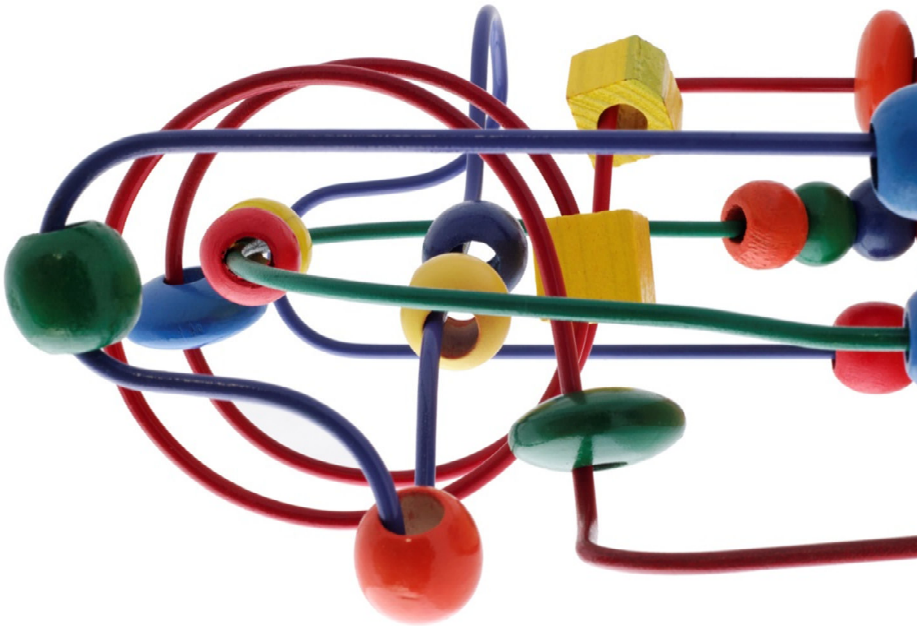
ACTUARIAL SOCIETY
OF SOUTH AFRICA

QUANTIFYING RISK, ENABLING OPPORTUNITY

IFRS 4 Phase II

Examples for Short Term Insurance



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ACTUARIAL SOCIETY OF SOUTH AFRICA

QUANTIFYING RISK, ENABLING OPPORTUNITY

Discussion points

- Areas considered / Scope
- Valuation Method - considerations in application
- Product based examples
- Concluding remarks

Disclaimer

Contents of this presentation represent my own views and not that of my employer. Areas considered in this presentation represent on a portion of the changes required under IFRS4 Phase II and should therefore not be taken as an exhaustive demonstration of all requirements.

Scope / Approach

- Consideration of a few typical Short Term (ST) insurance contracts
- Simple examples used to illustrate points – does not cover all eventualities
- Identify some of the considerations / pitfalls in switching from existing practice to IFRS4 Phase II
- Not going to go into details of OCI – but something that can be used for ST insurers

Valuation Method

Building Block Approach (BBA)

Principles

- Current
- Represent fulfilment of obligations under the contract
- Discounting
- Risk adjustment
- Contractual service margin

Block 3:
Contractual Service Margin

The unearned profit the insurer expects to earn as it fulfils the contract

Block 2:
Risk Adjustment

The amount between a certain and an uncertain liability

Block 1:

Present Value of Best Estimate Fulfilment Cashflows

Amounts the insurer expects to collect from premiums and pay out as it acquires, services and settles the contract

Use a discount rate to adjust the cash flows for the time value of money

Valuation Method

Premium Allocation Approach (PAA)

- **What is it?**

  Approach which is very similar to current 365ths method for UPP

- **When can it be used?**

  "Practical Expedient" for cases where:

