IFRS 17 Insurance Contracts

Presentation to the EFRAG Board

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Brussels / April 11, 2017

Allianz

What I would like to discuss with you today:

- **International financial reporting at Allianz**
- **Performance reporting under IFRS 17**
- **Findings from first impact assessment**
- **IFRS 17 impact on product mix and investment strategy**
- **Implementation approach at Allianz**
- **Way forward – Bringing IFRS 17 principles to life**

20 years of international financial reporting at Allianz

IASB

Fundamentals and measurement approach
ð current fulfilment value

P&L presentation and participating contracts
ð OCI solution, CSM unlocking etc.

- **1997**: IASC starts project on insurance contracts
- **1998**: Voluntary application of IAS for consolidated financial statements
  ð For insurance contracts: US GAAP
- **2005**: Effective date of IFRS 4 Phase I
  Application of IFRS 4 Phase I for insurance contracts
  ð For recognition and measurement: "Frozen US GAAP as of Jan 1, 2005"
- **2010**: First Exposure Draft
- **2017**: Final Standard expected in May
- **2021**: Effective dates of IFRS 17 and 9 (with deferral)

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Increasing number of Allianz entities applies IFRS for separate financial statements

§ As a leading global financial institution we support the creation of an IFRS for insurance contracts
§ Aligned initial application of IFRS 9 and 17 conceptually and operationally favorable

Performance reporting under IFRS 17 for Life/Health: non-GAAP measures

Currently strong focus on non-GAAP measures

Heterogeneity and complexity of products

Diversity in local GAAPs

- Market consistent embedded value (MCEV) developed by European Insurance CFO Forum as aligned and rigorous framework
- Financial crisis revealed MCEV's weaknesses, resulting in entity-specific adjustments and impaired comparability (e.g., value of new business)

IFRS 17 as opportunity for improvement

- IFRS 17 has its roots in embedded value reporting, but reflects learnings from financial crisis (ð variable fee approach)
- More consistency of GAAP and non-GAAP numbers, specific embedded value concept no more needed
- Better comparability with global peers, e.g. also in Asian market (IFRS often used also for stand alone financials)

Performance reporting under IFRS 17 Life/Health: alignment with Solvency II

Market Value Balance Sheet (MVBS) for Solvency II

- ð Measurement of insurance liabilities based on prospective, stochastic valuation

1) Disconnect in measurement models
2) No income statement under MVBS
   - ð Difficulties to explain own funds movement

Current IFRS (= local GAAP or US GAAP)

- ð Measurement of insurance liabilities generally based on locked-in assumptions / amortized cost

IFRS 17 as opportunity to better link Solvency II to IFRS

- § Similar conceptual basis: IFRS 17 and Solvency II based on a prospective current value measurement model.
- § Misalignment of project timelines of Solvency II and IFRS 17 resulted in development of two separate balance sheets with unnecessary differences.
- § Our preference: use IFRS balance sheet as basis for Solvency II, similar to the approach taken under Basel III.
  - ð EIOPA would need to accept a more principles based accounting framework as basis for Solvency II.
  - ð Would allow one standardized audit and avoid conflicting steering implications.

Performance reporting under IFRS 17 for Property-Casualty (P/C)

Status Quo: Only little complaints about inconsistency and intransparency from user side

Local GAAPs are similar all over the world	Challenges regarding transparency about adequacy of loss reserves is due to its nature	Limited focus on non-GAAP measures

No need for fundamental change through IFRS 17

- Premium Allocation Approach (PAA) is conceptually similar to current practice and generally provides a workable solution for P/C business
- Discounting of loss reserves and explicit risk adjustment with limited impact only
- Risk areas during implementation:
  - By nature, principle-based guidance requires interpretation when applied
  - Inappropriate interpretations may result in significant cost without substantial benefit for users (e.g., granularity of onerous contract test, scope of PAA, balance sheet presentation)

