Business Planning: Insurance

Overview

1. BP:I syllabus changes for 2018
2. IFRS 17
3. Investments, risk, and asset-liability matching
4. Ethics, regulation and commercial considerations
5. Exam technique and professional skills
6. Marking a sample script
7. Overview of 2017 exam sessions
8. Q&A

1

BP:I syllabus changes for 2018

Inclusion of IFRS 17 is the major change for 2018.
Otherwise changes are largely 'housekeeping'.

Business Planning: Insurance paper

- Professional Level module
- 2.5 hour computer-based exam
- 3 scenario based questions with multiple requirements (Q1 c.40 marks)
- 55% pass mark
- Access to all learning materials in the exam
- Students are strongly advised to complete FAR and AA before attempting BP:I
- A bridge between Professional and Advanced levels

Syllabus changes – sections 1 & 2

- 1(b) - explain the nature of general (non-life) insurance ~~(including Lloyd's markets)~~ and demonstrate an understanding of the issues and practices for different classes of insurance, including, but not limited to: property, motor, health, catastrophe and casualty
- 1(c) - explain the nature of life insurance and demonstrate an understanding of the issues and practices relating to savings products, annuities, pensions and other long-term insurance products
- 2 - Students will be able to identify the regulatory, operational and financial risks in relation to the insurance sector including the impact of data analytics and explain the principal methods and frameworks for managing those risks.

Syllabus changes – section 3

- 3(d) – demonstrate an understanding of IFRS 17, *Insurance Contracts* ~~of current issues in accounting for insurance contracts, and explain and appraise the proposals of Exposure Draft ED/2013/7, *Insurance Contracts*~~
- 3(e) - determine and calculate how different bases for recognising, measuring, disclosing and presenting investment ~~financial~~ assets and financial liabilities can impact upon reported performance and financial position in accordance with IAS 32, IAS39, IFRS 7, IFRS 9, IFRS 40 and FRS 103
- 3(f) - determine the impact on reported performance and financial position of the ~~including potential~~ recoverability of reinsurance receivables, allowing for insolvency of reinsurers, exhaustion of reinsurance, obligations arising from "financial reinsurance" and gaps in reinsurance cover
- 3(j) - identify and explain the circumstances where it is appropriate to use fair value measurement ~~for financial instruments~~ in accordance with IFRS 13 and evaluate the factors which may impact upon fair values, including trading cycles, credit risk, market risk and associated controls (but not including technical valuation)

Syllabus changes – section 5

- 5 - Where ethical issues and dilemmas arise, students will be required to apply the fundamental principles and guidance in the IESBA ~~IFAC~~ and ICAEW codes to identify, recommend and justify appropriate actions.
- 5(b) - recommend and justify appropriate actions where ethical issues ~~dilemmas~~ arise in a given scenario

