IFRS 4 PROFIT REPORTING FOR SOUTH AFRICAN LIFE INSURANCE CONTRACTS

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Motivation

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- “In Pursuit of the Chimaera” – Frank Redington, 1975.

- 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

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GOAL

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

APPROACH

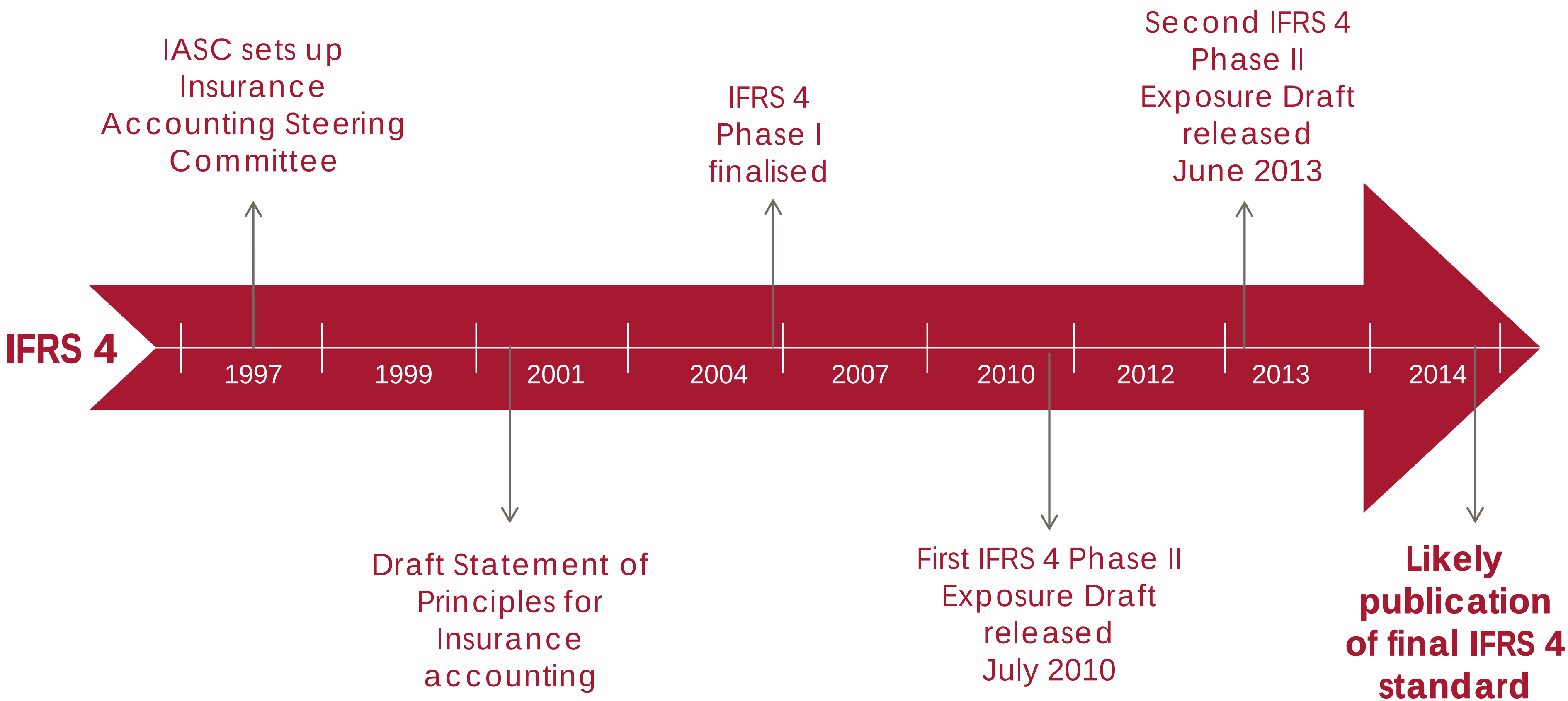
- Push past uncertain complexities in the exposure draft by making **necessary simplifications** which allow **meaningful comparison** between the FSV and IFRS 4 profit-reporting bases.

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.**



Comparison of IFRS 4 and FSV

Building Blocks of liability

IFRS 4	FSV	
Contractual services margin	Discretionary margins	Minimum additional prudence vs. fully discretionary prudence.
Risk adjustment	Compulsory margins	Company view vs. prescribed minimum allowance for risk on each cashflow.
Time value of money	Time value of money	An adjustment that reflects the time value of money. Discount rate can be the same for both bases (bottom-up).
Cashflows	Cashflows	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

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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

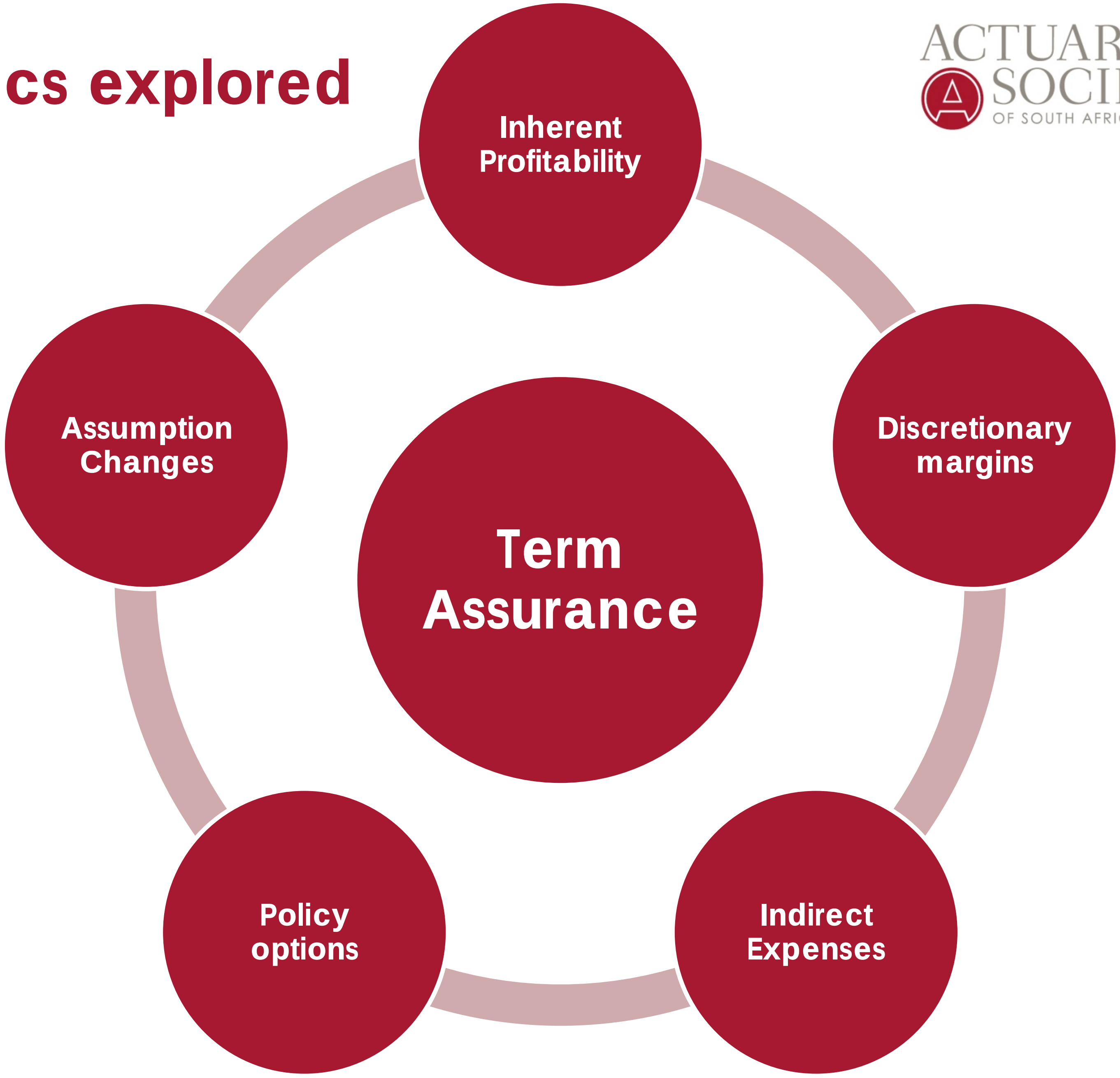
Components of profit

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



Basis for illustrative policy

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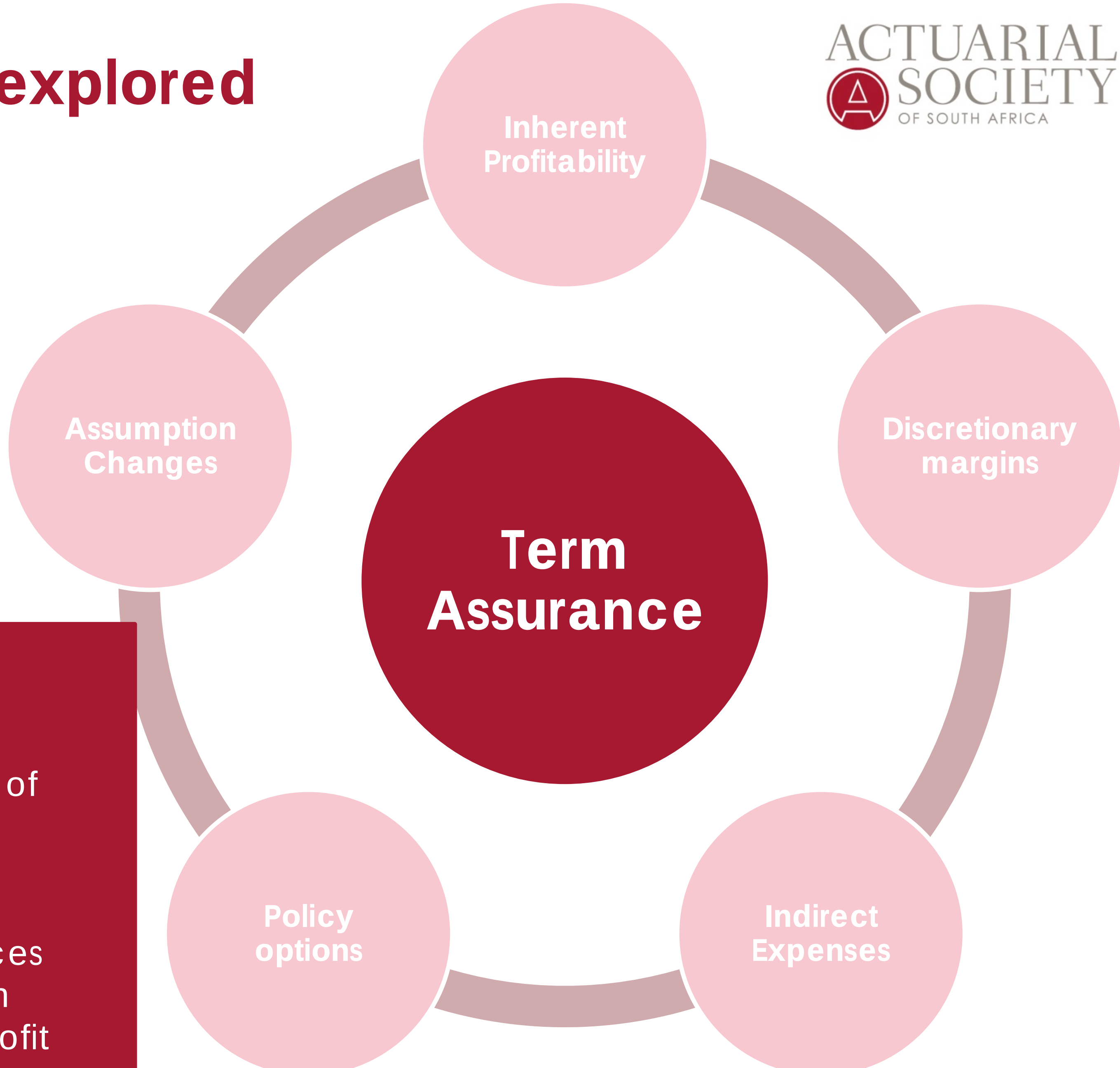
- Profitable 15-year non-taxable term assurance policy.
- 40-year old female policyholder.
- Level premium, fixed sum assured.
- Same premium, mortality, lapse, interest rate and expense (overall) assumptions.
- Projected experience as per expected basis.
- FSV approach: Compulsory margins as per SAP104.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

