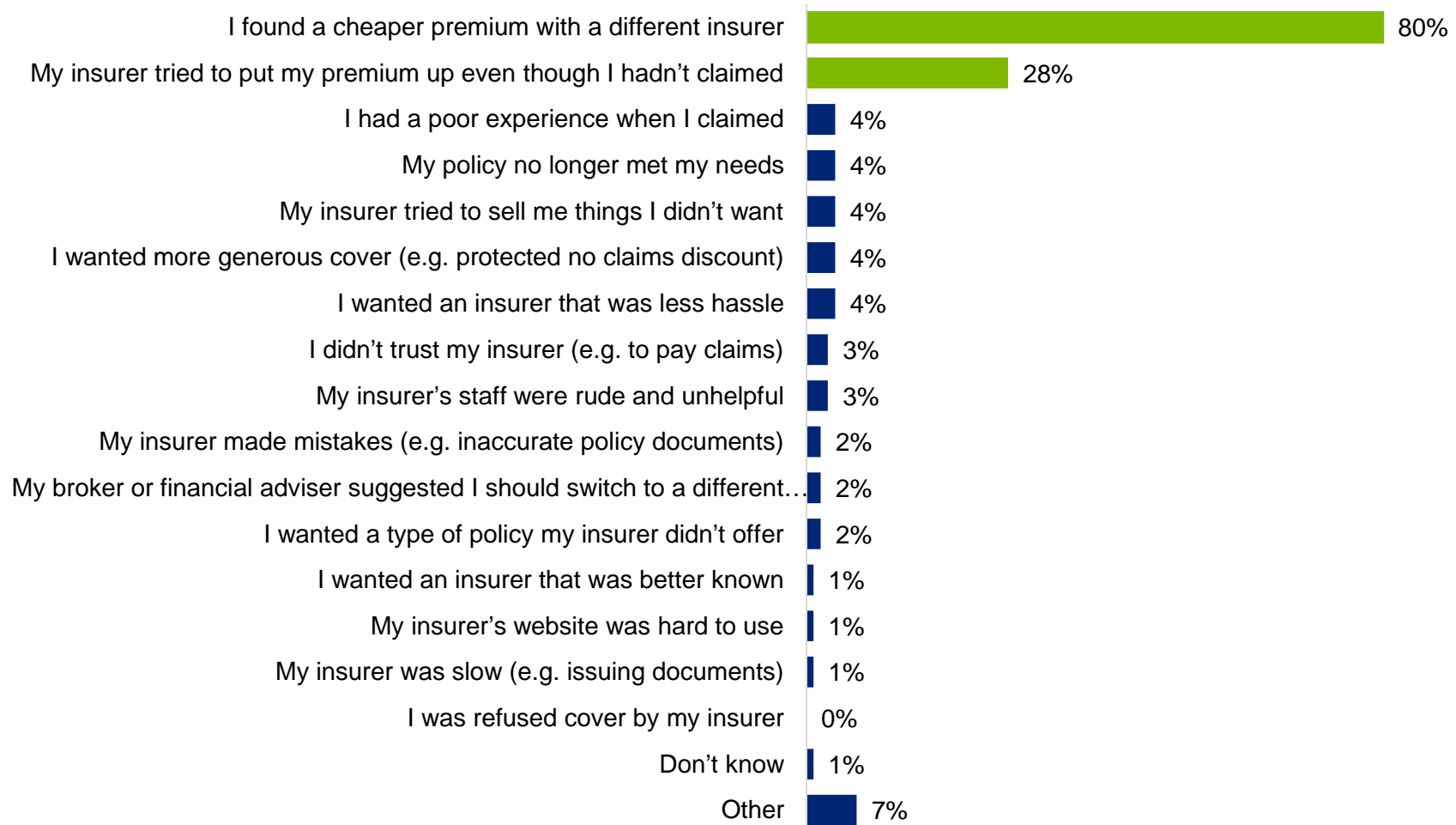
% motor, buildings or contents customers who switched from a different insurer at last renewal



Source: Deloitte Insight/YouGov, 10-16 April 2014. Sample: 2,849

Price is the overriding reason customers switch

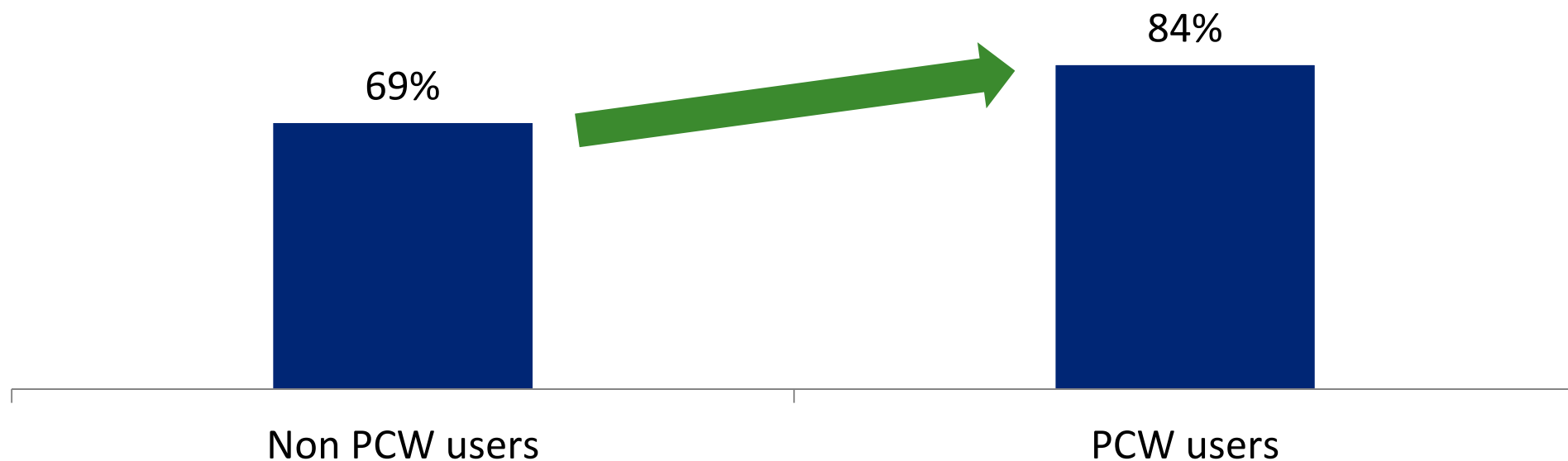
% motor, buildings or contents customers who switched from a different insurer at last renewal – by reason (respondents chose multiple reasons)



Source: Deloitte Insight/YouGov, 10-16 April 2014. Sample: 1,180

PCWs make customers more likely to switch on price

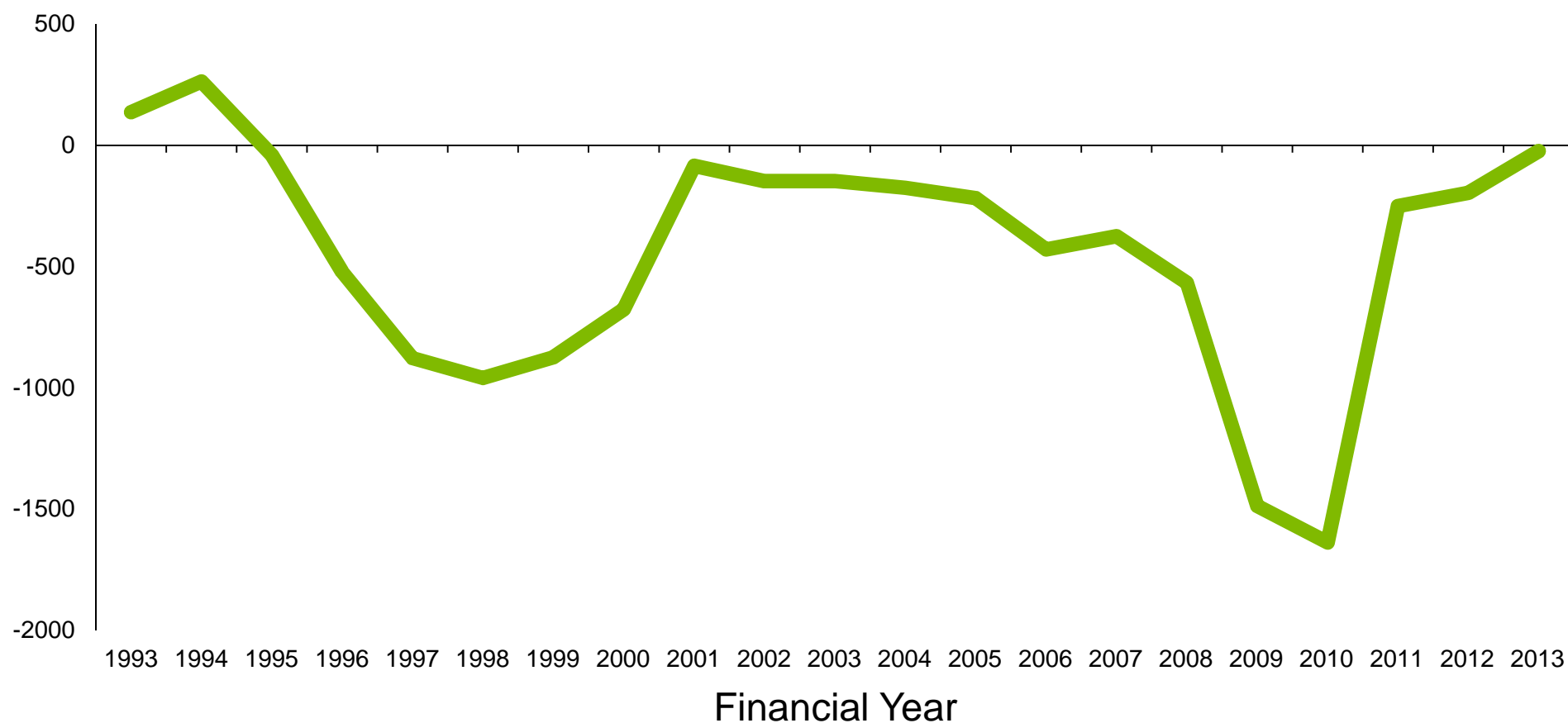
% motor, buildings or contents customers who switched from a different insurer at last renewal because they found a cheaper premium – by PCW users



Source: Deloitte Insight/YouGov, 10 – 16 April 2014. Sample: 1,160

Price comparison websites have put already-low motor insurance margins under pressure