Learning materials

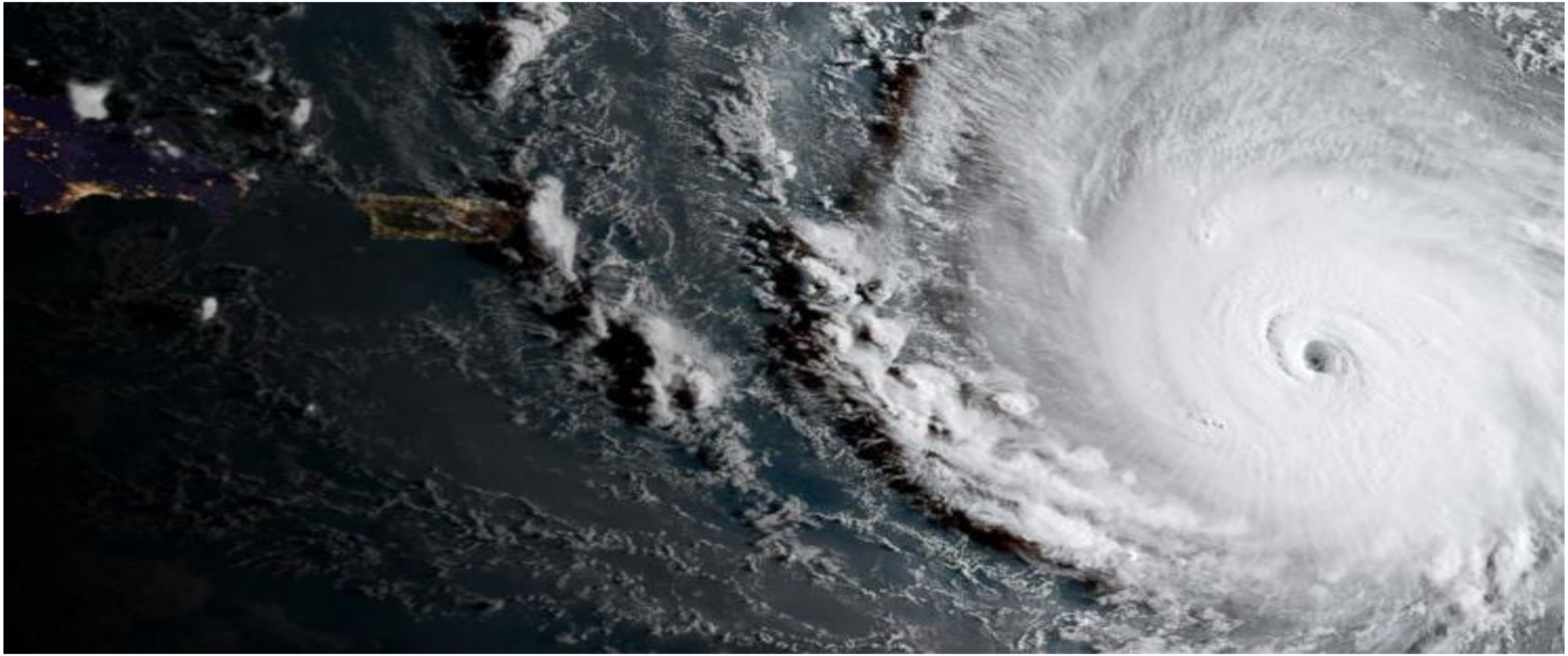
- Continuous quality improvement process
- New IFRS 17 section in chapter 4 and questions in QB/EQB
- Reorganised chapter 6 on risk management, new section on ALM added
- Audit of SFCR added to chapter 12 & 13
- Section on whistleblowing added to chapter 15

2

IFRS 17

A fundamental change to insurance accounting

IFRS 17: Insurance Contracts



The history of insurance accounting

Traditional: Lloyd's market three year funded accounting

Progressive move to one year accounting using ABI SORP:

- Unearned premium reserves
- Unexpired risk provisions
- Deferred acquisition costs

IFRS 4:

- Interim standard
- Lots of gaps, eg no guidance on premium recognition
- Deals poorly with long-term insurance business
- Alternative measures (eg MCEV) filled information gap

IFRS 17:

- A major step forward

Some important features of insurance accounting

Cash cycle inverse to normal business

Claims notified

Claims IBNER

Claims IBNR

“Tail” of claims

Long-term v short-term business

A composite insurer may write life business, general business and business that isn’t insurance contracts at all (eg savings products).