Dynamics explored

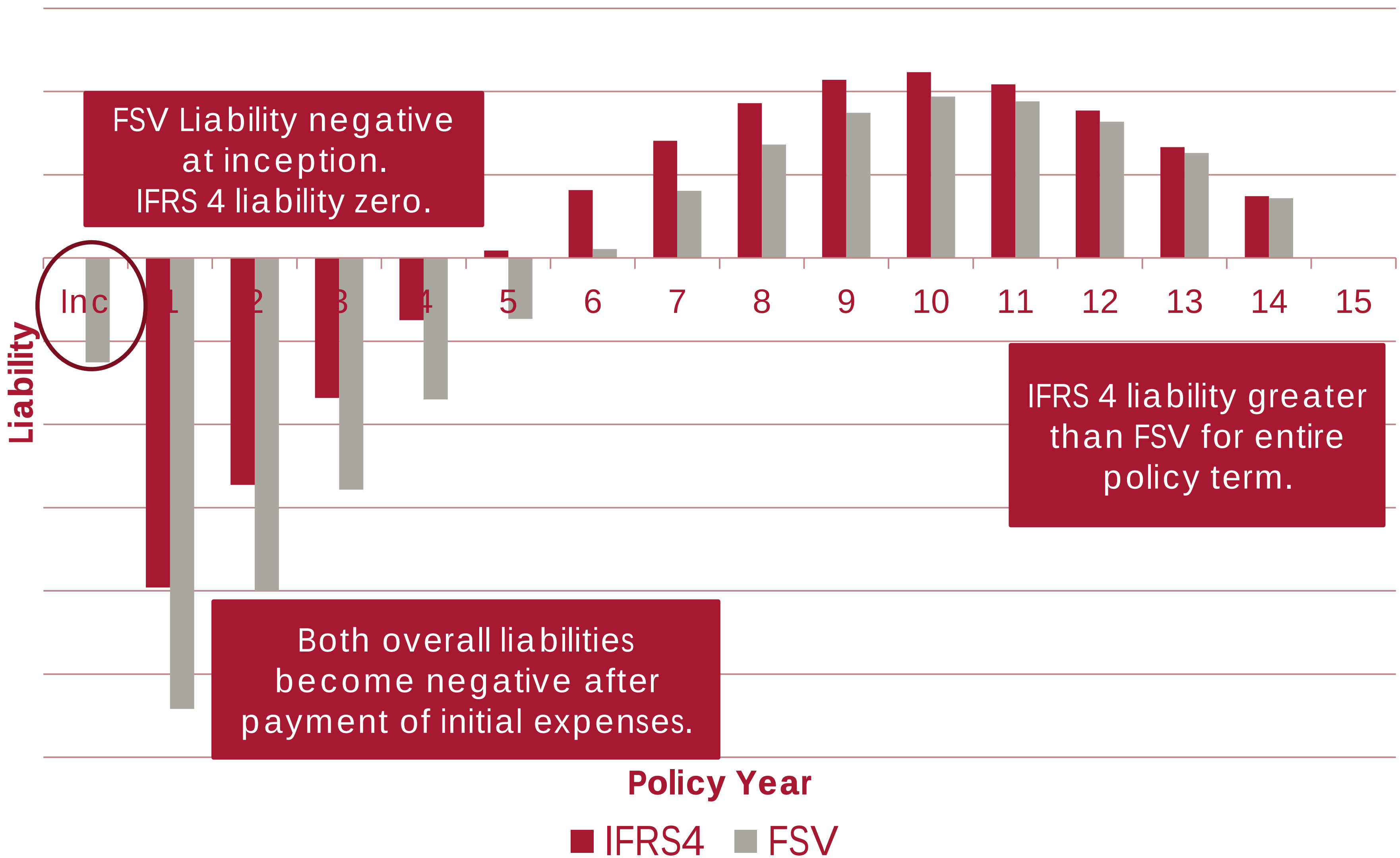


TAKE-HOME:

1. IFRS 4 results in a smoother pattern of profits.
2. Under IFRS 4, the contractual services margin is the main mechanism for profit deferment.