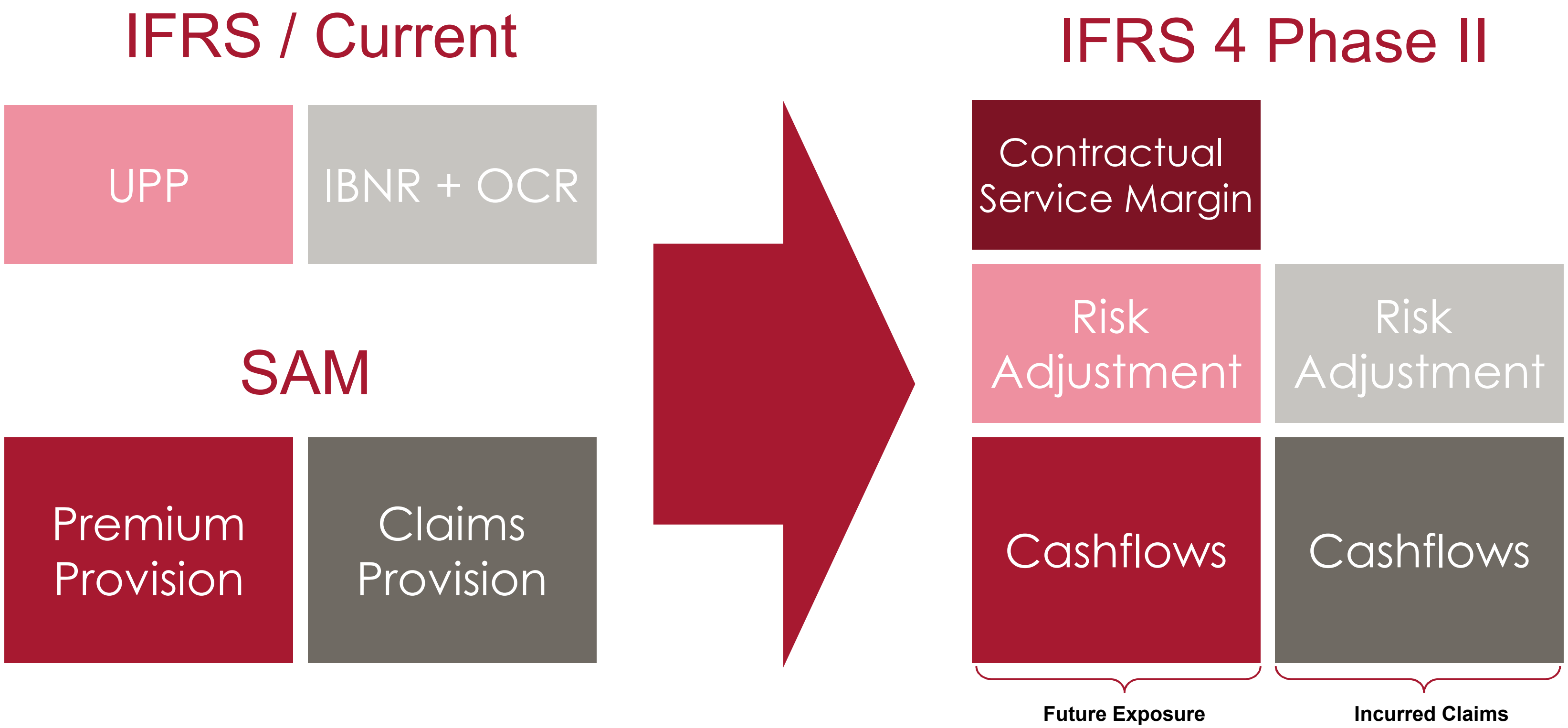
  - Term less than 1 year (and thus also no discounting)
  - Results would resemble Building Block Approach