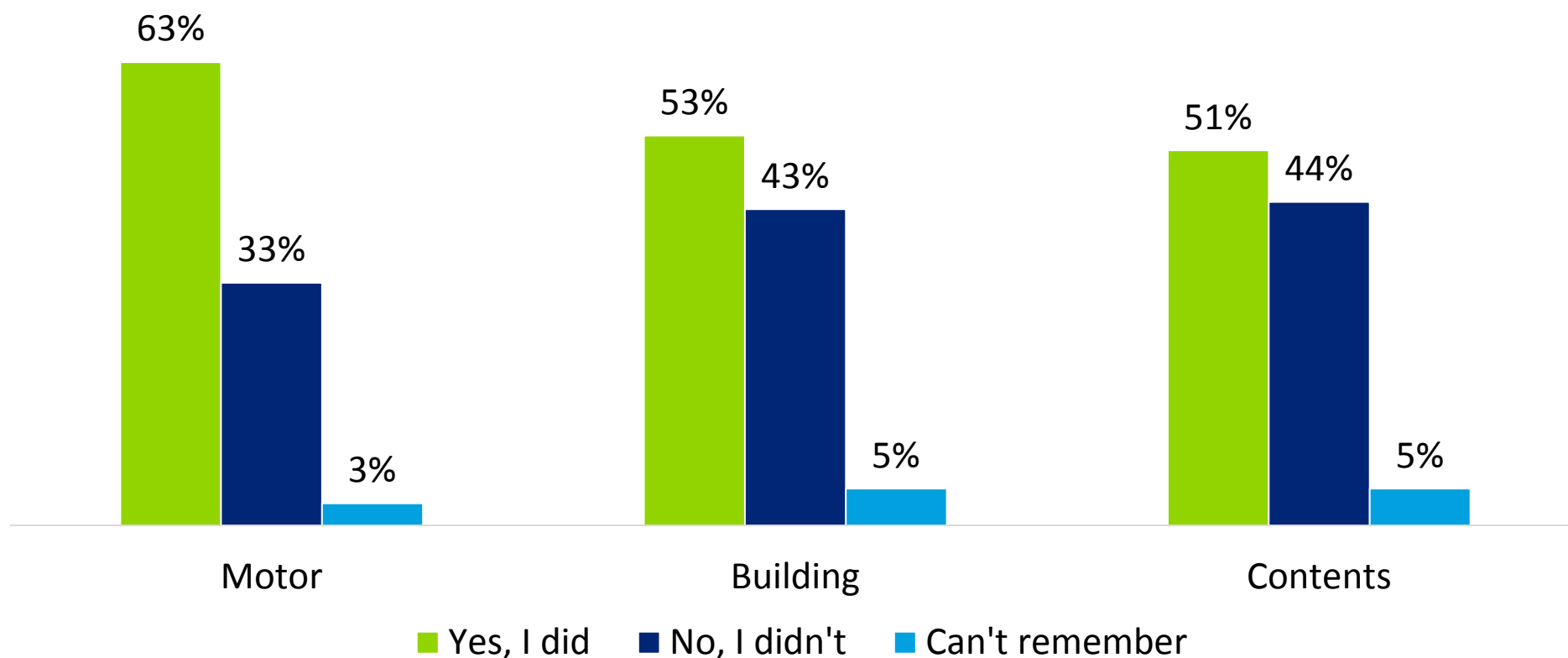
UK domestic motor insurance underwriting results 1993-2013 (£m)



Source: ABI Statistics

PCWs are most widely used for motor insurance, use for other products is likely to increase

% motor, buildings or contents customers who used a price comparison website before buying current policy – by type of policy



Source: Deloitte Insight/YouGov, 10-16 April 2014. Sample: 1,435 (Motor); 717 (Buildings); 697 (Contents)

Customers will interact with their insurers more in digital channels

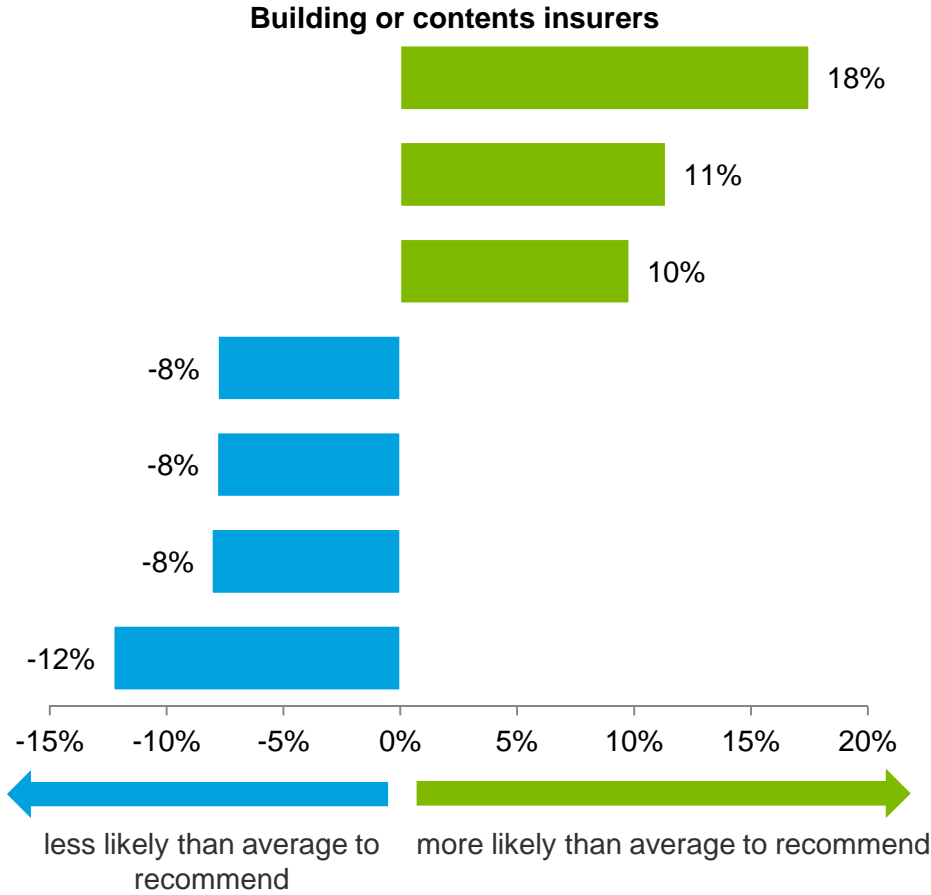
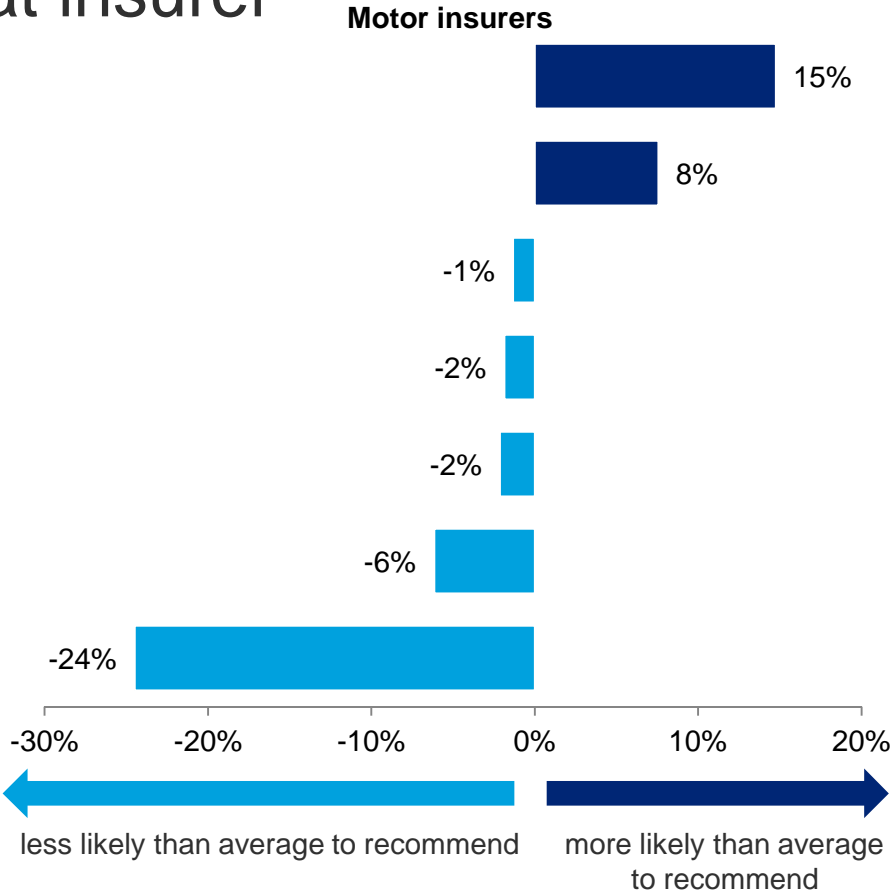
% motor, buildings or contents customers who communicate with their insurer – by channel



Source: YouGov survey for Deloitte – Sample: 238

Insurers have not yet created good enough web experiences for wider digital channel adoption

Likelihood of customers communicating via digital channels with insurer to recommend it vs. average across all customers at insurer



Digital channels: website, e-mail, online chat facility, smartphone app (all samples above 30)

Insurance disrupted

Where next?

