IFRS 17 Insurance Contracts Standard
Presentation to the EFRAG Board

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Brussels – 14 September 2017

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Proposed Agenda

- Context
  - Overarching considerations
  - Prudential Group's long-term insurance business
  - Development of the standard and insurers' current reporting

- Prudential perspective : Aspects that give rise to uncertainty over the combined effect
  - Complex and wide ranging changes to requirements
  - Multiple accounting options and judgements
  - Operationally complex and expensive
  - Untried and untested model

- Conclusions
  - Testing needed over 2018
  - Implications for endorsement process

- Discussion session

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Context – Overarching considerations

Importance of IFRS 17 and EFRAG endorsement process to Prudential Group.

- Listed in UK, US, Hong Kong and Singapore
- Asian operations are significant and local regulators look to IFRS as reporting basis
- Considerable proportion of Prudential shareholder base sourced from EU countries

Importance of ensuring IFRS 17 is right for the industry. The standard needs to be demonstrably a basis of reporting that is:

- Comparable between companies and from period to period
- Reflects business performance
- Understandable by users in practice
- Enables predictive usage, and
- The benefits outweigh the costs

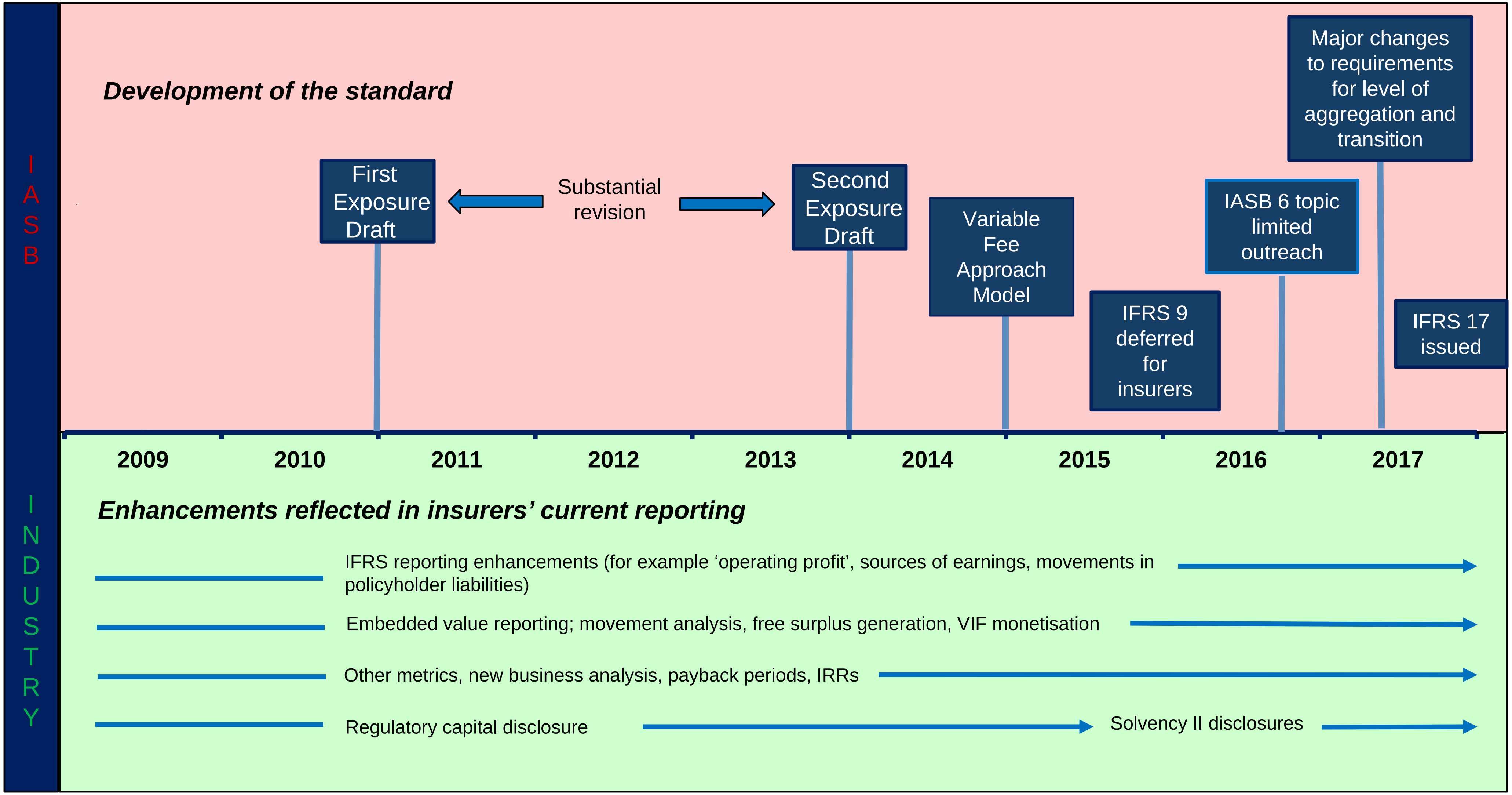
➢ **EFRAG endorsement process is key to ensuring a standard that is fit for purpose**