- **Where can it be used?**

  Only for 'unearned' portion of premium

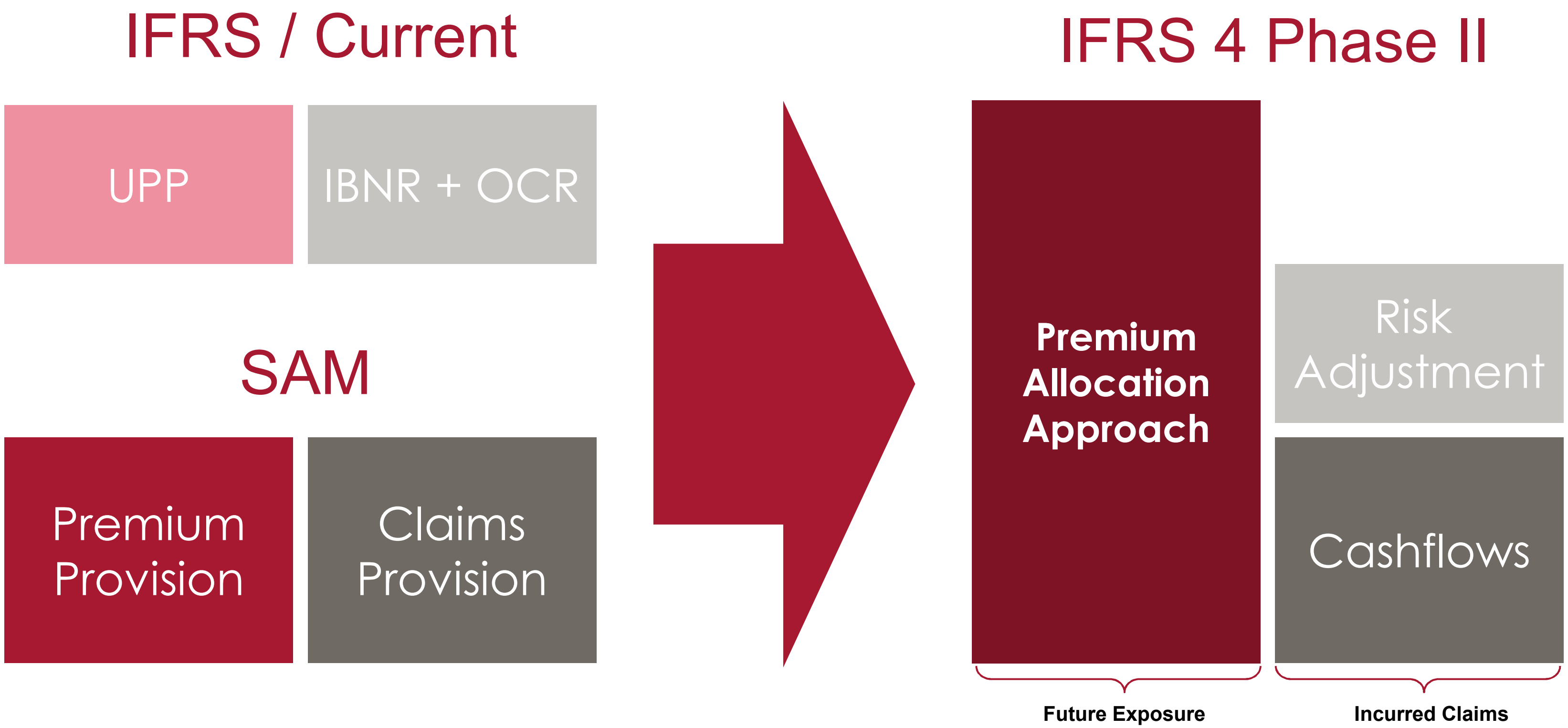
Example 1

Monthly Policy – e.g. Motor



Example 1

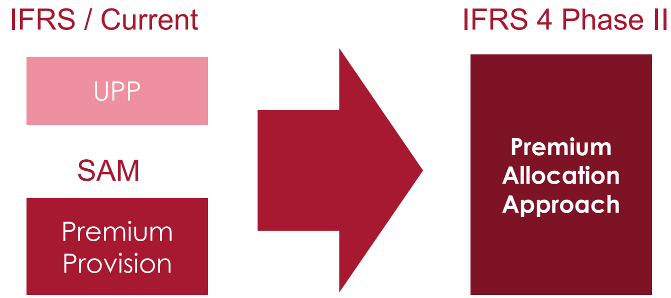
Monthly Policy – e.g. Motor



‘Unearned Premium’

Monthly Policy

IMPACT: **Minimal**



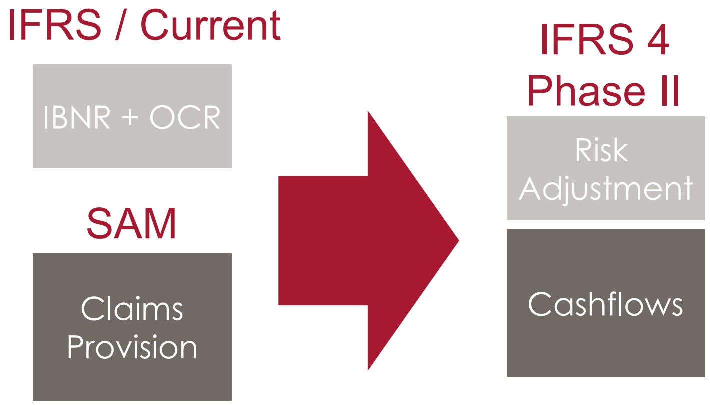
Considerations:

- Almost same as UPP profile over time
- ‘Implicitly allow’ for acquisition cost

- Given small size of amount, likely not worth effort of performing BBA
- Contract boundary similar to SAM – based on coverage period, but also up to point where policy can be re-priced

Incurred Claims

Monthly Policy



IMPACT: **Moderate**

Considerations:

- Best estimate cash flows – almost the same… although no allowance for overhead expenses / ULAE
- Risk Margin:
  - Could use percentile from reserve distribution
  - Alternatively use cost of capital approach, HOWEVER: wont be same amount as SAM:
  - SAM Risk margin based on 6% cost of capital, and depending on approach might differ (calculated per line of business, after diversification).
  - NB: As part of disclosures will have to indicate implied level of confidence

Example 2
Annual Policy

IMPACT: Minimal / Moderate

Incurred claims:

- Treated similar to monthly policies
- If run-off longer than 12 months, discounting will likely be required
- Disclosures include yield curve used for discounting

Future Exposure:

- PAA still most practical

Example 3

Motor Monthly Policy + CASH BACK

- Still some uncertainty around where exactly cash back will be accounted for…

- Latest from IASB seems to indicate:
  - Need to accrue for future cash back – similar to claims beyond coverage period / risks attaching
  - Seems likely to be accrued under Incurred claims
  - Actuarial estimate to be used (claim, lapse decrements, etc.) ***
- Definition of cash back to be considered carefully – must be ‘insurance liability’

*** to be confirmed – not in line with current exposure draft

Other Key Consideration

- If reward / cash back is certain:
  - Seen as non-distinct investment component - split out from insurance revenue

- I have SAM BE cash flows and risk margin – why not use BBA?
  - Maintenance of CSM over time is not a trivial task – adds complexity
  - Level at which calculation done becomes more important
  - Need to allocate risk margin between future exposure and incurred claims – wont be a straight forward calculation from SAM risk margin

Concluding remarks

- Changes are not as significant for Short Term as it is for Life, but… Devil is in the detail.
- Selection of methodology has further implications – disclosure, tracking of historical calculations…
- Consider Income Statement impact of guaranteed rewards
- Worth it to start early with implementation:
  - Early adoption likely to be allowed in transition period
  - ED largely finalised for short term contracts

Questions