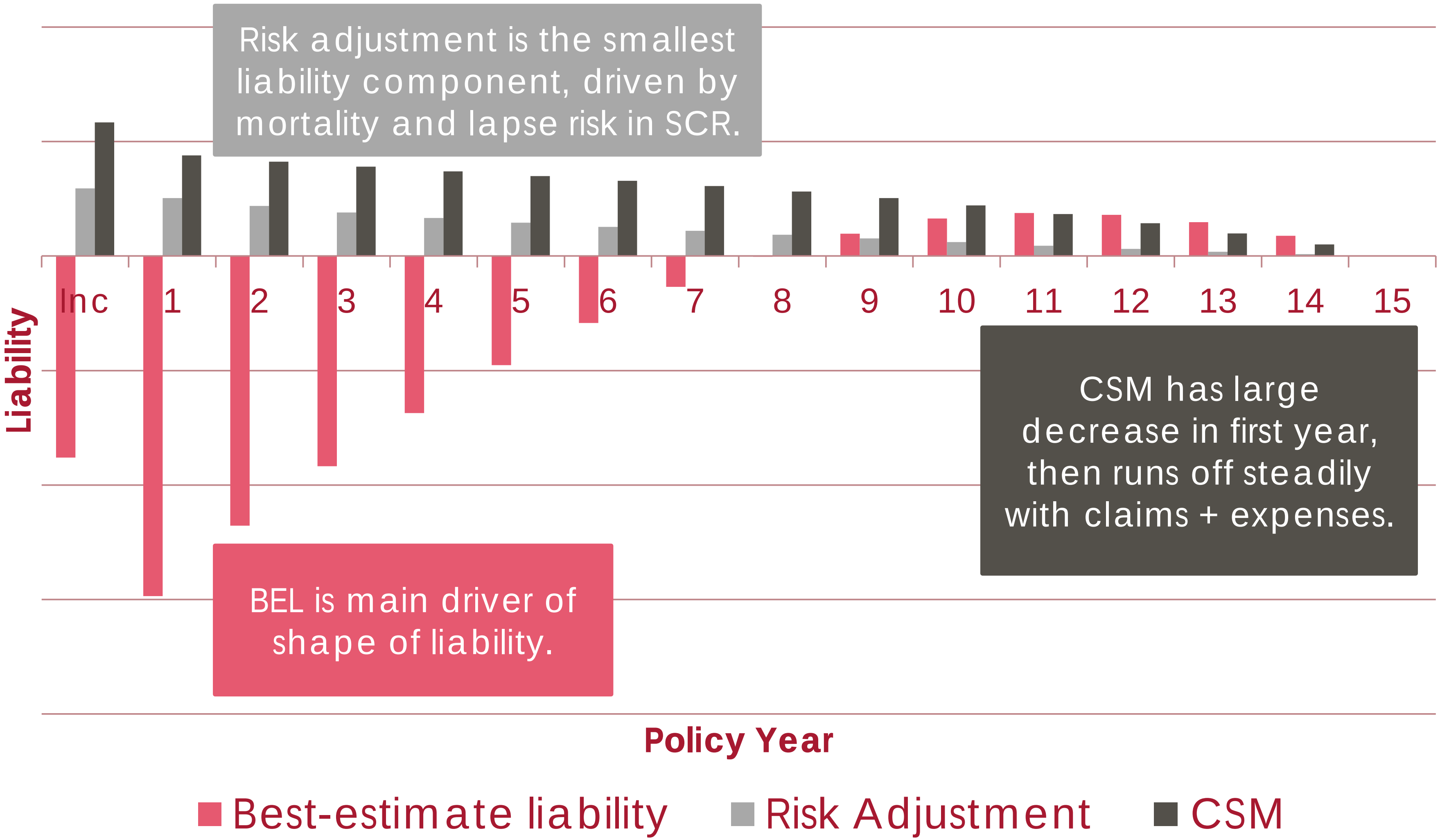
Term Assurance

Comparison of liability profile



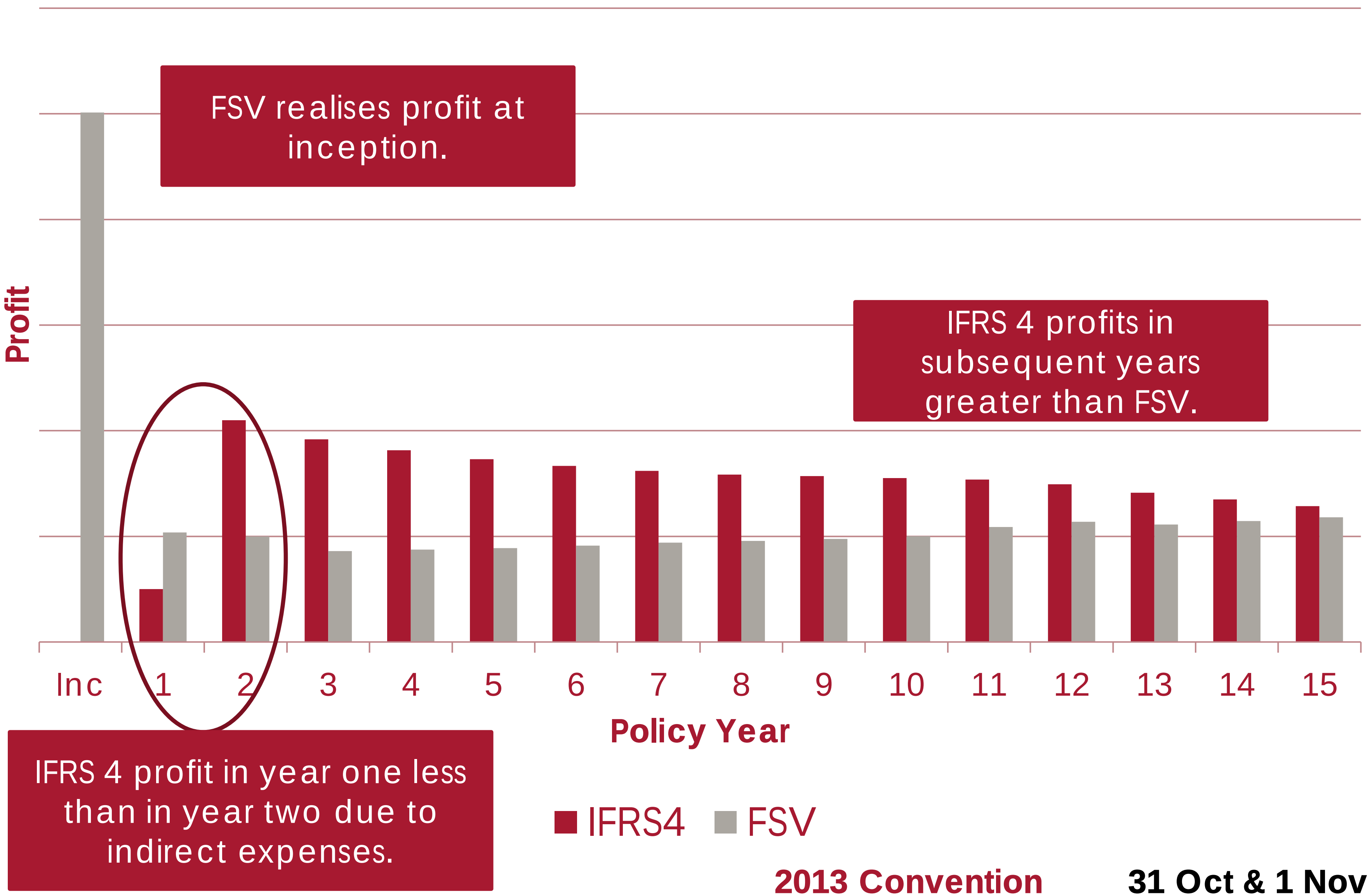
Term Assurance

Components of IFRS 4 Liability



Term Assurance

Comparison of profit profile



Dynamics explored

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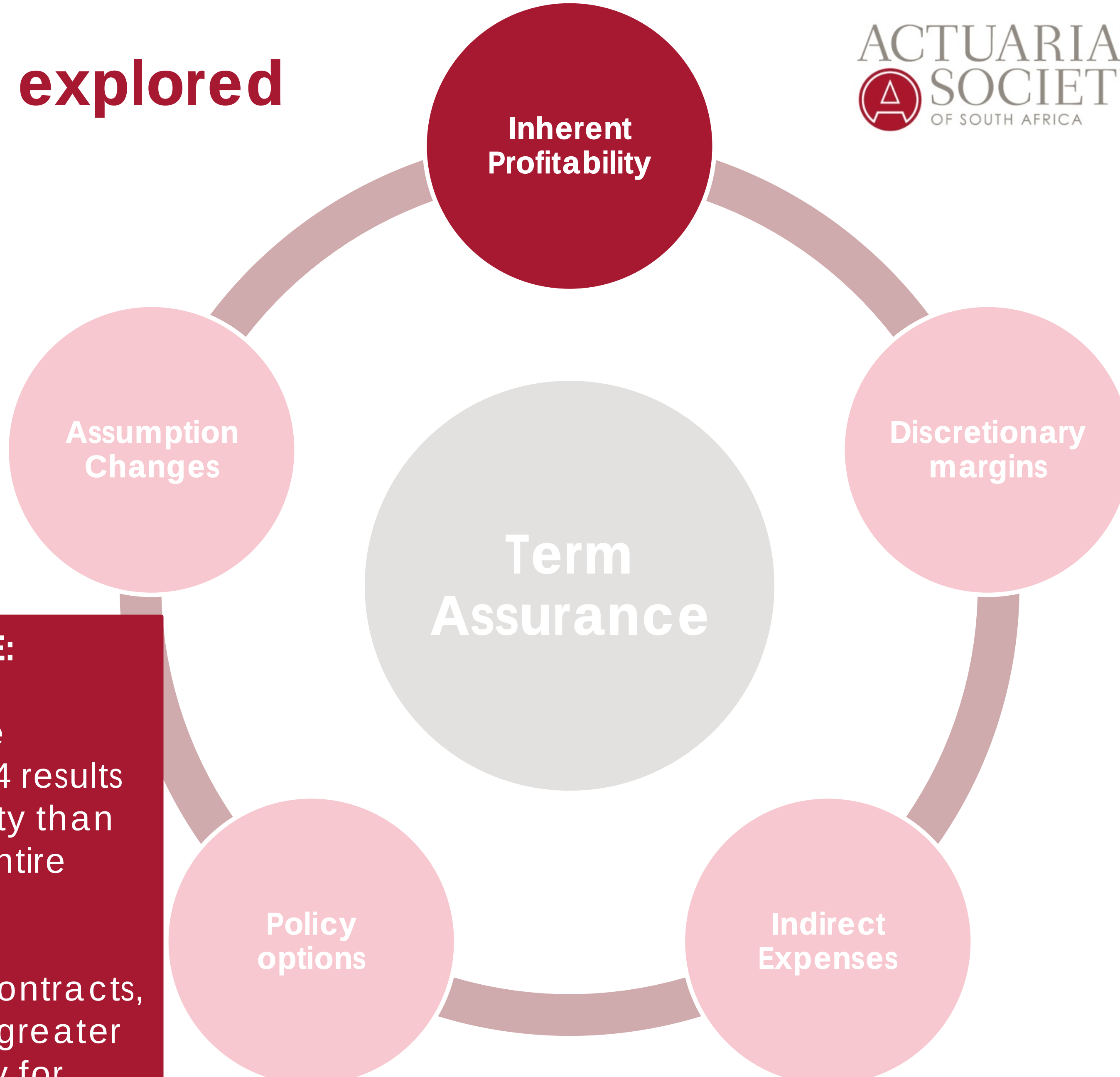


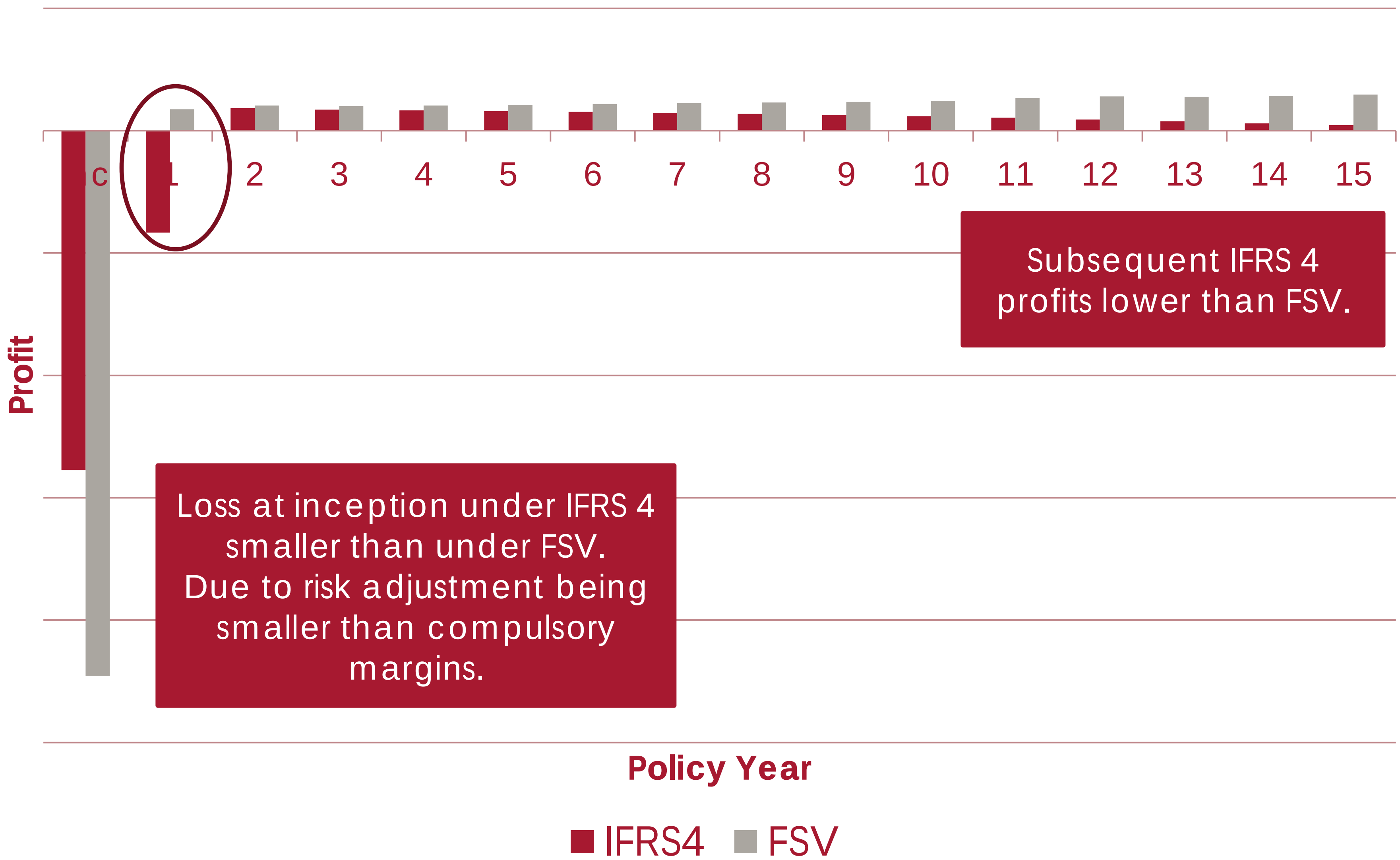
TAKE-HOME:

1. For unprofitable contracts, IFRS 4 results in a lower liability than under FSV for entire contract term.

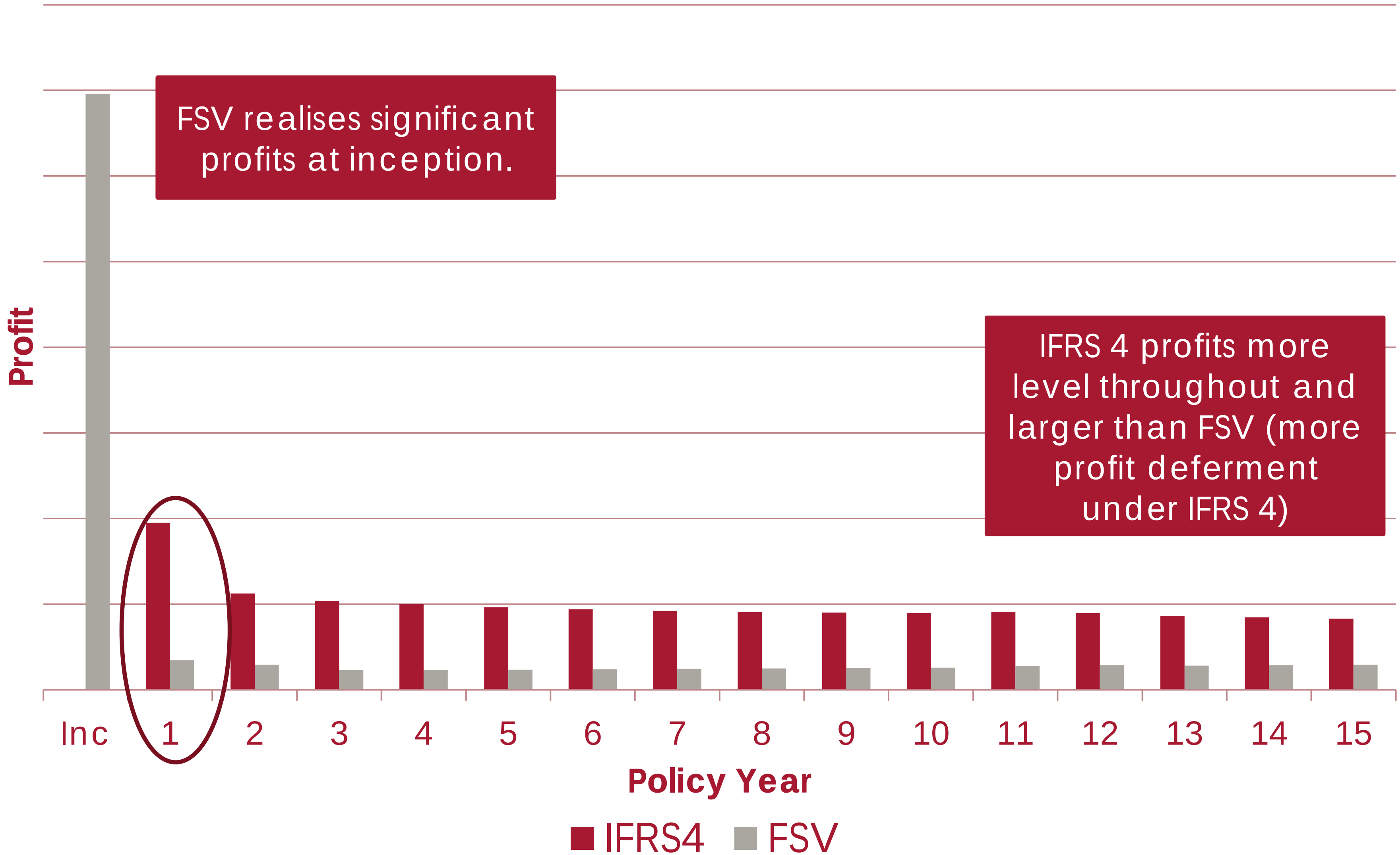
2. For profitable contracts, IFRS 4 liability is greater than FSV liability for entire contract term.

Low Profitability

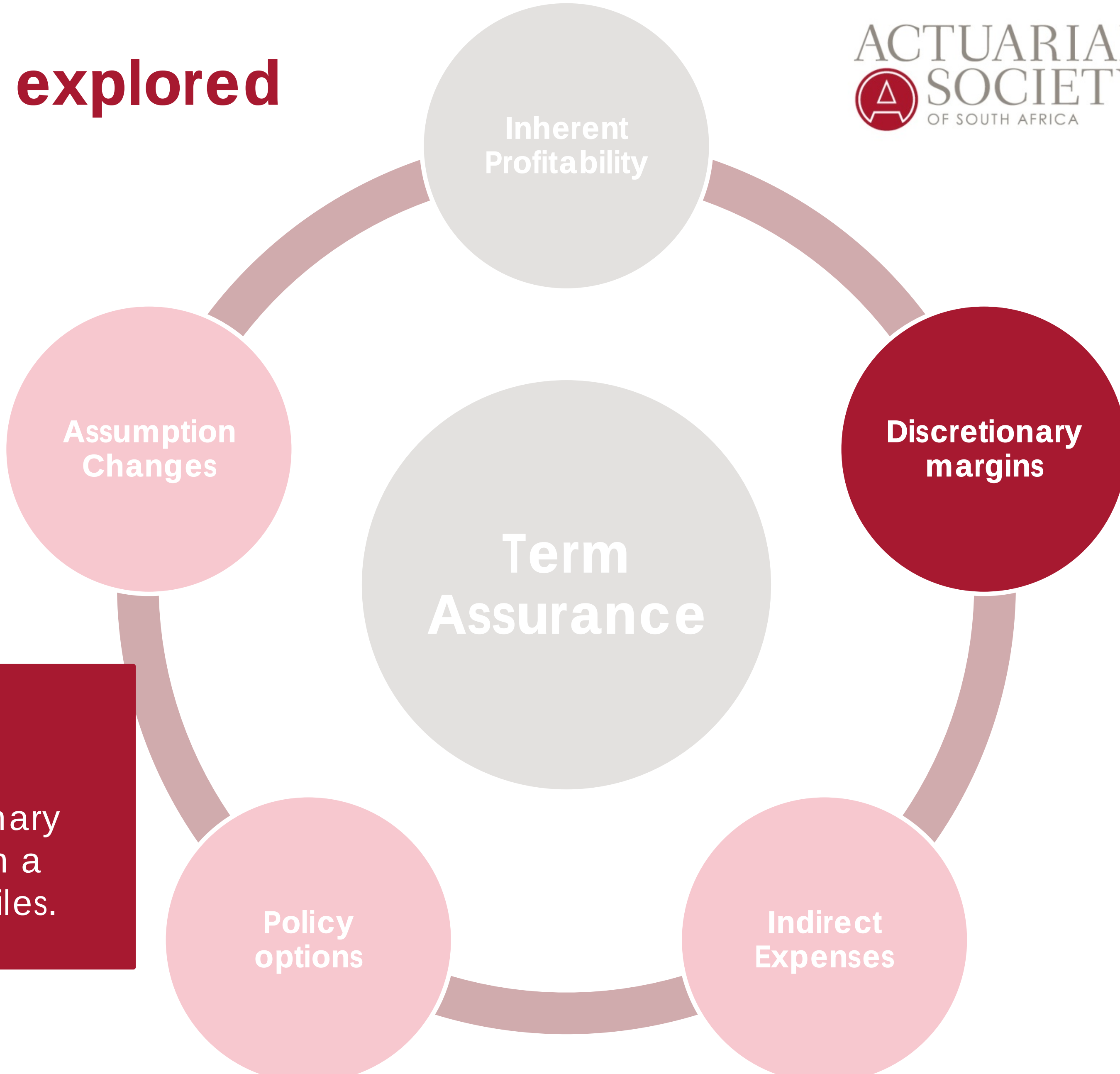
No CSM at inception



High Profitability
No discretionary margins



Dynamics explored

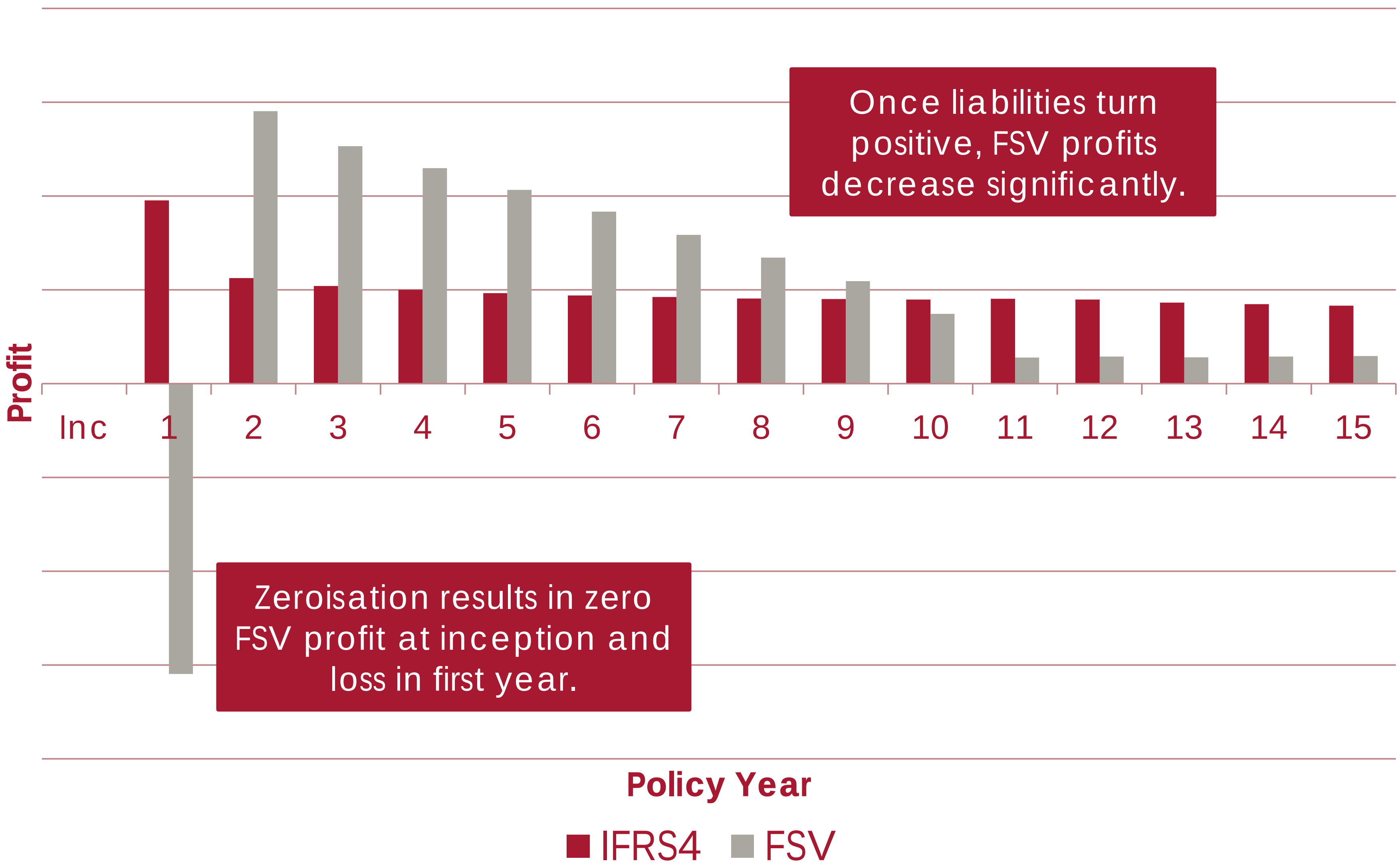


TAKE-HOME:

Under FSV discretionary margins can result in a variety of profit profiles.