Context: Prudential Group's long-term insurance business

	Total Long-term insurance 2016 £'bn	Asia	US	UK
Key focus for customers		Protection and regular savings	Retirement planning	Asset accumulation & retirement solutions
Principal products		- Unit linked & riders - Other savings products	- Variable annuity - Fixed annuity - Fixed index annuities	- With-profits & similar products - Annuities in payment
IFRS (Current IFRS 4 basis)				
Operating profit*	4.4	35%	47%	18%
Total assets	466.1	16%	42%	42%
Liabilities to policyholders	403.3	14%	42%	42%
Shareholders' equity	15.9	30%	33%	37%
European Embedded Value and other metrics				
New business				
- sales**	6.3	57%	25%	18%
- profits	3.1	66%	25%	9%
Operating profit*	5.7	54%	35%	11%
Underlying free surplus generation	4.1	32%	45%	23%
Shareholders' equity	40.9	46%	29%	25%

* Based on longer-term investment returns
** Annual premium equivalent: regular premium plus 1/10th of single premiums

Development of the standard and insurers' current reporting



- **Full suite of IFRS 17 requirements settled after much iteration only very recently with some late changes for some key aspects**
- **Insurers have developed extensive supplementary reporting measures alongside IFRS4 basis results. These measures will likely continue to be used for the foreseeable future. It is important that uncertainties over whether IFRS 17 is a clear step forward are addressed thoroughly whilst the currently stable platform is maintained.**

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Prudential perspective : Aspects that give rise to uncertainty as to the overall effect of the standard

a) Complex and wide ranging requirements, policy and choices, and judgements

b) Operationally complex and expensive

c) Untried and untested model

The <u>combined</u> effects of these factors are not yet fully understood.

We propose that the EFRAG endorsement process needs to include comprehensive testing to provide the necessary level of assurance.