- Telematics is the name for technology that captures and analyses data on driving, replacing demographic and postcode-based risk assessment

Two types:

- **Pay-As-You-Drive:** GPS device monitors distances driven; insurer charges based on distance driven
- **Pay-How-You-Drive/Usage Based Insurance:** monitors driving behaviour. GPS device with integrated accelerometer that monitors:
 - **Location** – motorways vs. neighbourhood, city vs. suburbs, distance from home
 - **Frequency** – daily vs. occasional, mileage, rush-hour vs. off-peak
 - **Behaviour** – acceleration, speed vs. limit, braking, cornering, crash data, lane changing

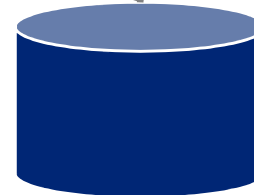
How it works



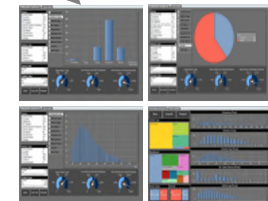
Device collects data on location, time and driving behaviours



Data is transmitted over networks



Data is collected and stored in databases



Data is processed using algorithms and insights are generated for insurer as well as customer



All change! Major accounting
changes for Insurers
IFRS 9

Kush Patel



Overview

The IASB has issued the final version of IFRS 9 Financial Instruments on 24 July 2014

Classification and measurement

Impairment

General hedge accounting

Macro hedge accounting

July 2014

International Financial Reporting Standard

IFRS 9 Financial Instruments



Separate project

Transition and effective date

IFRS 9 shall be applied for annual periods beginning on or after



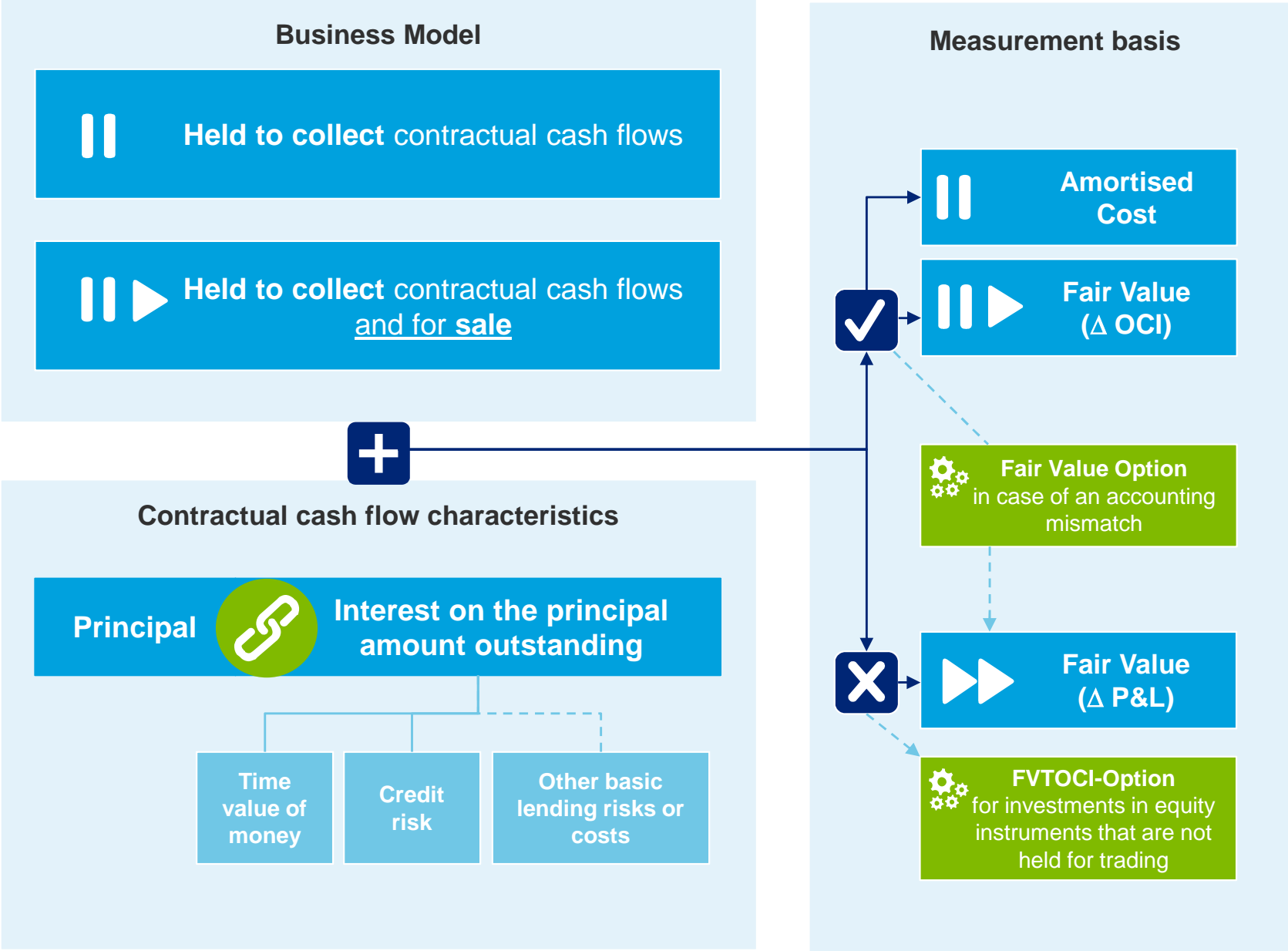
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retrospective

- No need to restate prior periods
- Application of all requirements of IFRS 9 (2014)
- Exemption: Financial liabilities designated at fair value through profit or loss

Early application permitted



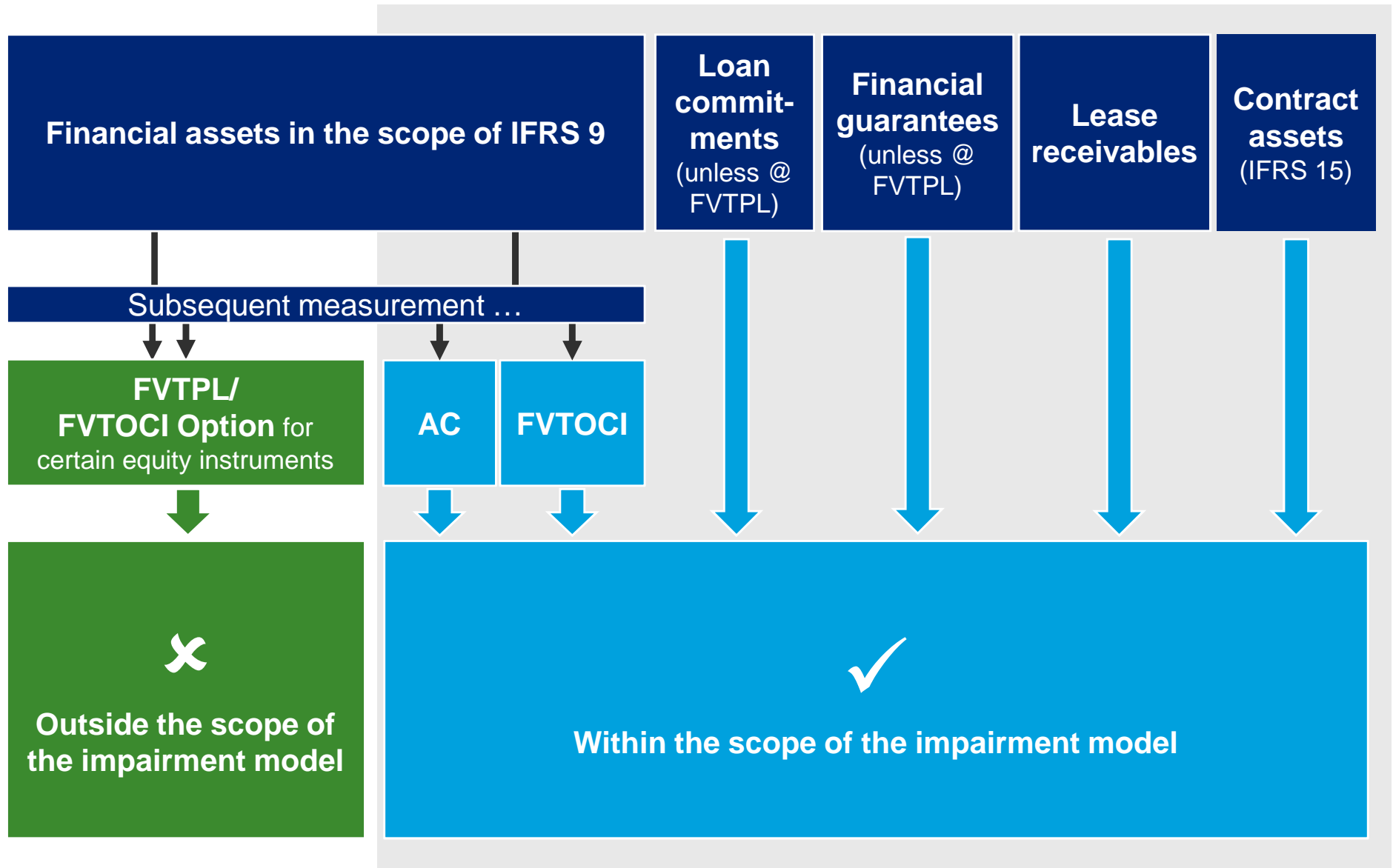
Classification of financial assets



Measurement of financial assets

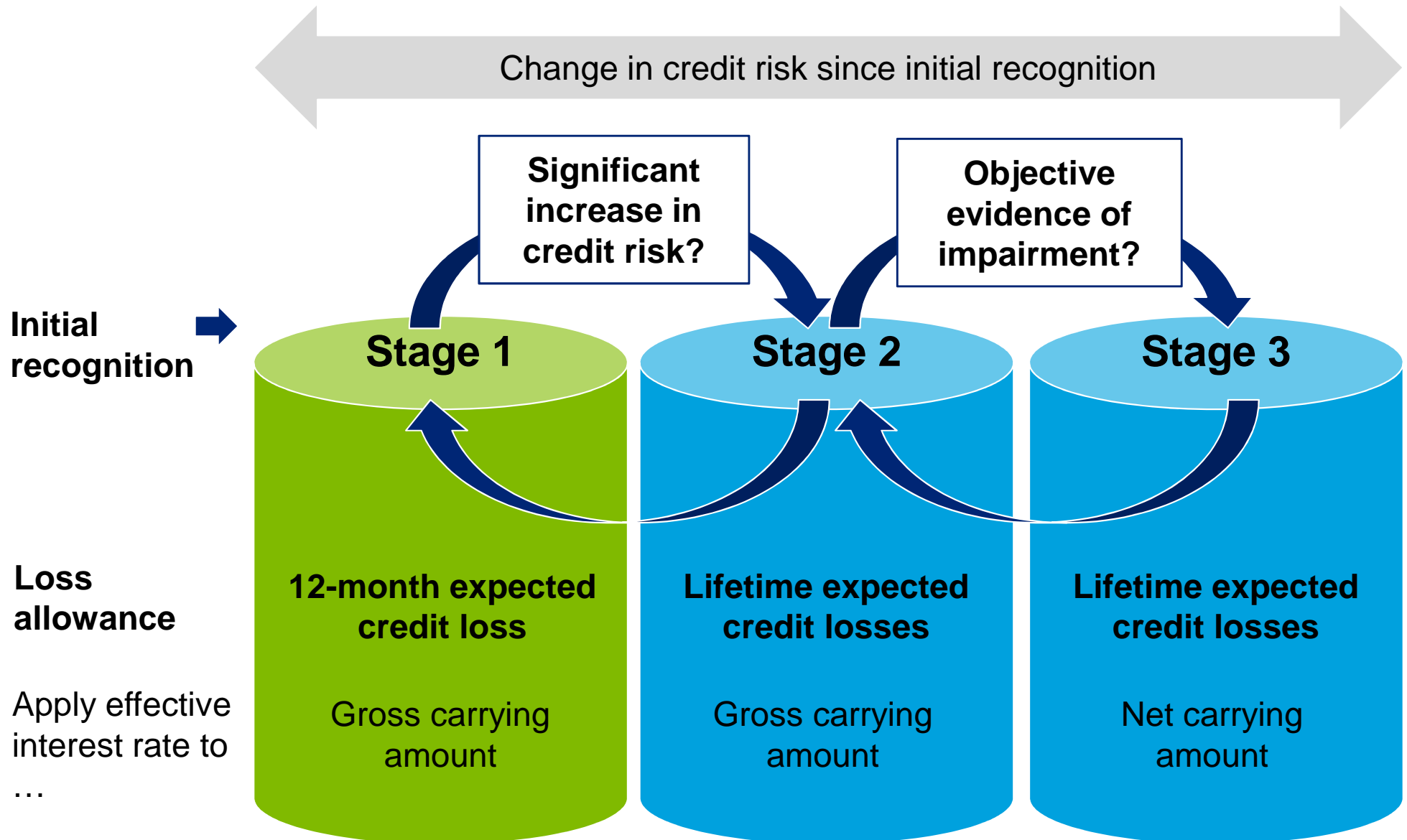
Initial recognition	Fair Value measurement			
	Certain debt instrument	Certain debt instrument	Certain debt instruments, equity investments & derivatives	Certain equity investment
Statement of financial position	Amortised cost	Fair value through OCI	Fair value through P&L	Fair value through OCI
P&L	Effective interest method, impairment & foreign exchange differences	Effective interest method, impairment & foreign exchange differences	(all) Fair value changes	Dividends
OCI ↓	---	(other) Fair value changes	---	(all) Fair value changes
Recycling	---	Yes	---	No