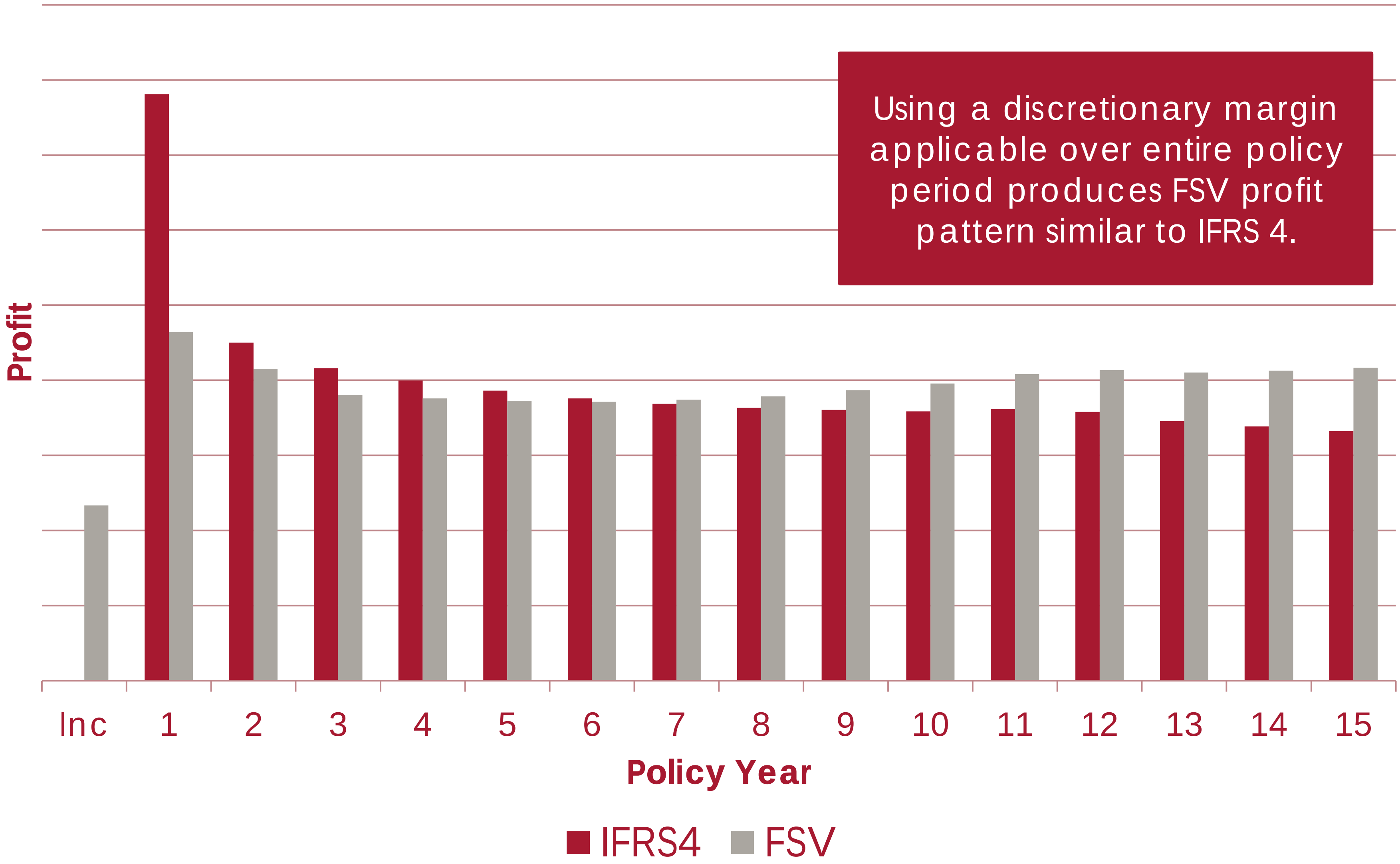
High Profitability

Discretionary margin - zeroise negative reserves

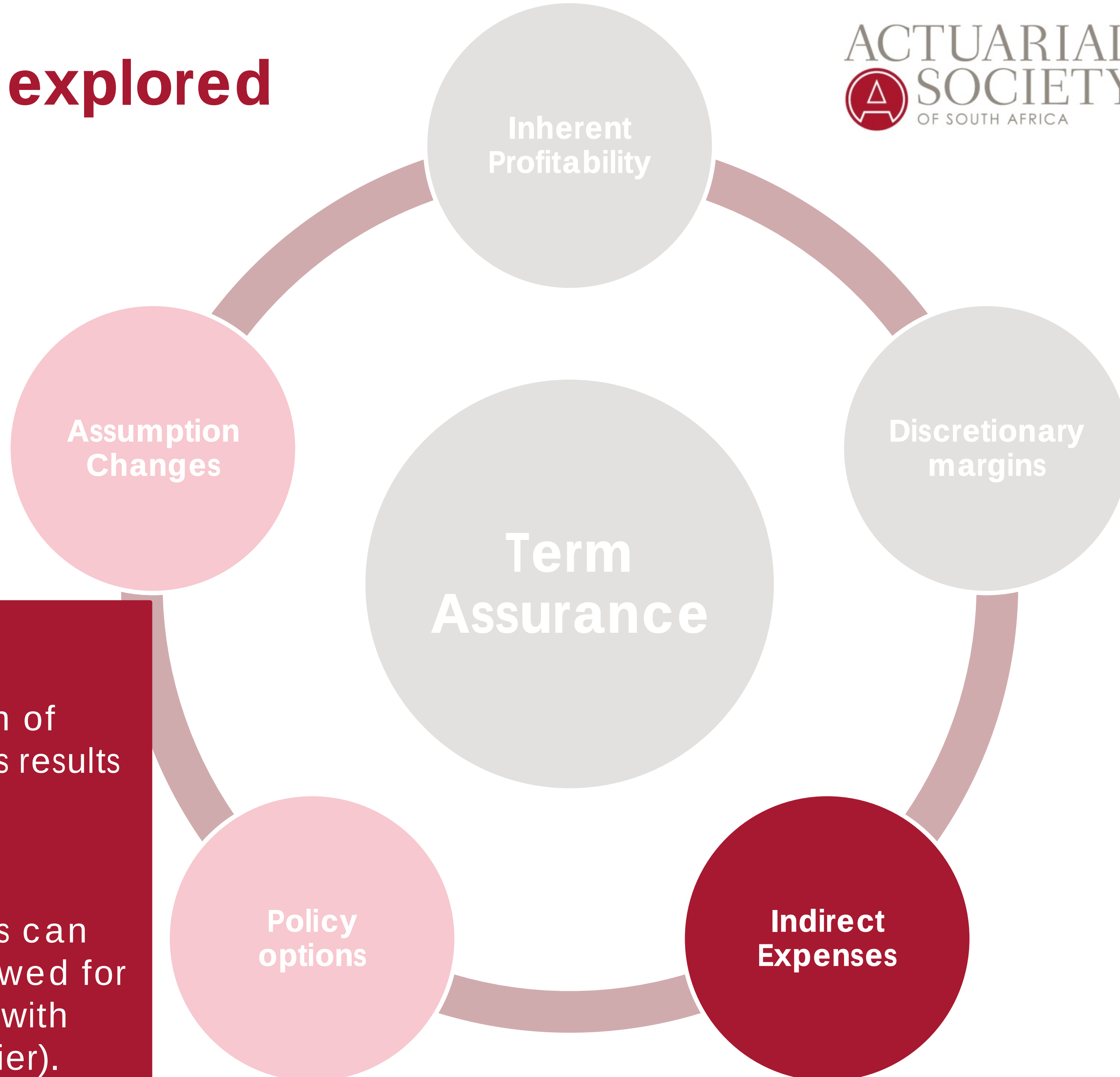


High Profit – Extra Mortality Margin

40% Increase in mortality rate



Dynamics explored



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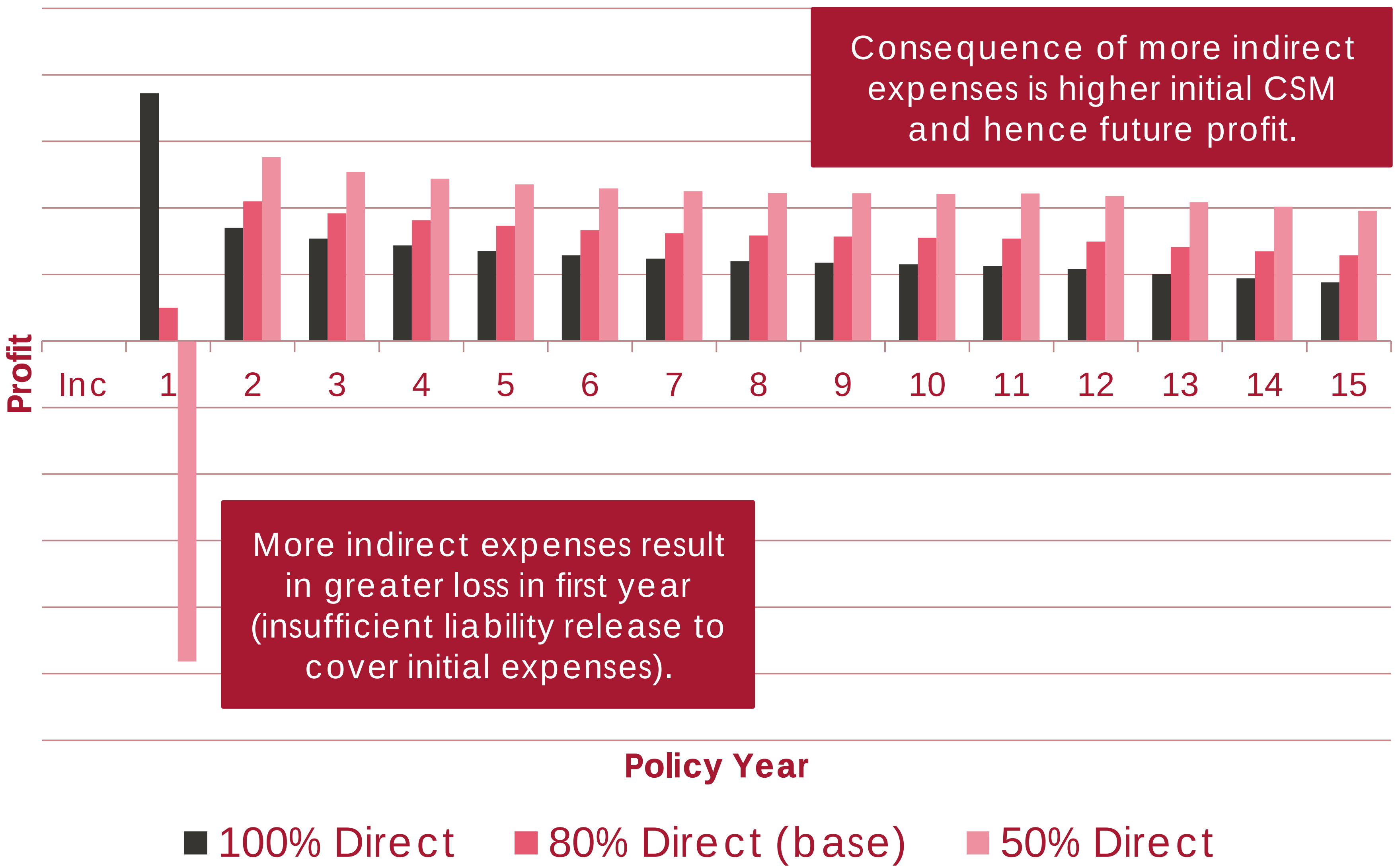
TAKE-HOME:

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).