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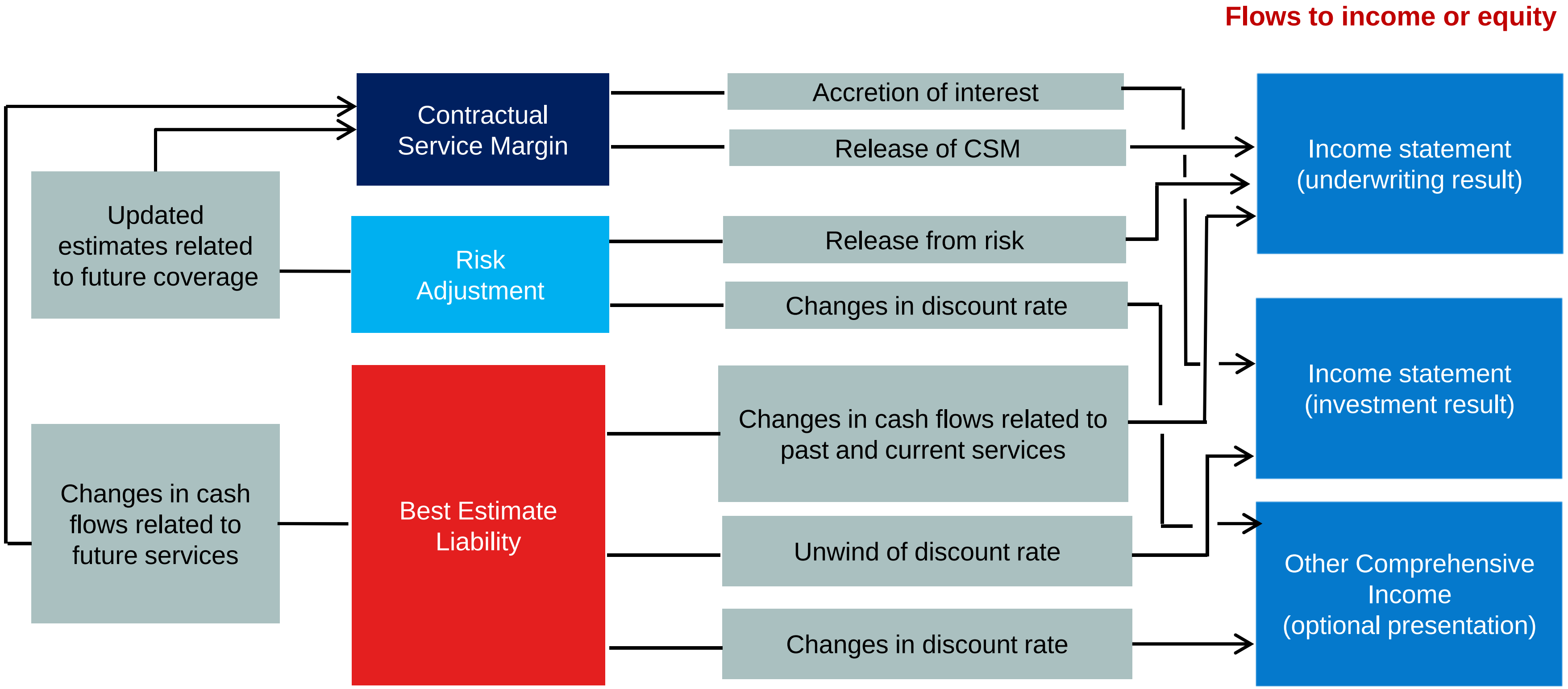
a) Complex and wide ranging changes to requirements