Both IFRS 4 and IFRS 17 cover insurance contracts, not insurance companies

Scope of IFRS 17

Scope of IFRS 17

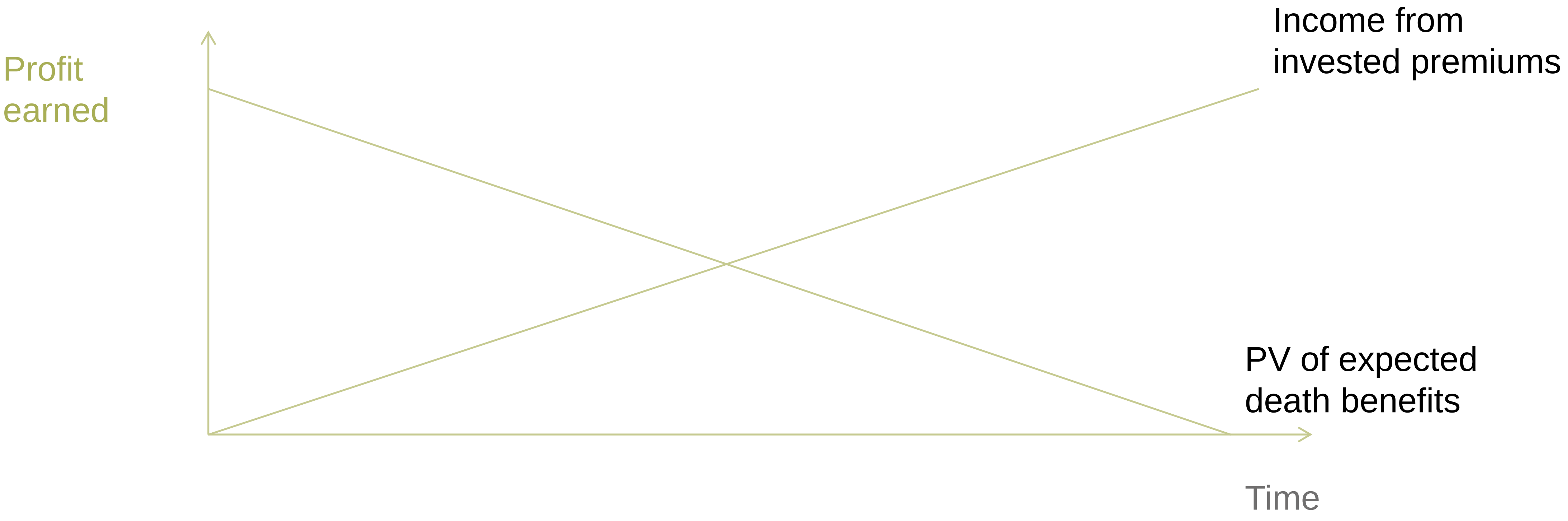
Key problems with IFRS 4

- Major gaps in content
- Focus on general insurance
- Misleading pattern of profit recognition for long-term/ life insurance
- Inconsistent use of discounting of insurance liabilities

Accounting for long-term life insurance

Example of a 20 year term life policy:

- At inception: On risk for mortality over the full 20 year life of the policy
- At inception: No deposits received, so no management fees



Extract from an embedded value report

in USD millions, for the years ended December 31	2016			2015
	Share-holders' net assets	Value of business in-force	Total	Total
Opening embedded value before the methodology change	**7,097**	**10,540**	**17,637**	**19,290**
Methodology change[1]	**1,849**	**(1,806)**	**43**	**(467)**
Opening embedded value after the methodology change	**8,946**	**8,734**	**17,680**	**18,823**
New business value	**(531)**	**1,398**	**866**	**912**
Expected contribution at reference rate	103	157	**260**	**239**
Expected contribution in excess of reference rate	222	140	**362**	**432**
Expected transfer to shareholders' net assets	878	(878)	**–**	**–**
Operating assumption changes	(37)	(214)	**(251)**	**(170)**
Operating variances	(34)	(426)	**(461)**	**41**
Embedded value operating earnings	**600**	**177**	**776**	**1,454**
Economic variances	404	(330)	**74**	**(46)**
Other non-operating variances	(376)	346	**(30)**	**(89)**
Embedded value earnings	**628**	**193**	**821**	**1,318**
Capital movements	(484)	28	**(457)**	**(1,166)**
Foreign currency translation effects	(592)	(402)	**(993)**	**(1,339)**
Closing embedded value	**8,498**	**8,553**	**17,050**	**17,637**