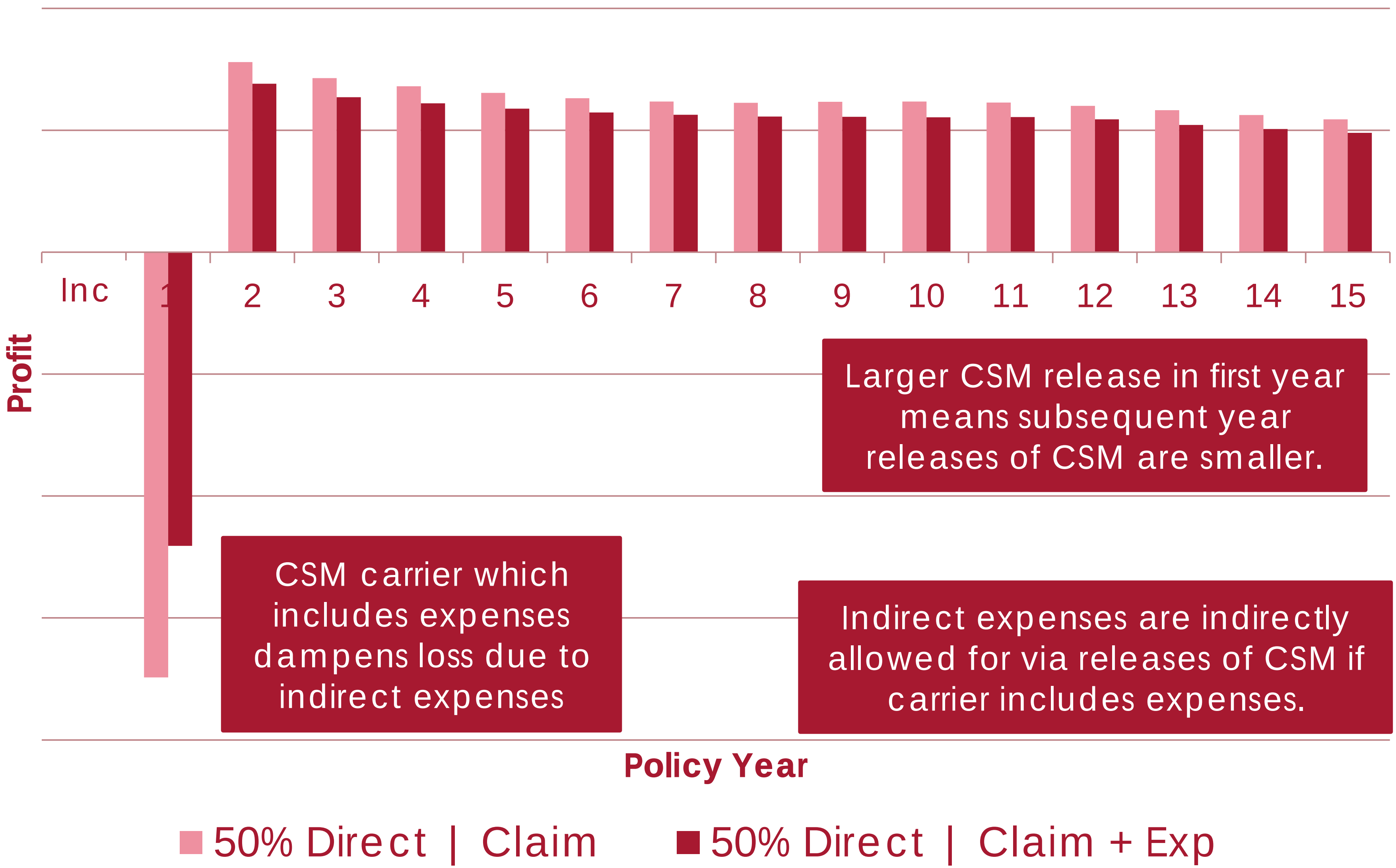
Indirect Expenses

Varying proportion of direct initial expenses

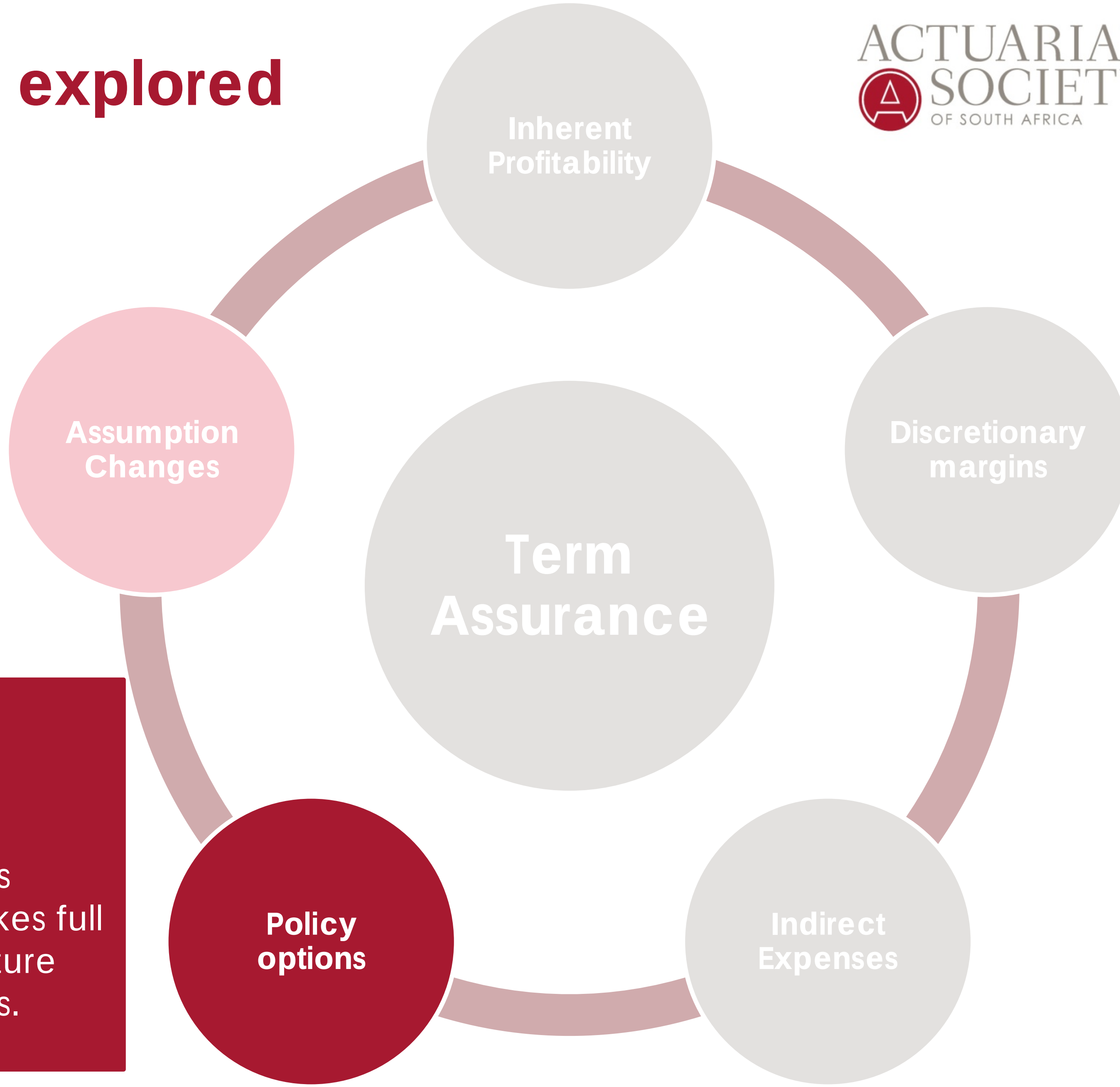


Indirect Expenses

Impact of CSM carrier on indirect initial expenses



Dynamics explored

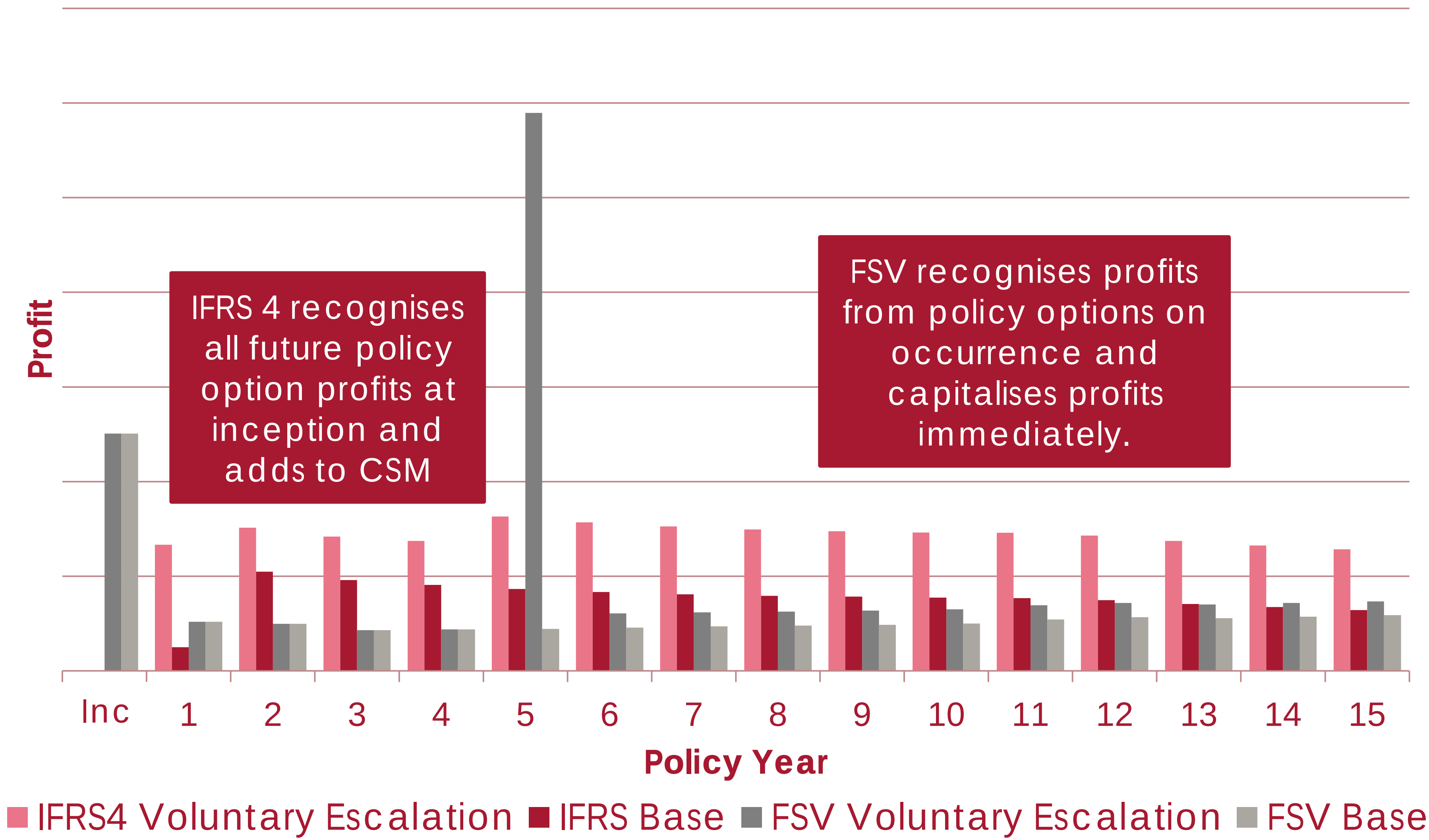


TAKE-HOME:

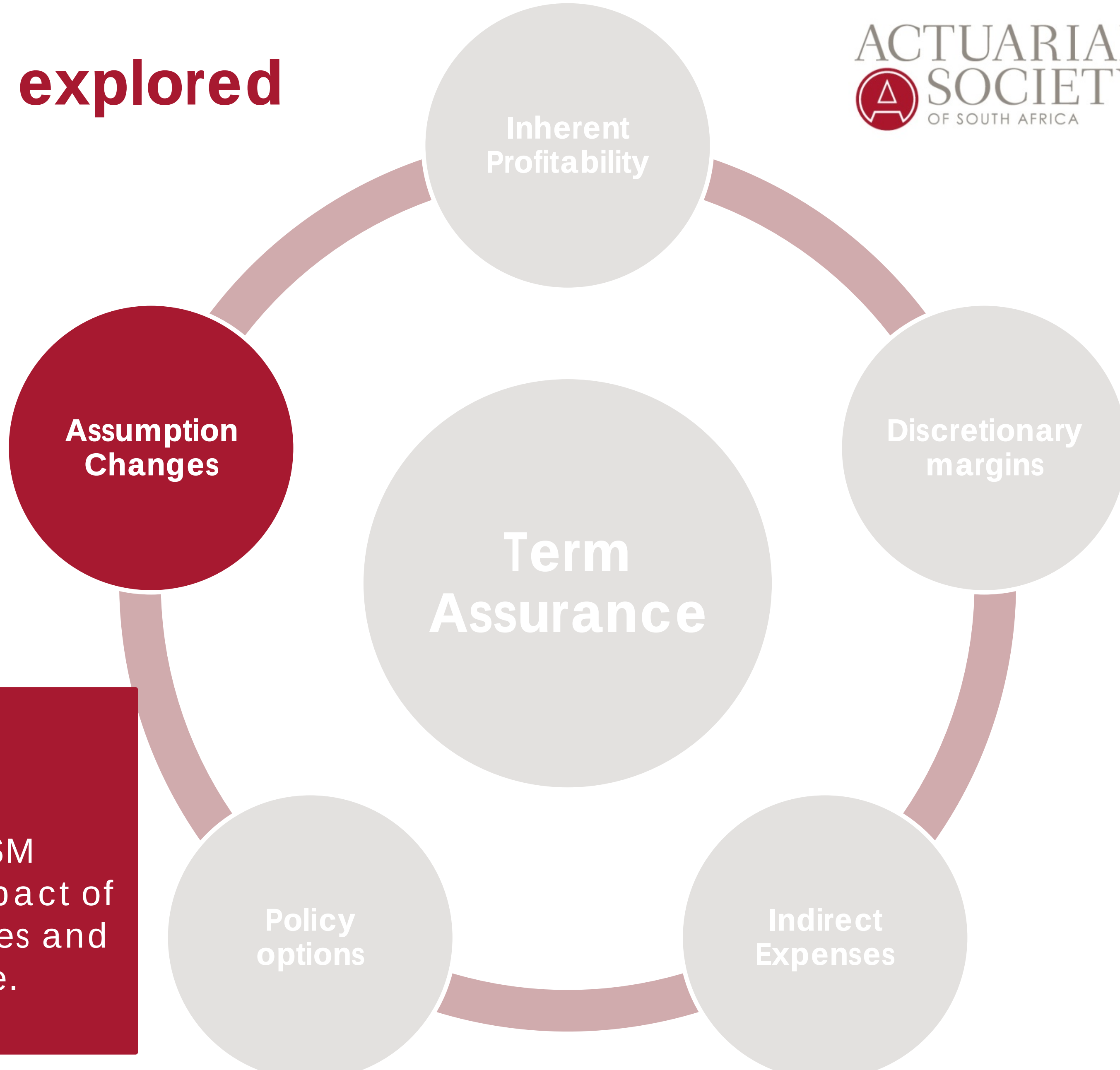
