European Insurance Finance and IFRS Conference

Key themes and discussions
Overview

Ernst & Young’s inaugural European Insurance Finance and IFRS Conference took place in London in December 2012, and was attended by just under 70 senior insurance professionals from the world’s leading insurers, guest speakers from the International Accounting Standards Board (IASB) and the European Insurance and Occupational Pensions Authority (EIOPA), and Ernst & Young insurance partners from across Europe.

The day prompted discussion and debate, offering delegates the opportunity to share their insights and challenges around International Financial Reporting Standards (IFRSs), Solvency II, integrated reporting and the future shape of the finance function, among other themes. It was a fascinating day, which resulted in great networking opportunities, changes in attitude and shared insights.

This paper brings together the key messages of the presentations made by Ernst & Young speakers and also analyzes the results of the audience poll conducted throughout the conference. I hope you find this an interesting read.

Thank you for coming along and helping to make the day a real success. Please expect an invitation to our next event soon.

Until next time,

David Foster
Conference Chair and Ernst & Young Financial Services Partner
As senior insurance executives gain greater insights into the new accounting and Solvency II requirements, more are concluding that it may be wise to maintain Solvency II project momentum and accelerate IFRS project planning to ensure more robust and strategic solutions, driving out synergies in project costs.

Complying with Solvency II requirements and the new IFRSs will continue to absorb substantial management resources within the insurance sector over the coming months and years.

Our inaugural European Insurance Finance and IFRS Conference in December clearly highlighted the substantial challenges facing finance teams and the industry. It provided a great forum for delegates to explore these challenges, and share experiences and proposed responses, with many revising their views by the end of the day.

**Substantial business impact**

An initial snap poll showed that the vast majority of delegates (85%) expect there to be substantial business impact that will result from the combined accounting changes arising from IFRS 4 Phase II (insurance contracts) and IFRS 9 (financial instruments).

In addition, almost 4 in 10 (39%) of all participants anticipated that complying with the accounting changes and achieving integration with Solvency II will result in significant additional project time and expenditure. But almost half (46%) expected that many of the requirements, and much of the work necessary to implement the IFRS changes, could be achieved through current Solvency II preparations and incremental developments with appropriate planning and alignment of projects.

Seeking synergies between IFRS and Solvency II projects obviously makes sense to reduce overall project spend and disruption to “business as usual.” However, as most insurers have yet to complete any substantial assessment of the impact of IFRS 4 Phase II and IFRS 9 on their business beyond an initial review of key accounting changes, and with many Solvency II programs now slowed due to unexpected implementation delays, a considerable challenge lies ahead to achieve this alignment and combined project synergies.
Just 14% of delegates had conducted a broader business and technology impact assessment, including the potential repercussions for reported financial results and business processes, systems and tools.

In terms of plans for IFRS projects, a slightly larger percentage — 24% — had either already initiated them or already had plans to do so in 2013. But, perhaps not surprisingly, many are waiting for the IASB to issue its revised IFRS 4 Phase II exposure draft (due in Q2 of 2013), to provide further clarity on requirements and confidence in timing, before committing further to any significant IFRS project work. On the day, 45% of delegates were expecting to initiate their projects once the revised exposure draft is issued. However, 31% said that they would wait for confirmation of the actual implementation date before making any further decisions on project timings. In such instances, having time to then align and seek synergies with Solvency II projects may prove even more of a challenge and could run the risk of higher overall project expenditure.

**Maintain momentum, align projects**

It became clear, as delegates discussed and considered further the remaining challenges to achieve Solvency II compliance and the additional reporting challenges likely to result from the proposed IFRS changes, that they agreed more with the need to maintain the momentum of their Solvency II projects.

By way of example, in a conference poll conducted before any substantial discussion, exactly half of the delegates said they had slowed or deferred remaining aspects of their Solvency II project until they had more certainty of revised time lines. But, after hearing a panel of insurance industry peers share their concerns and experiences on remaining implementation challenges, almost three-quarters (74%) said they would now use the extended time lines to either “catch up,” particularly around Solvency II Pillar 3 reporting requirements, or plan to develop a more robust and strategic solution.

**Q.** For many organizations, Pillar 3 is the least developed aspect of Solvency II. Given the extended time lines, how will you use the extra time?

- 74.08% Will use the time to either catch up or revisit Pillar 3 plans to develop a more robust and strategic solution
- 22.22% Doesn’t apply as our Pillar 3 solution is already well developed and is or will be fully fit for purpose
- 3.7% Not sure
Delegates agreed that the work required to meet the external reporting requirements of Solvency II Pillar 3 is substantial to say the least, with many agreeing that original estimates were probably understated.

Our European Solvency II survey in 2012 also concluded that significant work remained for most insurers to meet Pillar 3 requirements. The data challenge alone is considerable, and meeting the original 2014 Solvency II implementation date was going to be challenging for some insurance companies. Therefore, an advisable approach is to keep project momentum or accelerate transition into business as usual to complete the work, not least because time lines remain uncertain, and local regulators may still push ahead with their own requirements for additional reporting.

As discussion of the combined IFRS and Solvency II challenges continued over the course of the day, delegates were also considering the need to focus on alignment opportunities.

When polled toward the end of the day, 75% said they would now use the Solvency II delays as an opportunity to align or integrate their Solvency II and IFRS projects to drive out project synergies or take a more strategic, forward-looking approach to solutions.

Q. Will you use the SII delays as an opportunity to align or integrate your SII and IFRS projects?

- 25% No plans currently and little appetite to think about it until time lines are more certain
- 35% Yes, this is a significant implementation challenge given the potential “converging” of time lines
- 40% Yes, it is also an opportunity to design more strategically for the future
**Minimize risk, maximize opportunity**

Insurers resolving to push ahead with preparations may also have the opportunity to gain “reputational” advantages.