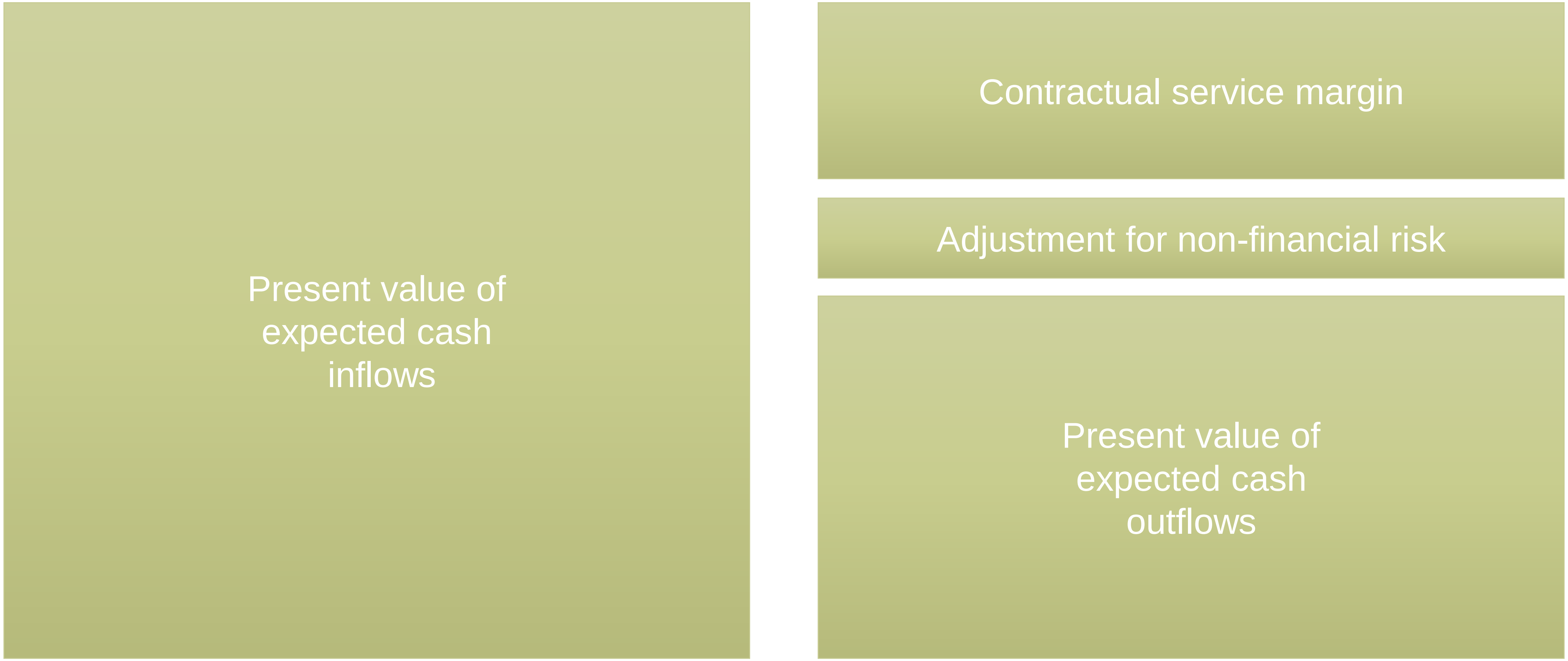
Source: Zurich embedded value report 2016

IFRS 17's two methods

- **Premium allocation approach**
  - Contracts 12 months or less
  - Fairly simple accrual accounting
- **General measurement method**
  - Contracts over 12 months
  - Some similarity with MCEV

The premium allocation approach is a simplification allowed only in restricted circumstances. The default method of IFRS 17 is the general measurement method.

GMM: Value of insurance policy at inception



GMM example: Blue Moon 1

- Blue Moon Insurance writes an insurance contract that incepts on 1 January 2018.
- The contract provides three years of cover, expiring 31 December 2020.
- The premium of £42,000 must be paid in full up front.
- The expected cash outflows (claims and claims handling expenses) are estimated at 1 January 2018 as having a present value of £34,000. This was arrived at by discounting expected payments at an annual rate of 3%.
- The company estimates that an adjustment of 6% of expected claims is appropriate, given uncertainties about the underwriting result.
- The premium was not yet paid on 1 January 2018.

Show the impact of this contract on the financial statements at 1 January 2018.