FSV and IFRS 4 treat policyholder options differently: IFRS 4 takes full allowance for all future policyholder options.

Policy options

Voluntary increase premium and sum assured (yr 5)



Dynamics explored

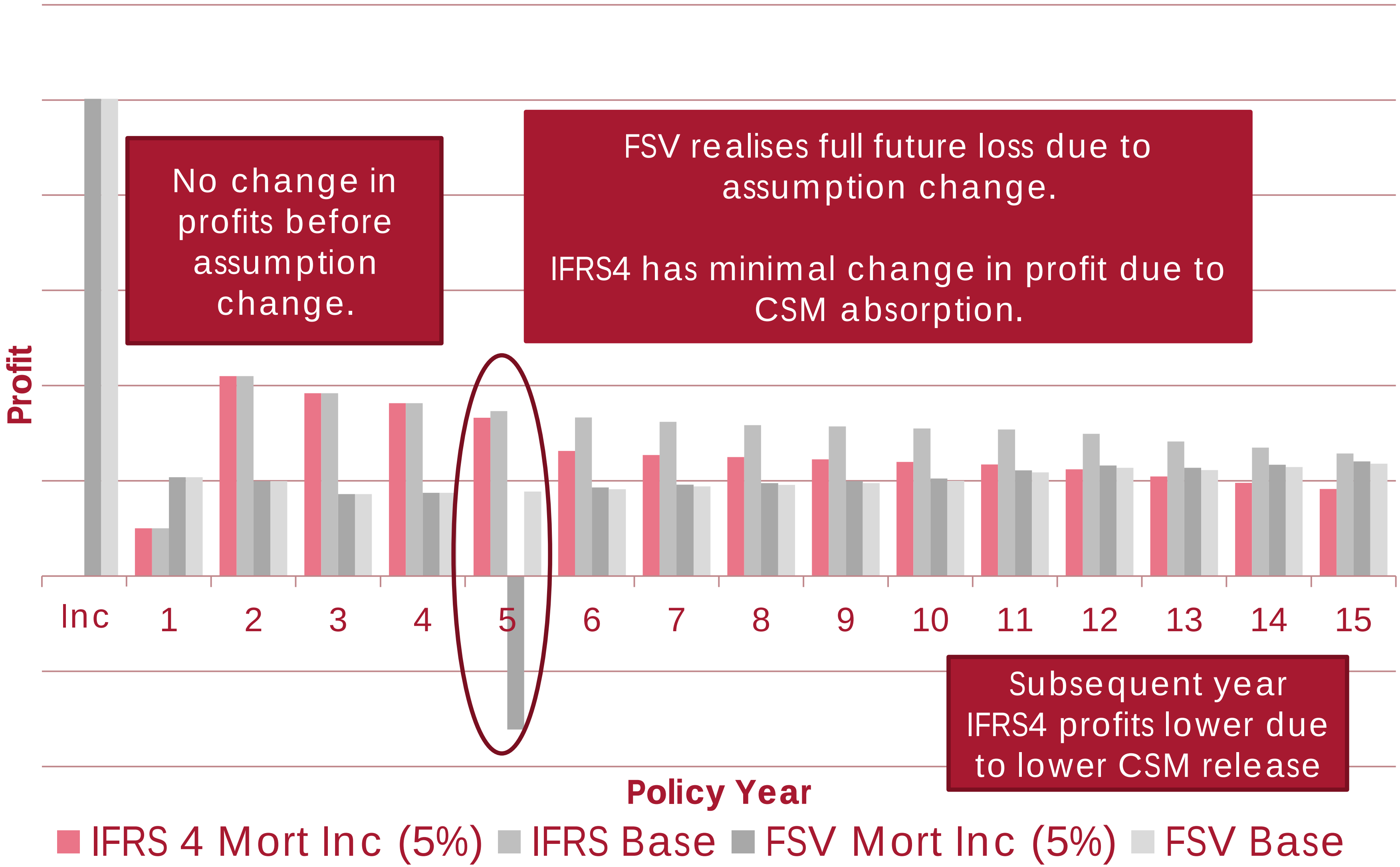


TAKE-HOME:

Under IFRS 4 the CSM dampens profit impact of assumption changes and spreads it over time.