Findings from first impact assessment: IFRS 9/17

	Traditional European Par Business (Variable Fee Approach – VFA)	Universal Life Type Business (Modified Building Blocks Approach)	Retail P/C Portfolio (Premium Allocation Approach)
Investment	§ Under IFRS 9, fair value through P&L (FVPL) measurement for equities, non-consolidated debt funds and debt investments failing SPPI test § Fully mitigated under VFA through book yield and CSM unlocking (ð Potentially even broader investment/ hedging possibilities)	§ Predominantly fixed interest investment portfolio – not much change expected from IFRS 9 § No mitigating effect in P&L from IFRS 17	§ Under IFRS 9, FVPL measurement for equities, non-consolidated debt funds and debt investments failing SPPI test § No mitigating effect in P&L from IFRS 17
Underwriting	§ Net income predominantly determined by allocation of contractual service margin (CSM) over coverage period § Higher volatility from potential onerous legacy books (no buffering CSM existing)	§ Approach seems to work for universal life type business § Approach would be unfavorable for European par business with more diverse investment portfolio	§ Underlying accounting model is very similar to current practice, but balance sheet and P&L presentation changes § Existing KPIs (e.g., combined ratio) remain with adjustments due to e.g. discounting of loss reserves

Majority of Life/Health business falls under VFA approach which works well; Premium allocation approach also workable, but (too) granular onerous contract testing requirements might cause undue costs and efforts without substantial benefits.

IFRS 17 impact on product mix and investment strategy

Product mix	**Property-Casualty** § No impact expected **Life/Health** § Prospective, current measurement of insurance liabilities makes costs of long-term guarantees transparent ð Requires discipline in product design and pricing ð May drive management action on onerous legacy books § In Europe, already anticipated by Solvency II; impact may be more significant in other jurisdictions IFRS 17 does not change existing trends in the insurance market
Investment strategy	**Property-Casualty** § Only weak link between underwriting and investments; while IFRS 9 may trigger changes, no impact from IFRS 17 expected **Life/Health** § Variable fee approach (VFA) reflects the strong interaction between investments and policyholder benefits for participating contracts ð Investment strategy can focus on optimization of returns for policyholders and Solvency II risk position ð Hedging of embedded options and guarantees generally does not create accounting mismatches – depending on product features, hedge accounting becomes partly more complex, partly easier Under the VFA, reduction of accounting constraints for asset-liability management of participating contracts

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Implementation approach at Allianz

Upcoming standards require significant investments in IT and processes	§ Implementation costs in the lower three digit million Euro range expected – up to the range of Solvency II implementation costs § Fundamental change and complete reset of the balance sheet requires early testing and parallel run of old and new regime
Leverage group solutions and Solvency II	§ Do not reinvent the wheel – avoid multiple local investments in IT solutions and concepts § Leverage existing solutions where appropriate, in particular Solvency II
Strong impact on Accounting and Actuarial function	§ Complex accounting model requires strong central governance over accounting and actuarial processes and related IT § Close collaboration of Accounting and Actuarial function absolutely necessary under IFRS 17
Internal and external Communication a significant challenge	§ Management needs to understand new KPIs – planning and steering processes need to be adopted § Users will need significant time to adopt to new accounting world and rebuild experience and their trust in the numbers

Way forward – Bringing IFRS 17 principles successfully to life

We need workable solutions

Examples of **critical topics**:

- Property & Casualty: Granularity of onerous contract test, scope of premium allocation approach, balance sheet presentation.
- Life / Health: Level of aggregation for contractual service margin, scope of variable fee approach.

Also during the implementation period additional issues might emerge (e.g., transition rules).

How we can get there

After the publication of the standard:

1. Industry together with key stakeholders (auditors, actuarial associations, users, etc.) drive **hands-on interpretation** of IFRS 17, in particular with regard to critical topics.
2. Use IASB's **Transition Resource Group (TRG)** to resolve critical topics that cannot be resolved with key stakeholders, which requires an open and dynamic decision process in the TRG.
3. Ultimately, IASB needs to be prepared for **fine-tuning of IFRS 17 rules** before first application if severe issues cannot be resolved via interpretation.
4. **EFRAG** could support the above mentioned process with its technical capabilities (i.e., Insurance Working Group) and by leveraging the insights from the endorsement process in a constructive manner.