Blue Moon 1: Estimate of initial cash flows

At contract inception	£
Present value of cash inflows	
Present value of expected cash outflows	
Net present value of cash flows	
Risk adjustment	
Fulfilment cash flows	
Contractual service margin	

GMM example: Blue Moon 2

- In the year ended 31 December 2018, Blue Moon paid claims totalling £12,000.
- The premium was paid in full on 3 January 2018.
- The expected remaining cash outflows (claims and claims handling expenses). are re-estimated at 1 January 2018 as having a present value of £23,020. The discount rate of 3% was unchanged.
- The company estimates that an adjustment of 6% of expected claims remained appropriate for non-financial risk.

Show the impact of this contract on the statement of financial position and statement of profit or loss for the year ended 31 December 2018.

Blue Moon 1: End of year 1

At end of year 1	£
Present value of cash inflows	
Present value of expected cash outflows	
Net present value of cash flows	
Risk adjustment	
Fulfilment cash flows	
Contractual service margin	
Liability for remaining coverage	

General measurement method

	PV future cash flows	Non-financial risk adjustment	Contractual service margin	Liability for remaining coverage
1 Jan 2018				
Changes related to future service				
Cash inflows				
Insurance finance expense				
Changes related to current service				
Cash outflows				
31 Dec 2018				

General measurement method P/L

	£	£
Insurance revenue		
Insurance service expense		
Insurance service result		
Insurance finance expense		
Investment income		
Investment result		
Profit for the year		

Premium allocation approach

Some surprising features relative to current insurance accounting GAAP:

- Acquisition costs can be written off directly to profit or loss at policy inception
- No requirement to split income on premiums paid by instalments into premium income and finance income
- Discounting if time value of money is material

Premium allocation approach permitted use

The PAA is permitted where:

- Insurance contracts have a life of no more than 12 months; **or**
- Where no significant changes in cash flow estimates are likely to occur before claims are incurred and no significant judgement is required in order to allocate the premium over time.

Blue Moon 2

- Blue Moon Insurance also writes a professional indemnity insurance policy that incepts on 1 January 2018.
- The premium for the year of £20,000 is paid in advance in full on 1 January 2018.
- It paid a broker £500 to arrange the policy on its behalf with the policyholder.
- By the end of Q1 (31.3.18), no claims have been notified, nor are believed to have been incurred.
- By the end of Q2 (30.6.18), a claim has been notified with a claims reserve of £35,000. Experience suggests that this is likely to be around the correct figure and claims handling costs of £5,000 will be incurred handling the case. Assume that both will be expected to be paid on 30 June 2020.
- A discount factor of 3% per annum is estimated as being appropriate.
- The company elects to write off business acquisition costs immediately to profit or loss.

Required

Show the impact of this transaction in the quarterly management accounts for Q1 and Q2, using the premium allocation approach.

Extracts from financial statements: PAA

	Q1 result	Q2 result
P/L: Insurance income		
P/L: Insurance expenses Q2:		
SOFP: Cash Q2:		
SOFP: Insurance liabilities Deferred income		
SOFP: Equity Q2:		

3

Investments, risk and asset-liability management

Core area for insurance companies, particularly life companies. Likely to be a component in most exam sessions. Candidates' scripts often show a lack of depth on these areas.

Three related issues

- Investments and their characteristics
- Risk related to investments
- Asset-liability matching (ALM)

Exam performance

- Likely to be an element in most sessions
- Some strong answers on these areas, but
- Tendency to be superficial
- Some reveal a weak understanding of the nature of risk