Basic building block approach

Accounting treatment of changes in components of the balance sheet



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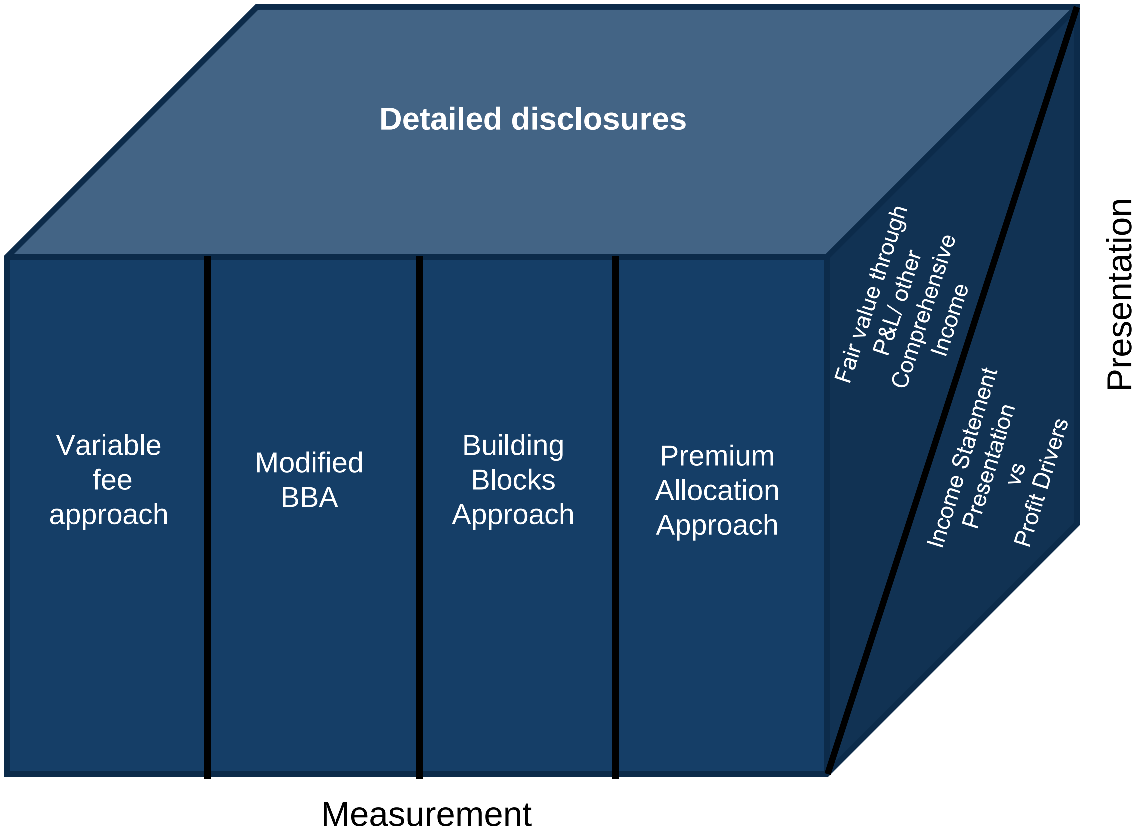
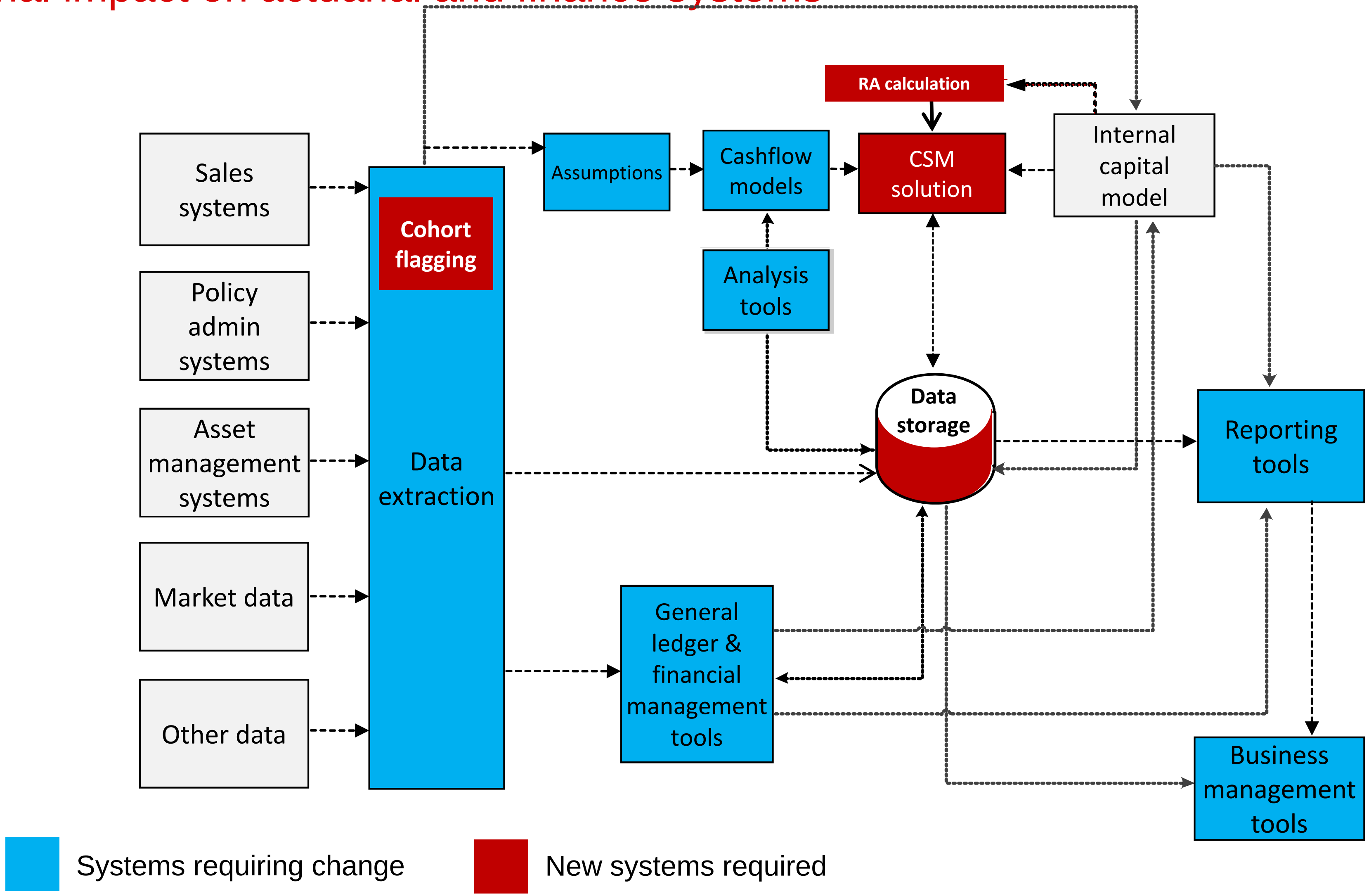
Multiple areas of complexity for the whole IFRS 17 model