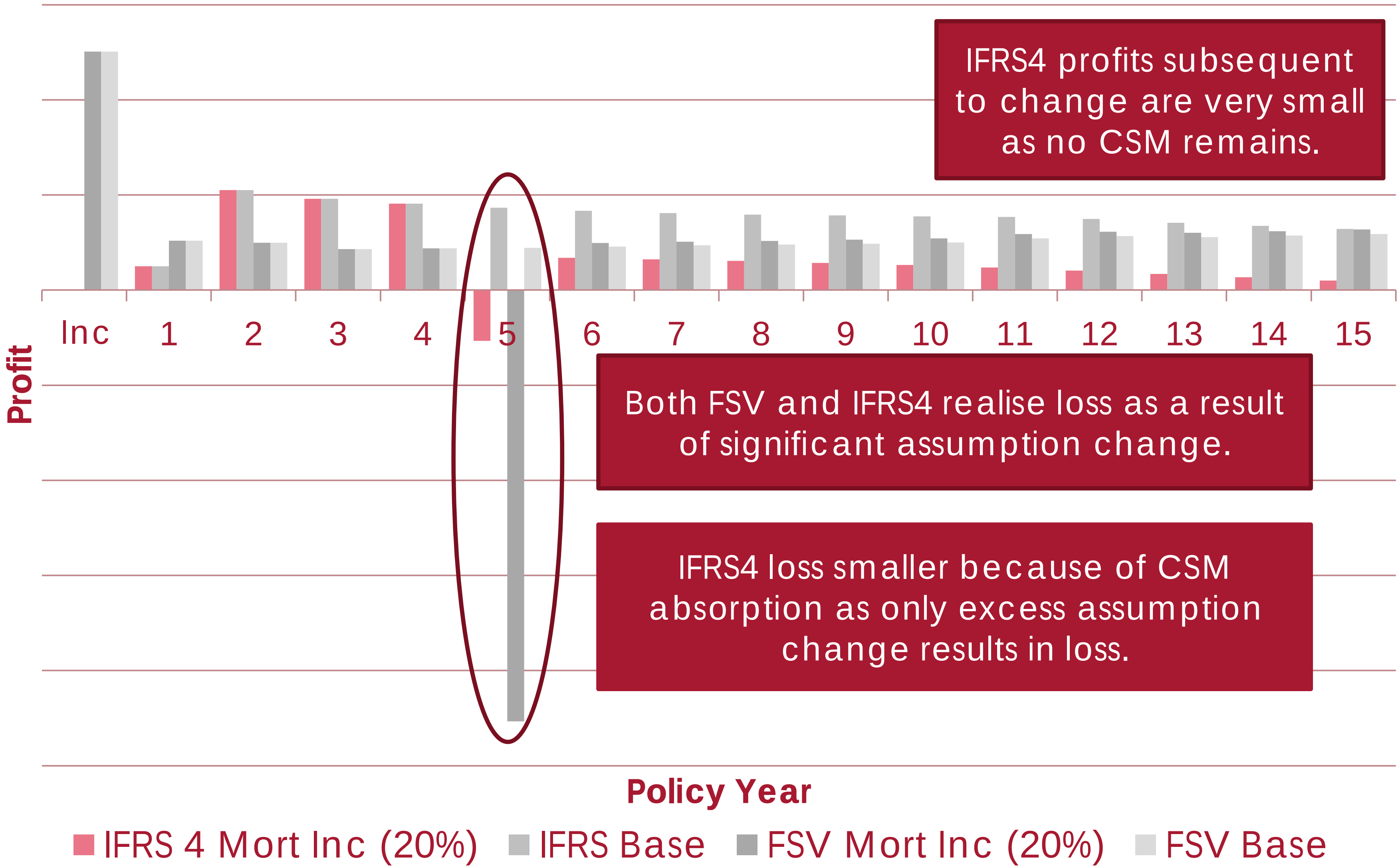
Demographic assumption change

Small mortality rate increase (yr 5)



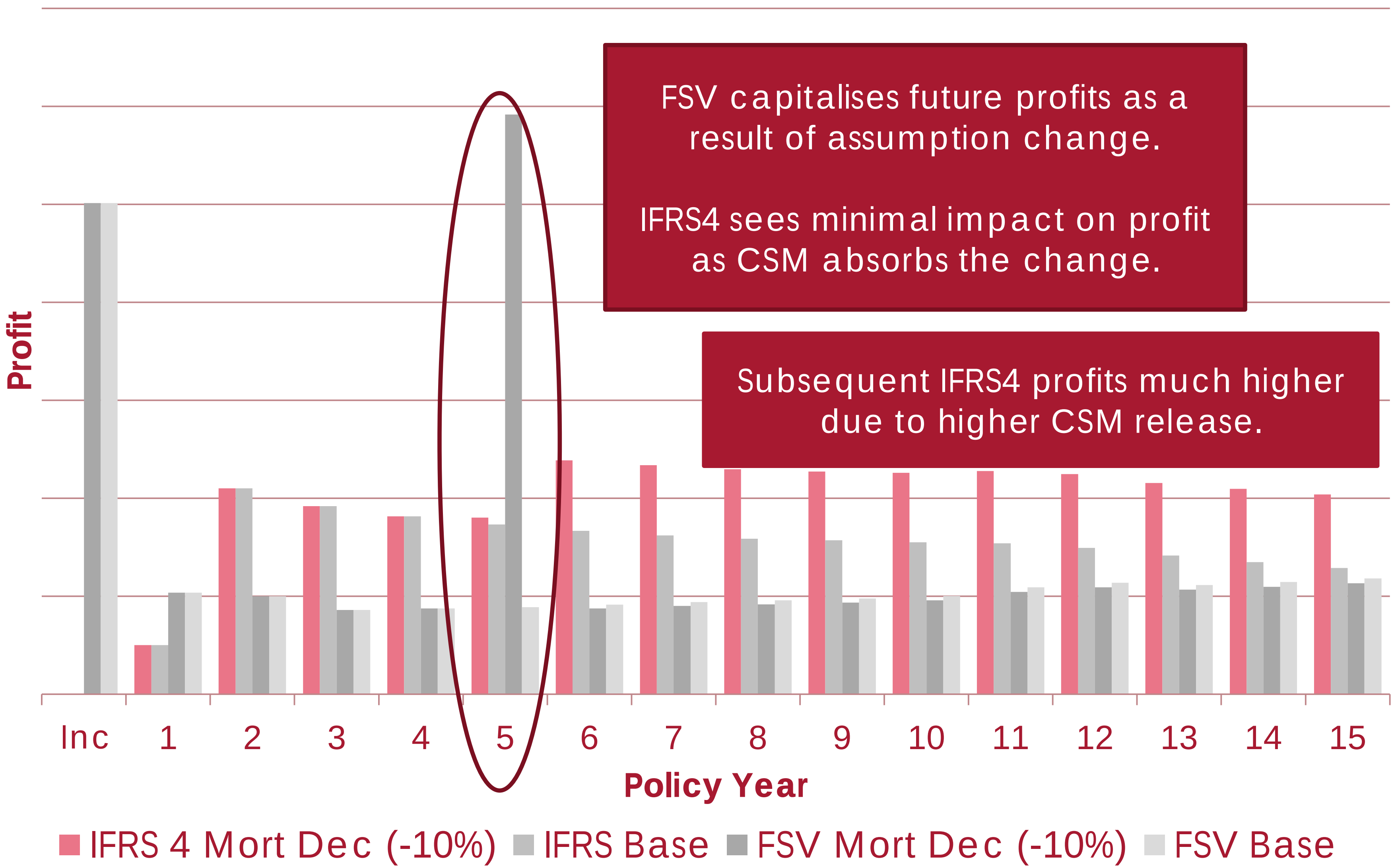
Demographic assumption change

Large mortality rate increase (yr 5)

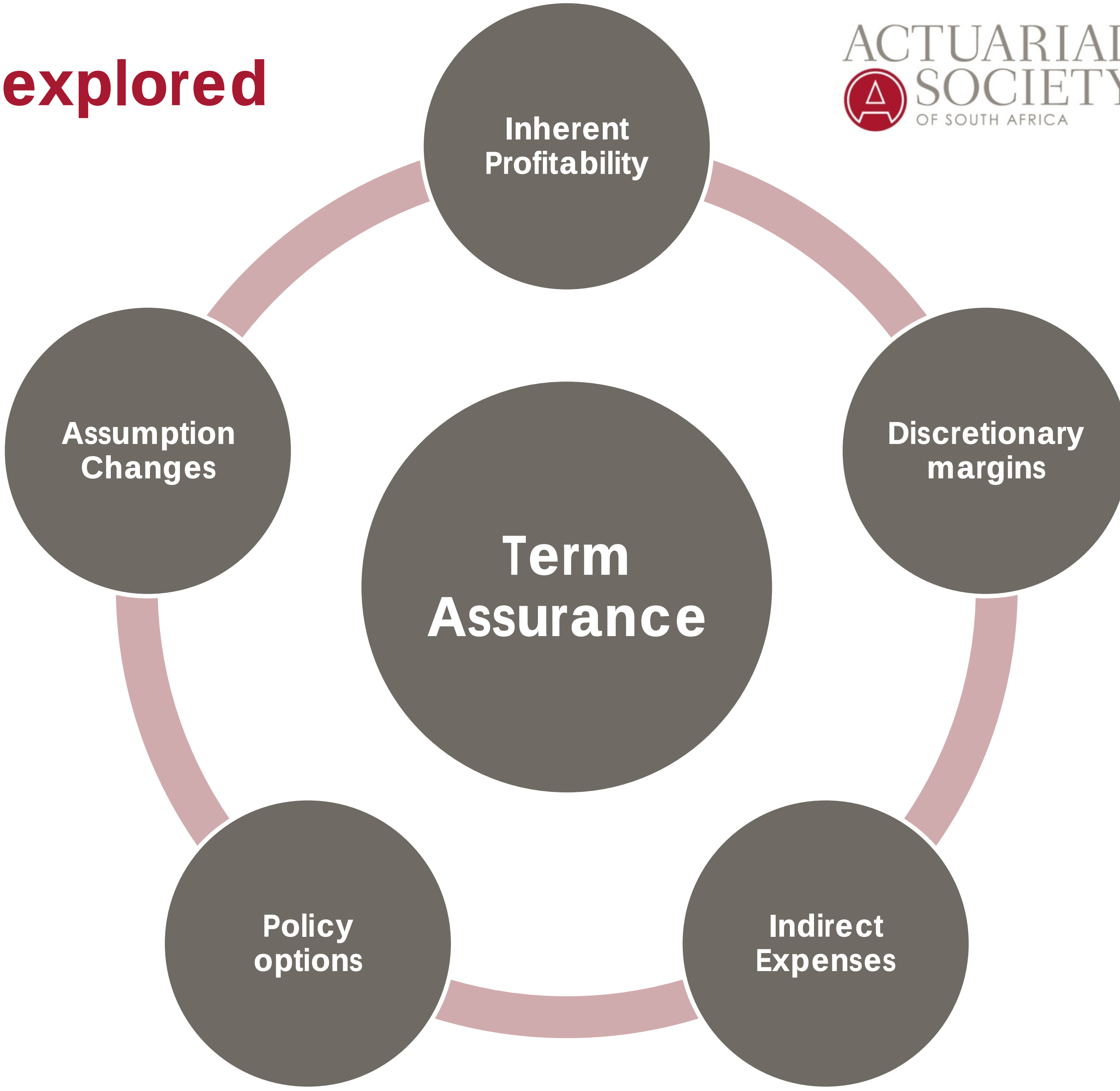


Demographic assumption change

Mortality rate decrease (yr 5)



Dynamics explored



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