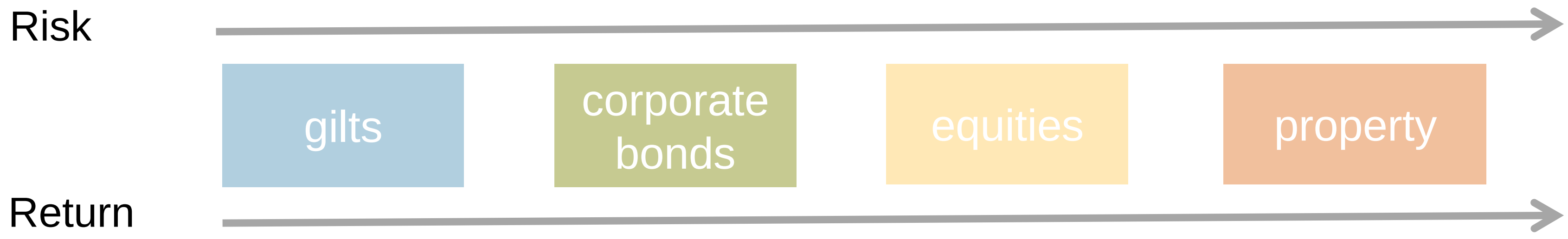
Investment and their characteristics

- Investment assets back insurance liabilities/provide benefits/create return
- Can breakdown into asset classes
  - Equities, corporate bonds, gilts, property etc
  - Need to appreciate their characteristics
- Avoid generalisation
  - UK vs overseas
  - Listed vs unlisted
  - Smaller companies vs FTSE100
  - Longer vs shorter dated bonds
- Apply professional scepticism, don't just accept management view/portfolio

Risk related to investments

- Uncertainty in the future value of asset or liability
- Probability of not meeting future claims
- Candidates need to consider different types of risk
    - Credit
    - Market
    - Liquidity
    - Inflation
    - Currency
- Not sufficient to just comment on overall risk level
- ALM necessitates decomposition of risk

Inadequate approach



- Too simplistic
- Fails to consider types of risk
- Doesn’t provide an effective link into ALM

Preferred approach

ASSET CLASS	CREDIT RISK	MARKET RISK	INFLATION RISK	LIQUIDITY RISK
GILTS	None	Interest rate Depends on duration	Yes, for straight gilts	Low - deep and liquid market availability of repo
UK CORPORATE BONDS	Higher than gilts. Varies on issuer. Can be high	Interest rate plus issue specific factors	Yes, if fixed interest	Can be relatively high after issue
UK EQUITES	-	Affected by wide range of factors depending on stock and sector	Generally low, provide real return	Variable, low for listed large cap, may still suffer block discounts
UK PROPERTY	None	Affected by wide range of factors	Low, historically provide real return	High – heterogeneous assets, may take time and costs to sell

- Decomposes overall risk
- Encourages greater precision
- Provides the necessary info to make ALM decisions

Asset-liability matching

- Matching risk characteristics of assets and liabilities
- Enables reduction of overall risk faced
- Maximises the return than can be earned
- Examples
  - Currency matching € liabilities
  - Duration matching liabilities and bond holdings
  - Holding property to meet illiquid liabilities
- Recommend/analyse investment choices
- Reliant on an understanding of investments and risk

What we would like to see

- Better analysis of assets/liabilities
  - Identify and use information given in scenario and exhibits
- More precision in comments and recommendations
  - Equity – overseas/UK/large cap/listed etc.
  - Bonds – rating/duration
  - Gilts – duration
- More nuanced view on risk, avoid broad unsupported statements
  - ‘Equities are too risky’
  - ‘Property investment is unsuitable’
  - ‘Insurers should avoid risk’
- Avoid allergy to risk – ‘invest in gilts’ not a universal panacea

4

Ethics, regulation and commercial considerations

Ethics and regulatory issues are often linked and feature in all exam sessions. Candidates can score high marks, but some miss this opportunity.

Ethics

- 5 -10% syllabus weighting
- Practice ethics – candidates generally do well
  - Relate circumstances to ethical code, duties, safeguards etc
- Insurance industry ethics – often weaker performance
  - Need to show an understanding of duties/responsibilities of insurers
- Tendency to overstate the role of regulation vs commercial interest
- Treating customers fairly is not a universal panacea

Exam performance

- Unsupported assertions are common
  - ….this is unfair/unethical…
  - ….this is not treating customers fairly….
- To score well statements must be justified
  - Not enough emphasis on how and why
- Tendency to be too ready to call foul
- Pricing mainly a commercial issue
  - Regulator unlikely to intervene unless another issue eg. transparency, suitability
  - Insurers not obligated to charge lowest price for policies
- Ethics/regulation questions can provide an opportunity to score well

What we would like to see

- Apply regulation/ethics to facts extracted from scenario and requirement
- Produce a balanced conclusion
  - Candidates should avoid becoming consumer advocates
- Avoidance of dubious blanket statements, such as
  - ‘Insurers should not increase premium just because a policyholder makes claim’
  - ‘Not fair to increase premiums for those with greatest need for insurance’
  - ‘Not permitted to take into account factors over which the policyholder has no control’
- Ensure that comments are balanced and commercially credible

5

Exam technique and professional skills

The scenario based questions in BP:I require good exam technique and professional skills if candidates are to make the most of their knowledge and skills.