- **Measurement model necessarily complex to reflect different types of product**
- **Fundamental change on all aspects for measurement, presentation and disclosures**
- **In addition, multiple policy choices, options and judgements will be applied by companies**

b) Operationally complex and expensive

Operational impact on actuarial and finance systems



- The level of operational requirements are fundamentally different to those under current accounting.
- Implementation of the new reporting process will be complex, take time and require significant scarce resource
- Fundamental reconfiguration and enhancement to systems and processes required

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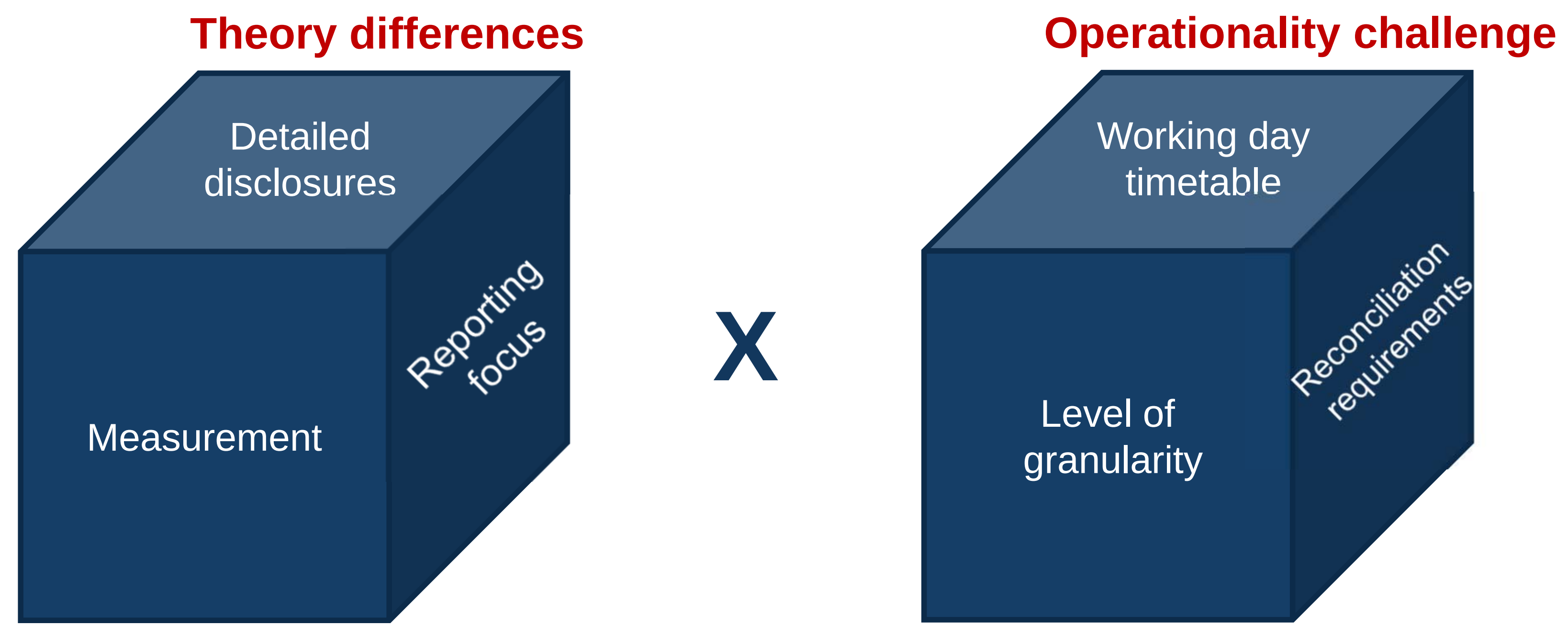
Differences between Solvency II and IFRS 17



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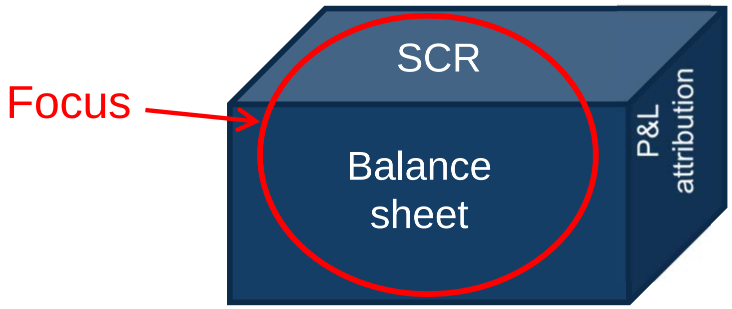
- **The level of operational requirements are also very different to those under Solvency II.**
- **Solvency II cost UK headquartered groups and companies in excess of £3 billion. On any reasonable assessment IFRS will cost them £1 billion to £2 billion. Extrapolation of these estimates to the total across Europe will give rise to tens of billions of euros of implementation cost.**

Different focus of Solvency II and IFRS reporting and fundamentally different detailed disclosures

Solvency II



Focus: Own funds
(Capital requirement)

Excess capital

Reporting requirements:

- Sensitivities
- Pillar 3 (mostly balance sheet focused)
- SFCR
- RSR

IFRS 17

Focus:

- In period performance
- P&L, OCI and CSM emergence
- IFRS equity

Disclosure:

- Explanation of recognised amounts including reconciliations
- Significant judgements
- Nature and extent of risks
- Sensitivity analysis

- **Although there are some reconciling elements, the focus of stakeholders between the two methods is very different**