Impairment – scope



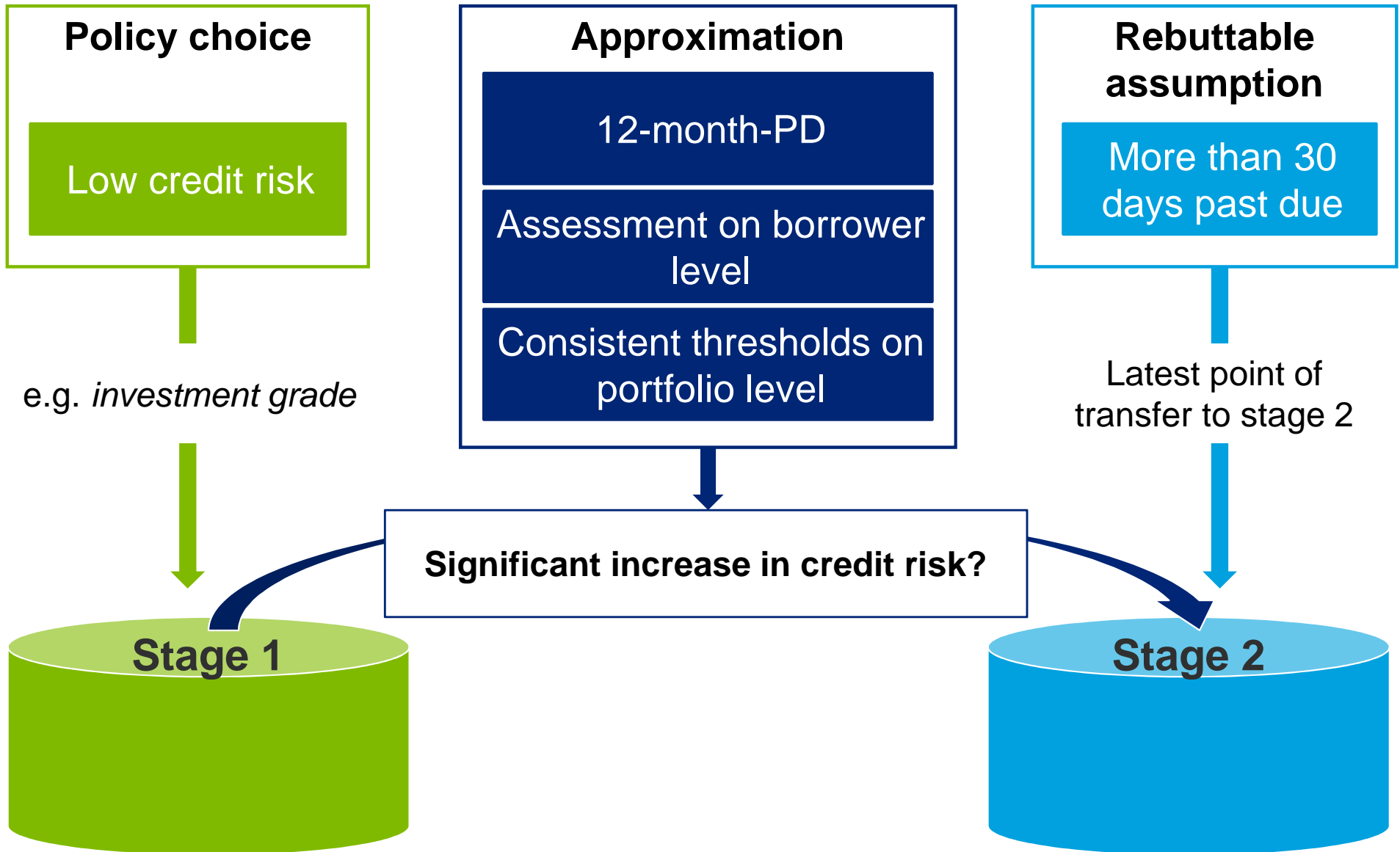
Expected loss model

General impairment model

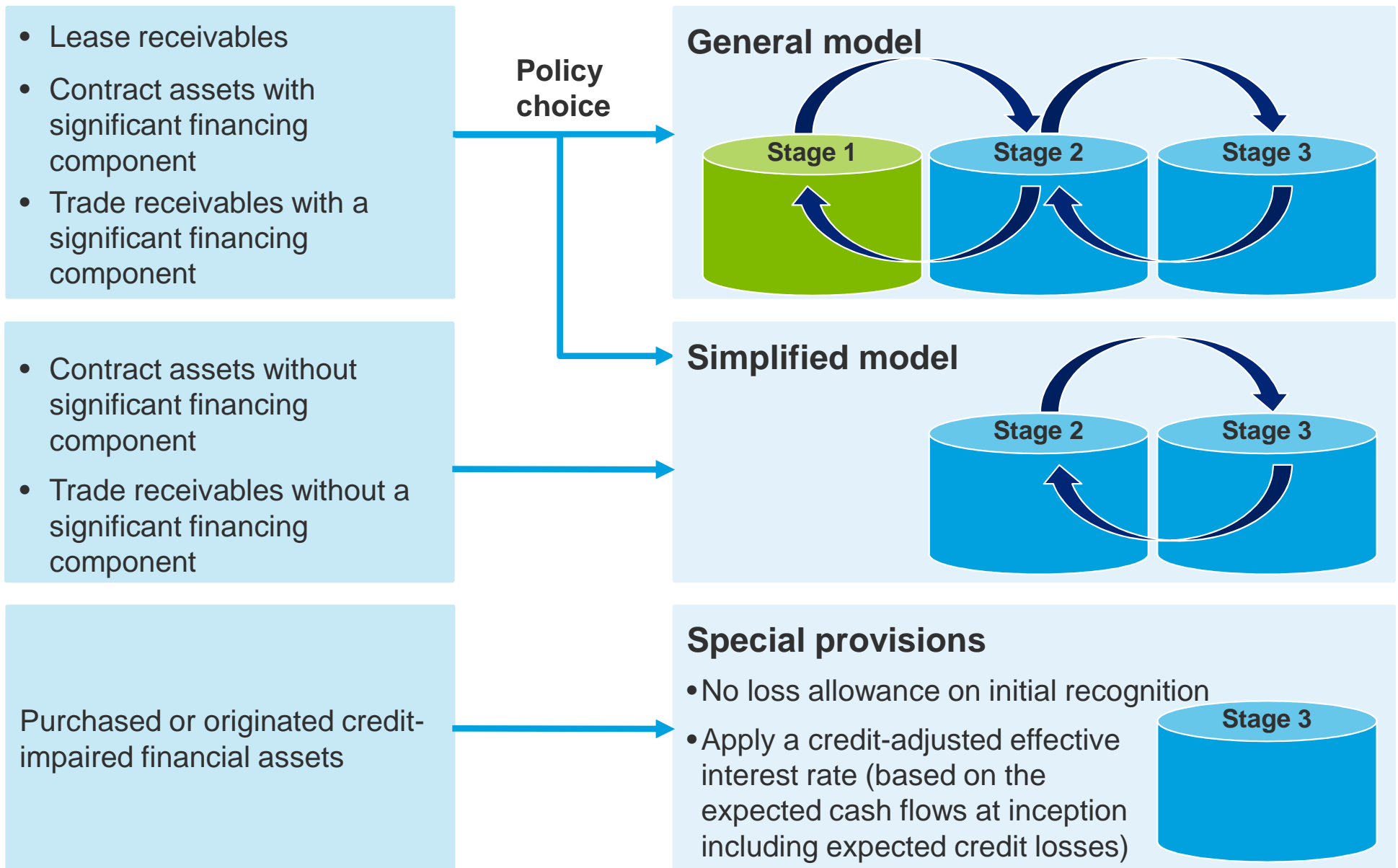


Transfer out of Stage 1

Assumptions and approximations



Exemptions from the general model



All change! Major accounting changes for Insurers IFRS for Insurance Contracts

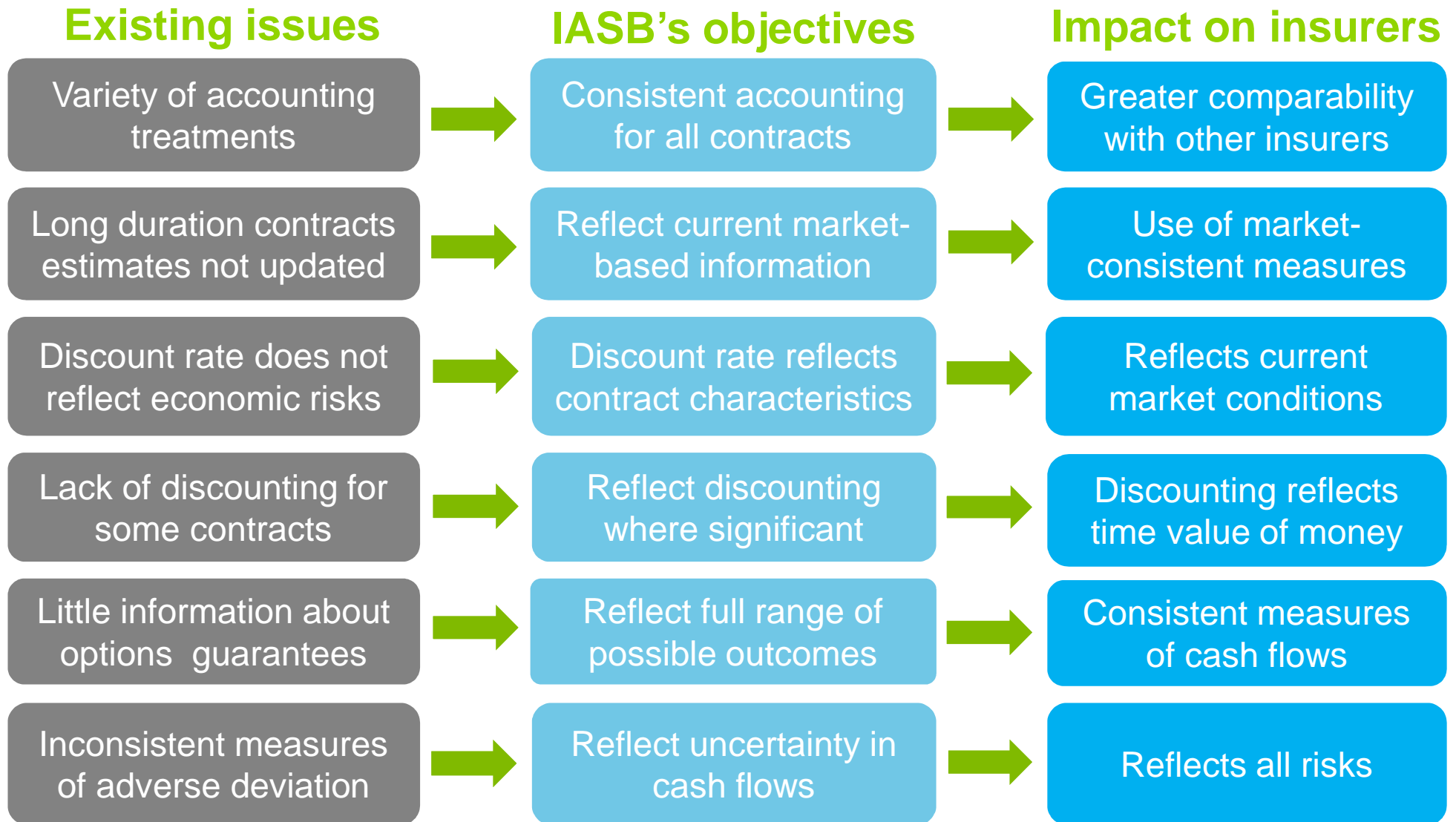
Derek Haynes



Background to the new IFRS for insurance contracts

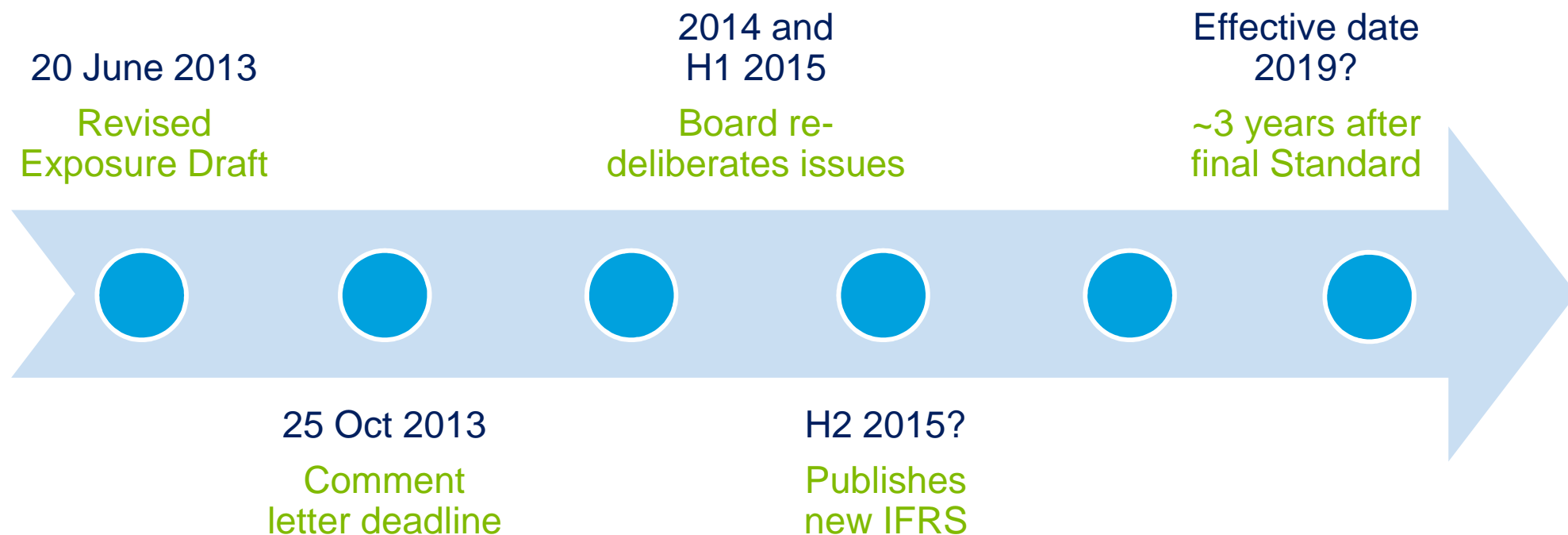
New IFRS for Insurance Contracts – background

Consistent, transparent method of accounting



New IFRS for Insurance Contracts – background

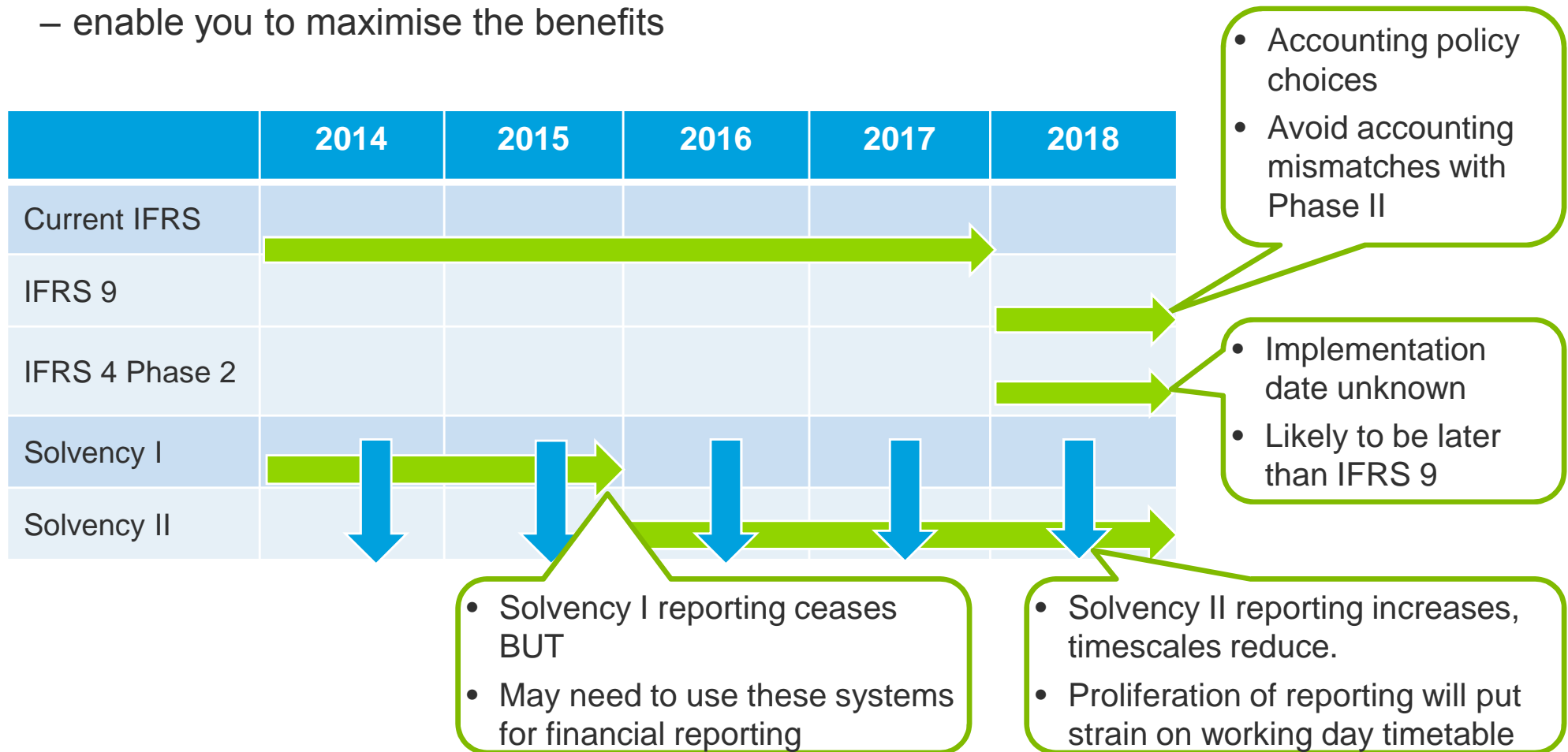
Latest estimate of timeline



New IFRS for Insurance Contracts – background

A tough few years, but you should see benefits

- A sequence of demanding changes to reporting requirements
- Early planning will:
 - minimise the impacts on your business; and
 - enable you to maximise the benefits



IFRS 4 Phase II – progress to date

IFRS 4 Phase II

Progress to date – major topics

Description of the topic (** re-exposed)	Redeliberation complete?
Definition and Scope	Yes
Unbundling	Yes
Which Cash-Flows?	Yes
Contractual Service Margin **	Yes, subject to participating contracts
Level of aggregation	Yes
Discount rate and OCI solution **	Yes
Risk Adjustment	Yes
Participating Contracts **	To be completed early 2015?
Reinsurance assets	Yes
Premium Allocation Approach	Yes
Presentation **	Yes
Disclosure	Yes
Transition **	Yes, subject to participating contracts

IFRS 4 Phase II

Progress on re-deliberating 2013 Exposure Draft

Exposed topics

- Unlocking the CSM – **DONE**
- Insurance revenue – **DONE**
- OCI solution – **DONE**
- Transition - **DONE**



All decisions reached for contracts with NO participating features only at this stage

Non-targeted issues (all **DONE**)