Importance of technique and skills

- BP:I exam comprises longer scenario based questions
- Requires good exam technique
- Development and application of professional skills important
- Many scripts exhibit poor technique and skills
    - Can be the difference between pass and fail
    - Includes some candidates that are otherwise well prepared
    - Some pass despite lack of technique and skills
- Largely relatively obvious things, but need to be practised

Read the question

- Not identifying key information from the scenario
  - Irrelevant info
  - Missing the point
- Not answering the precise requirement
  - Irrelevant info
  - Partial answer
- Leads to other problems
- Solutions
  - Read more!
  - Refresh memory of each requirement before attempting
  - Note down key info

Structure answers effectively

- Some candidate don’t stipulate what they are answering
- Others merge requirements
- Marker cannot justifiably ‘read in’ structural elements
- Solutions
  - Follow explicit requirement structure and guidance in the requirement, such as
    - ‘for each element of the investment portfolio…..’
    - ‘critically assess each of the suggested accounting treatments’
  - Use an effective format
    - Headings, tables etc
- Beneficial side effects

Time management

- Candidates who don’t address all requirements don’t fare well
- Often the side effect of repetition/irrelevant material
  - Open book exam so little credit given for definitions or writing out tracts from the manual
- Longest answers rarely score highest
- Focus on getting the most marks in the time available
- Solutions
  - If unsure don’t keep writing!
  - Read all a question’s requirements first
  - If time is short, may not be expedient to attempt requirements in order

Professional skills

- Skills important to BP:I
  - More involved scenarios
  - Multiple information sources
  - Techniques inferred, rather than specified
- Business planning papers develop skills used at final stage
  - Understand the situation and requirements
  - Identify and use key information
  - Apply critical thinking and professional scepticism

Computer based exams

- Will remove handwriting related intelligibility issues
- Makes structure important
- Ensure that calculations can be followed
  - Only what is actually shown in cells is seen by marker
- Find a way to replicate annotation of exam paper

Break

6

Marking a sample script

You should have on your desk:

Real exam paper from December 2017
Marks plan for December 2017
Confidential tutor mark plan for December 2017
Confidential typed student script from December 2017

7

Overview of 2017 exam sessions

2017 exam sessions – numbers and pass rates

SESSION	JUNE	SEPTEMBER	DECEMBER	2017 MEAN
OVERALL PASS RATE	78.7%	64.5%	78%	73.7%
NUMBER OF CANDIDATES	61	31	91	
FIRST ATTEMPT	38	19	80	
FIRST ATTEMPT PASS RATE	79.2%	78.9%	77.5%	78.5%
RE-SIT	10	12	11	
RE-SIT PASS RATE	76.9%	41.7%	81.8%	66.8%

2017 exam sessions - average mark by question

	JUNE	SEPTEMBER	DECEMBER
QUESTION 1	66%	52%	61%
QUESTION 2	55%	55%	72%
QUESTION 3	61%	54%	62%
OVERALL	61%	54%	65%

Session specific issues

- June
  - Walk through tests and control tests confused by many candidates
  - Answers included both claims and premiums cycles, when just claims cycle in question
  - Some showing off with knowledge not related to the scenario
- September
  - Candidates rarely did well across all three questions
  - Some struggled with life insurance in Q2 and difference between solvency and liquidity
  - Weak exam technique adversely affected many scripts
- December
  - Poor understanding of IBNER, IBNR
  - Intelligibility of failing scripts still a problem
  - Time management seemed better than previous sessions

8

Q & A

Now, or over coffee…

ICAEW