Changes required to Solvency II actuarial models to enable IFRS17 results

	Non-participating business: ▪ **UK annuities** ▪ **PCA non-linked protection**	**Participating business:** ▪ **UK & PCA with-profits** ▪ **PCA unit linked** ▪ **Jackson variable annuities** ▪ **Jackson spread**
Discount rate	▪ Top-down or bottom up rate reflecting characteristics of liabilities. ▪ Multiple locked-in discount rates require multiple model runs.	▪ Discount rate reflects dependence of cash flows on returns on underlying assets.
Fixed cash flows	▪ Although cash flows are similar to Solvency II, there are differences in some areas (e.g. overhead expenses, contract boundaries). ▪ A single material difference to Solvency II will result in additional model runs.	
Variable cash flows	▪ N/A	▪ Consistent with differences in discount rate between IFRS 17 and Solvency II there will be differences in projected earned rates and economic scenarios used to value options & guarantees.
Detail of output	▪ Significant increase in detail of output to support: ➢ Unlocking of CSM ➢ Presentation (e.g. separation of investment component) ➢ Disclosure requirements (e.g. roll-forwards, separation of contracts in asset/liability position)	
Granularity	▪ Significant increase in granularity of output (e.g. by annual cohort and 3 profitability groups)	
Reporting timetable	▪ IFRS 17 reporting timetable is accelerated compared to Solvency II reporting timetable. ▪ Multiple reporting processes will need to be carried out in parallel.	

- **Actuarial models and IT infrastructure will require significant enhancement to facilitate:**
  - ➢ **Alternative assumptions**
  - ➢ **Increase in the number of runs**
  - ➢ **More detailed and granular output**
  - ➢ **Faster processing**

Operational complexities

	IFRS 17	Solvency II
Granularity	▪ Separate unit of account for: ➢ Portfolios ➢ Level of profitability (3 groups) ➢ Annual cohorts	▪ Unit of account is at the level of Homogeneous Risk Group (similar to IFRS 17 portfolio)
	⇒ IFRS 17 is fundamentally more granular for determining CSM	
Working day timetable	Timetable for production and review of results will need to be very closely aligned for reporting deadlines to be met.	
	⇒ The need for timely financial reports will drive a requirement for parallel processes but different systems (and possible different teams) will be required to support each reporting framework.	
Reconciliation requirements	▪ Balance sheet reconciliation: ➢ Between Solvency II own funds and IFRS 17 shareholder equity ➢ Between Solvency II BEL and IFRS 17 BEL ▪ Reconciliation of profit drivers: ➢ Between release of CSM and risk adjustment under IFRS 17 and movement in Solvency II own funds	
	⇒ Significant effort will be required to explain the difference between IFRS 17 and Solvency II disclosures	