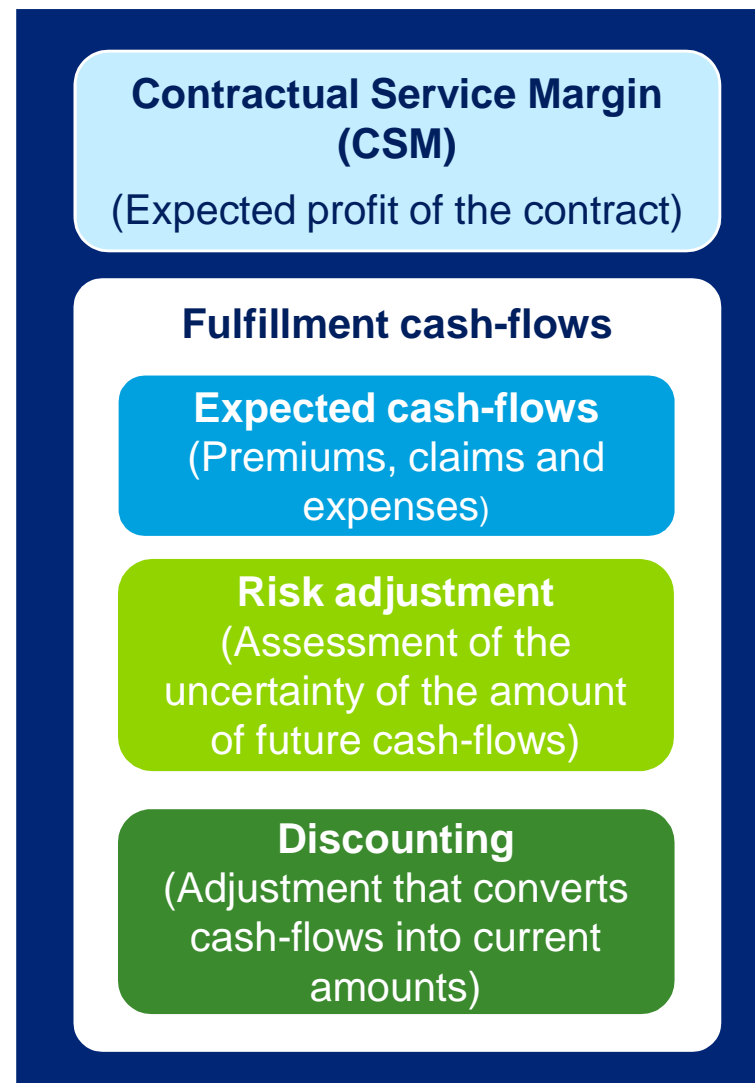
- CSM earning pattern
- Gains on reinsurance contracts
- Level of aggregation and portfolio definition
- Non-observable discount rates
- Significant insurance risk
- Fixed fee service contracts
- Portfolio transfers and business combinations
- PAA – revenue and interest expense

IFRS 4 Phase II overview

Building Block Approach

Overview of measurement

- The value of the insurance contracts consists of the **present value of the fulfilment cash-flows** and a **contractual service margin**
- The present value of the fulfilment cash-flows includes a **risk adjustment**, which reflects the uncertainty in the cash-flows



Building Block Approach – fulfilment cash-flows

Cash flows

Current estimate of **all cash-flows** that will arise, being:

- Premiums;
- Claims and benefits paid to policyholders, plus associated costs;
- Cash-flows resulting from options and guarantees;
- Costs (successful and unsuccessful) of selling, underwriting and initiating contracts; and
- Fixed and variable overheads directly attributable to fulfilling the portfolio.

Building Block Approach – fulfilment cash-flows

Risk adjustment

- An adjustment to reflect uncertainty in the estimate of fulfilment cash-flows
- Measures compensation required to make the entity indifferent between:
 - fulfilling an insurance liability with a **range** of possible outcomes; and
 - fulfilling a liability that will generate **fixed** cash-flows with the same expected present value as the insurance contract
- Re-measured at each reporting period
- Effects of diversification between portfolios is allowed
- No technique specified

Building Block Approach – fulfilment cash-flows

Discounting

- Adjusts cash-flows for time value of money
- Discount rate based on characteristics of the insurance liability:
 - Currency, duration, and liquidity
 - Consistent with observable current market inputs for instruments with similar cash flow characteristics
 - Rates should exclude factors not relevant to the insurance liability
- Updated each reporting period
- If amount, timing or uncertainty of cash-flows depend on return from underlying items the discount rate should reflect that dependency

Tentative decisions

June 2014 – Develop unobservable inputs using best information available, reflecting how market participants would assess such inputs

July 2014 – Contracts *without* participating features – use rate locked-in at inception to accrete interest and calculate present value of cash flows that unlock the CSM

September 2014 – Contracts *with* participating features – use rate locked-in at date claim incurred to determine interest expense

Building Block Approach

Contractual Service Margin (CSM)

- Risk-adjusted expected profit from a contract
- Eliminates any gain at inception of the contract
- Unlocked for changes to actuarial assumptions
- Interest calculated using locked-in discount rate
- CSM cannot be negative, i.e. the present value of losses must be charged immediately to profit or loss
- Amortised over remaining coverage period in a systematic way that best reflects the transfer of services

Tentative decisions

May 2014

- CSM unlocks for changes to actuarial assumptions
- CSM unlocks for changes to the risk adjustment due to changes in actuarial estimates
- Past losses should be recovered from a restored CSM

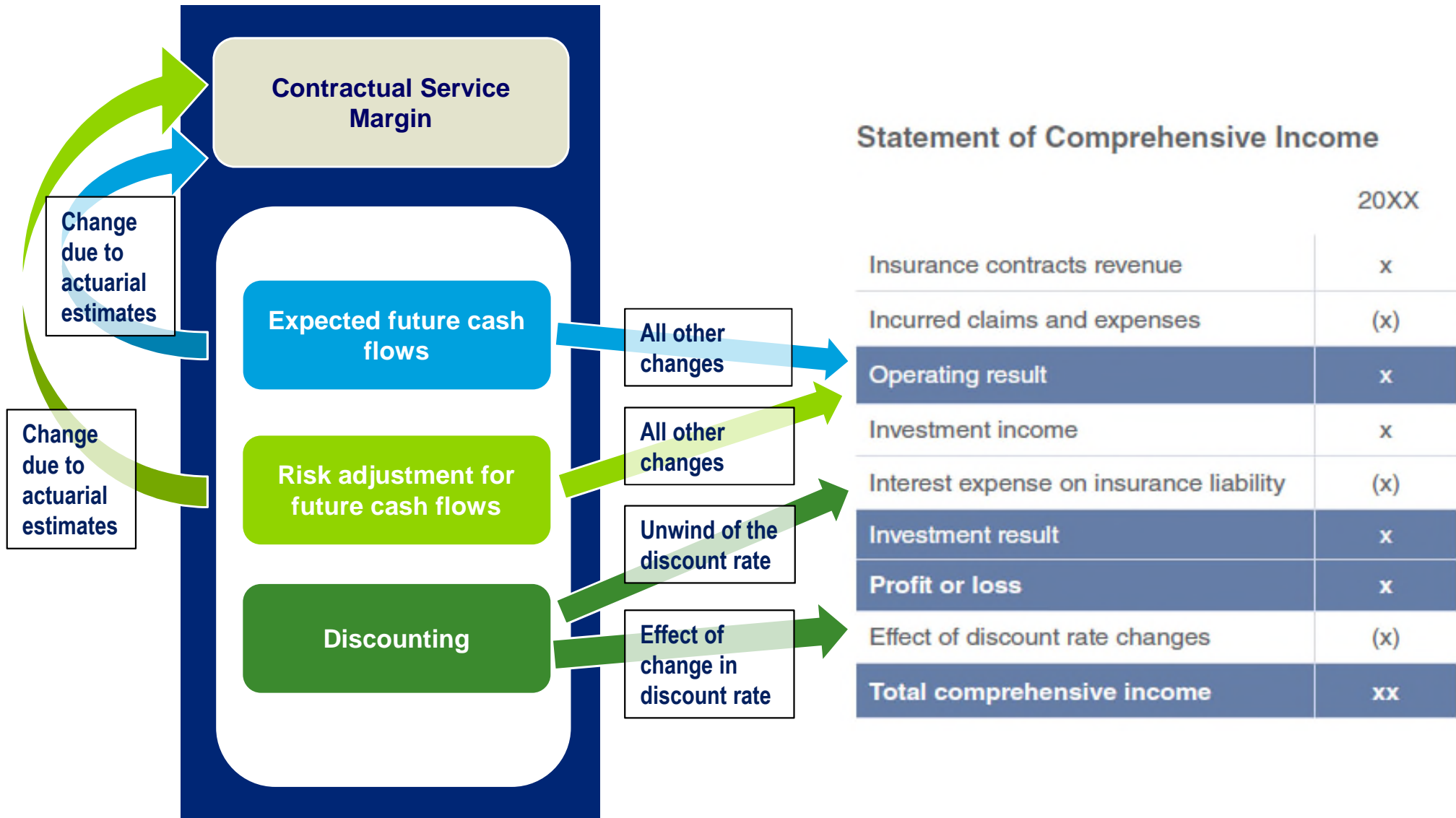
Premium Allocation Approach

Eligibility

- Measurement of the liability for the **remaining coverage** may be simplified if:
 - doing so is a **reasonable approximation** to the BBA, or
 - the coverage period at initial recognition is less than one year
- An approximation is reasonable if the components of the BBA would not have significant variability during the period before a claim is incurred
- Variability increases with
 - the existence of **options and guarantees** in the insurance contract, and
 - the **length of the coverage period**
- Liability for **claims incurred** should be calculated using the **BBA**. Discounting not required if cash-flows are expected to be paid in less than one year