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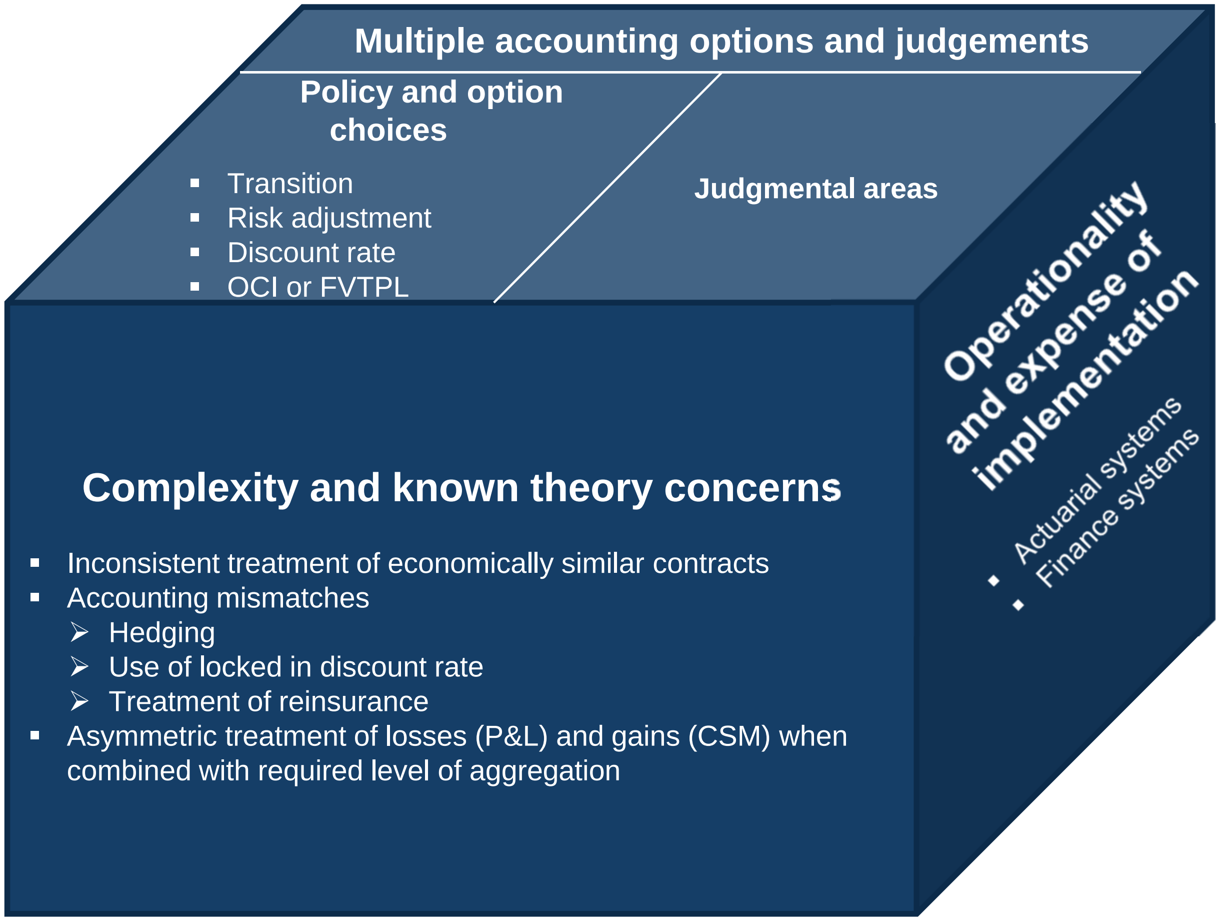
Summary illustration of multiplicative effects on impact of requirements



- **Very challenging Rubik's cube which gives rise to uncertainties as to how the standard will work in practice**

c) Untried/untested model

- Transparent process with the industry as the IASB has developed its requirements
- Extensive changes following the 2010 and 2013 Exposure Drafts
- Approach to participating contacts revamped in 2015 following CFO Forum representations but scope of VFA limited to certain criteria.
- IASB outreach in 2016 limited to 6 topics of a very complicated model and confined to understandability and ‘operationality’ of the proposals as they stood then. This then led to significant changes to the requirements for level of aggregation and Transition, for determining the CSM in the opening balance sheet.

➢ **Final important step is to test the application of the standard to provide sufficient assurance as to whether the standard is fit for purpose.**

Conclusions

What is needed?

- Sufficient quantitative evidence on whether IFRS17 will in practice meet the necessary criteria for such a fundamental change in requirements

- Comprehensive testing over 2018, recognising that the findings need to emerge in a timely manner, with work in progress conclusions at stages throughout the year, to enable a smooth endorsement process.

- The testing approach needs to reflect a realistically pragmatic approach to what is possible in the time available
  - Needs to be sufficiently focused to deliver conclusions on known problem areas

    and
  - Provide a comprehensive enough approach as to whether the criteria for the standard are met in practice and whether it is resilient to stress effects

- It is important for shareholders, investors, and the wider financial community that IFRS17 is a robust accounting standard that is fit for purpose. We stand ready to support the EFRAG testing for such a fundamental change to the industry.