Presentation

Presentation of insurance revenue and expenses



Presentation

Effect of changes in discount rates

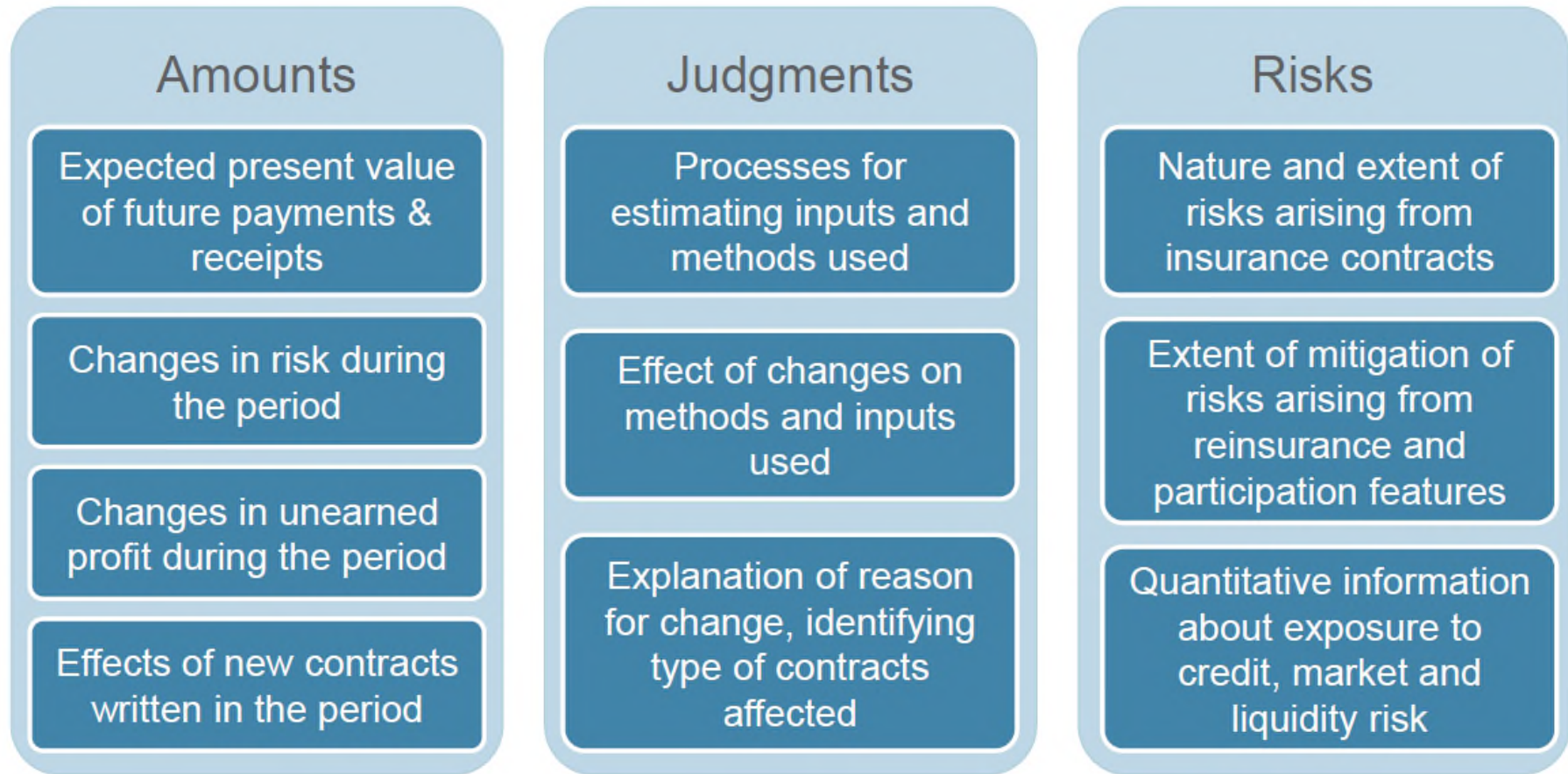
Non participating contracts (tentative decision)

Accounting policy choice

- The effect of changes in discount rate can either be presented in:
 - Profit or loss; or
 - OCI
- This is an accounting policy choice for each portfolio
- Where there is a change in accounting policy, the requirements of IAS 8 have to be complied with (but see transition requirements)

Presentation

Disclosure requirements



Tentative decision (May 2014)

Confirmed all disclosure requirements will be as per the 2013 ED

Participating contracts – current status

Contracts with participating features

Current status of IASB debate

- 2013 ED proposed a “mirroring approach” which has been widely rejected
- Using the BBA with the following adaptations is being considered:
 - “Unlocking” the CSM to take into account the changes in the insurer’s future share of returns generated by the underlying items
 - An accounting policy option to present the discounting separately between OCI and profit or loss, using an asset dependent yield curve based on projected crediting rates

Contracts with participating features

European CFO Forum alternative proposal

- Would apply to all contracts that offer a variable return linked to a specified pool of assets irrespective of whether such assets are held by the insurer
- Broad scope which would capture investment contracts which includes a discretionary return derived from underlying items
- The key features are:
 - No bifurcation of cash flows
 - Single discount rate curve for all cash flows for balance sheet measurement
 - Book yield rate for the presentation of the time value of money in profit or loss, with the difference presented in OCI
 - CSM represents the insurer's share of future profits from the underlying items, with full unlocking of all variables
 - Profit recognition based on delivery of the service to the policyholder

The impacts and challenges of Phase II

The impacts and challenges of Phase II Transition – contracts with no participating features

- **Full retrospective application** of the new requirements is required, unless this is **impracticable**
- Where impracticable, the **simplified approach** in the 2013 ED must be applied
- Where impracticable to apply the simplified approach, a **fair value approach** is applied from the date of transition
- The above will require analysis and judgment
- Differing methods of transition are likely to be applied to different portfolios of insurance contracts within the same company

The impacts and challenges of Phase II

Practical, commercial and strategic implications

- Many years of changes – Solvency II, IFRS 9 and IFRS 4 Phase II
- Consequential impacts on e.g. working day timetable, management information, budgets and forecasts, dividends and executive remuneration
- Process, technology and information
 - Technology and data
 - Finance and actuarial systems
 - Solvency II systems need the functionality to produce Phase II measures
- Consider impact on the Target Operating Model
- Communication with stakeholders

The impacts and challenges of Phase II

Basis of financial reporting for Life Insurers after Solvency I

- Life insurers currently use the modified statutory solvency basis
- Most likely option is to maintain existing Solvency I systems to enable financial statements to be prepared using consistent measurement bases
- A change in accounting policies is permitted if the financial statements more relevant and no less reliable, or more reliable and no less relevant
- Could base insurance liabilities on Solvency II values, but changes in accounting policies in 2016 and again when Phase II is implemented
- Would require assessment of:
 - the adjustments required to the Solvency II values
 - cost and effort; and
 - loss of comparability over a relatively short timescale

IFRS 9 Financial Instruments interaction with Phase II

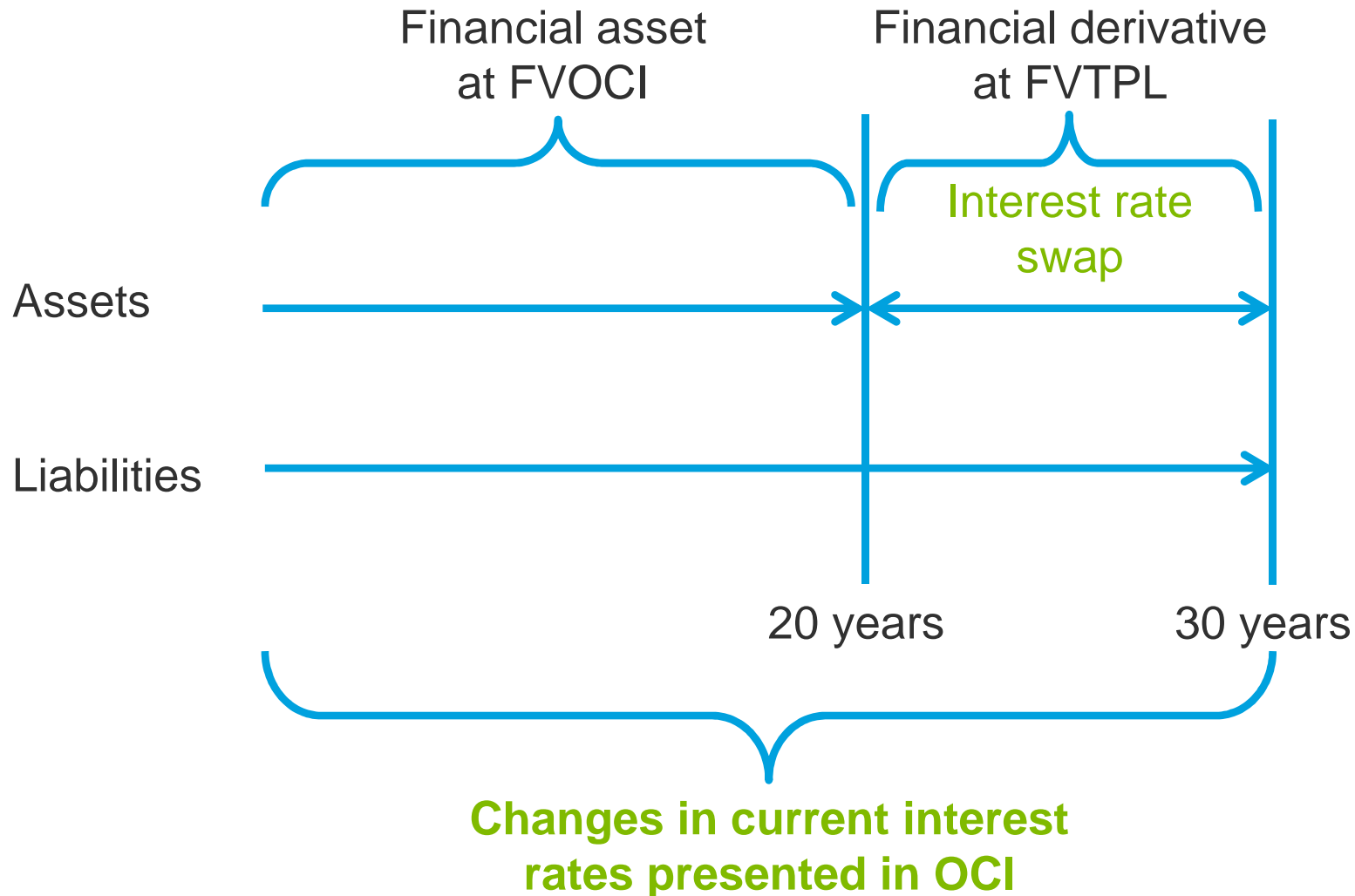
IFRS 9 – interaction with Phase II

What are the implications for insurers?

- FVTOCI is notable because an insurer often undertakes regular buying and selling activity to rebalance its portfolio of assets to meet cash flow needs
- FVTPL is an option available on initial recognition if this would eliminate or reduce an accounting mismatch
- An assessment of the measurement impacts of the combination of IFRS 9 and Phase II will be needed to minimise volatility in profit or loss
- Investments of sufficient duration to match insurance liabilities may not be available, therefore insurers may hedge this mismatch by entering into derivatives (which must be accounted for at FVTPL)
- An accounting mismatch will result if the accounting policy is to present in OCI the effect of a change in discount rate on the insurance contract liability

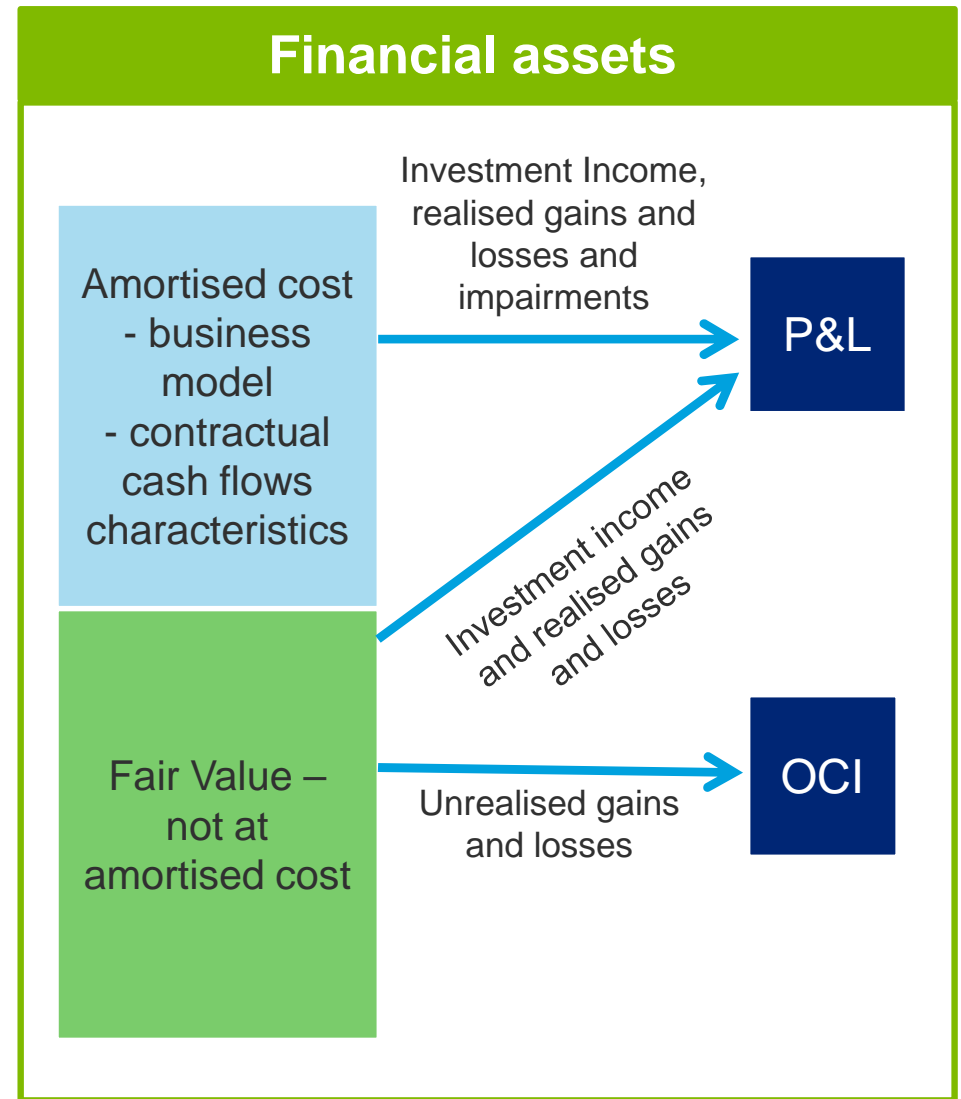
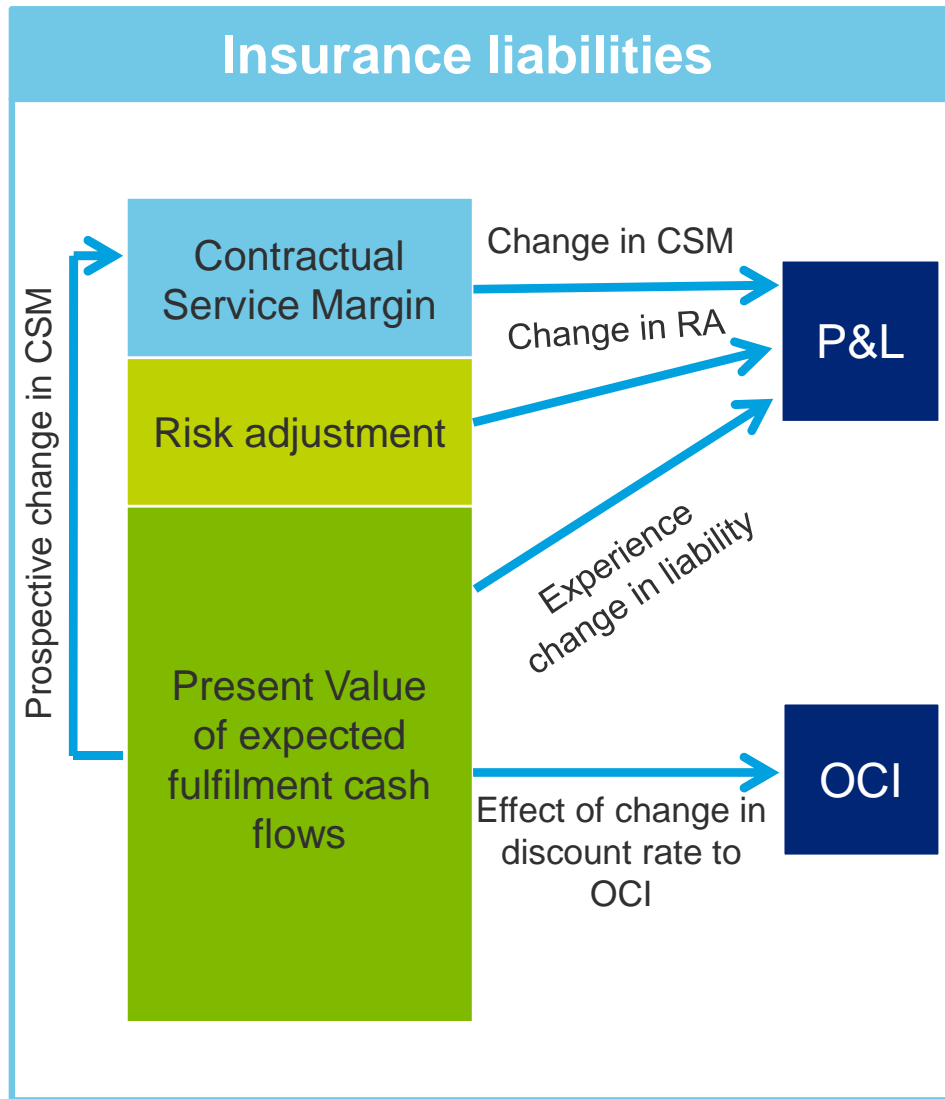
IFRS 9 – interaction with Phase II

Mismatches of duration between assets and liabilities



IFRS 9 – interaction with Phase II

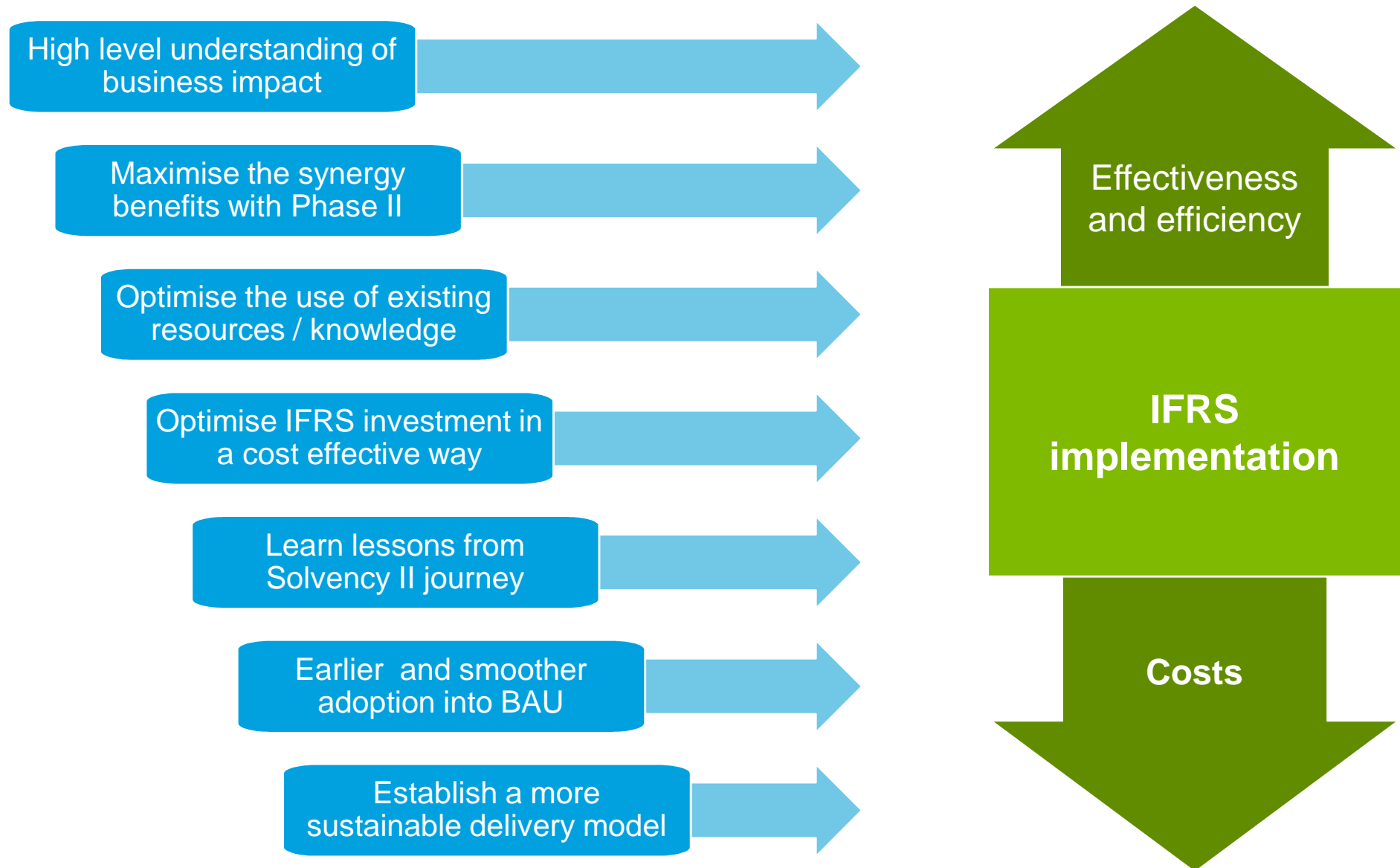
Potential accounting mismatches



Next steps for Insurers

Next steps for Insurers

Opportunity for more cost effective delivery



Questions?

Deloitte Finance Club

Upcoming programme

- Holiday finance checklist 2014

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2015 programme to be released soon

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Contacts and resources

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Resources:

- Deloitte Finance Club home page: www.deloitte.co.uk/financeclub
- UK Accounting Plus (formerly IAS Plus): www.ukaccountingplus.co.uk
- Future of UK GAAP: www.deloitte.co.uk/futureofukgaap



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