With the proposed accounting and regulatory changes providing more information and changing the presentation of financial information, insurers will need to carefully manage their message to stakeholders. Hence the need to help them understand the accounting changes and impacts, and distinguishing these from the underlying genuine changes in business performance and value.

Insurers will need to manage the message to stakeholders carefully, helping them to appreciate the pure accounting changes and impacts, and distinguishing these from any underlying genuine changes in business performance and value. The earlier insurers assess the likely impact on reported results and capital requirements, the greater the potential for optimizing that impact – even potentially improving their reported results and capital position under the new reporting requirements.

In addition, the effectiveness of IFRS and Solvency II planning is likely to determine not only the overall project spend, but also ongoing operational costs. History and common sense has shown us that the more major finance change projects such as these are “squeezed” in terms of implementation time-frames, the greater the propensity to resort to tactical work-arounds and multiple spreadsheet solutions. As we all know, these tactical and temporary solutions then have a habit of living on many years beyond the original plan, thereby reducing finance’s operational efficiency and effectiveness, and increasing current and future running costs.

Drawing on the insights shared during the conference discussions, almost 40% of delegates in a closing poll concluded that they may need to rethink Solvency II plans and accelerate their IFRS planning. Given the clear challenges facing the insurance sector, this is an encouraging response.
Insurers face significant IFRS and regulatory reporting changes over the next few years. Although the IFRS 4 Phase II and Solvency II time lines are still moving, the key aspects of the new standards are becoming clear. As a result, reporting will become more complex.

The need to use the building block approach in the measurement of insurance liabilities will impact not only the finance team, but all aspects of the insurer’s business.

From an operational perspective, this will put much pressure on the organization, so it is important that insurers act quickly to enhance their processes, systems, data and models to meet these new requirements. The fact that the effective dates of IFRS 4 Phase II and Solvency II are not aligned is an additional implementation challenge.

There are many similarities between the requirements of IFRS 4 Phase II and Solvency II. However, when taking a look at the fine print of the standards, it becomes clear that a significant number of differences, some larger and some smaller, exist on almost every aspect of the standards.

A clear example of the differences is the requirement to use a residual margin under IFRS 4 Phase II, which is not required under Solvency II. However, potential differences can also be found in the recognition of insurance contracts, cash flows and discount rates. To ensure a successful implementation of both IFRS 4 Phase II and Solvency II, insurers should perform a timely gap analysis to ensure that they can build in the Phase II requirements in their Solvency II project. This will save both time and money.

To address industry concerns, the IASB has taken action to reduce volatility in the income statement, and has tentatively decided to require changes in discount rates under IFRS 4 Phase II to be accounted for in other comprehensive income (OCI).

The IASB has proposed changes to IFRS 9 which would require the fair value changes of certain financial assets to be recognized in other comprehensive income rather than net income. This is meant to avoid an accounting mismatch and would result in part of the volatility as a result of duration mismatches between insurance liabilities and assets backing those liabilities to be presented in other comprehensive income rather than net income.

However, when taking the accounting effects of risk management actions such as the use of derivatives to reduce the exposure to interest rate risk, volatility may be back in net income because IFRS 9 requires derivatives to be marked to market through net income unless hedge accounting is applied. Hedge accounting may not always be possible and comes with additional processes and systems. As a result, the question arises: will insurers see a trade-off between their IFRS accounting and risk management strategies?

Clearly the IFRS changes to reduce volatility will have an operational impact, as accounting is becoming even more complex. It is expected that the measures to address volatility will feature prominently in comment letters on the revised exposure draft to be published in the next few months.
Solvency II Pillar 3 requires reporting to the public and the regulator about an entity’s solvency and financial condition, the business that it writes and the risks that it faces. Reporting requirements, both qualitative and quantitative, are extensive, and will be required within very short reporting timelines. Additionally, reporting will need to be produced by a robust and accurate process.

In most organizations, the coordination and production of these reports will fall to the finance function, and will sit alongside many other reporting demands. Yearly reporting timetables are therefore likely to include the production of:

- Group financial reporting (annually and quarterly)
- Local annual statutory financial reporting
- Annual and quarterly Solvency II reporting templates
- Annual public Solvency II document (Solvency and Financial Condition Report)
- The annual regulatory report (report to supervisors)

Production of the Solvency II information will have to be scheduled alongside the running of the internal models and actuarial calculations necessary to support it. This will mean that the roles and functions of finance in the future will need to change. This will impact on the resources required in finance – both in terms of numbers and skills required.

Our clients are at various stages in their preparations for Solvency II Pillar 3 reporting. Our recent European Solvency II survey revealed that Pillar 3 is the least well-progressed of all parts of the Solvency II preparations.

Having conducted gap analyses of required reporting and mocked-up draft versions of reports, the insurance groups that are further ahead are now paying increasing attention to the implications on reporting systems and on their processes, people and organizations.

Alongside new information, Pillar 3 of Solvency II calls for information that might already be produced in the organization – albeit in a slightly different format – for financial, regulatory or management reporting. There are also overlaps with information that will be produced for own risk and solvency assessment (ORSA) reporting under Pillar 2.

Given this overlap, we believe that the most efficient way to approach the production of Pillar 3 is to conduct an analysis of all the financial and risk reporting that an organization is required to produce, with the objective of finding a way to produce the information only once. This can help ensure that a consistent message is put out by the organization, that constant reconciliation between slightly different information is reduced and that there is a reduction in duplication.

Insurers should use the additional time granted to them by the likely delay in the Solvency II implementation date to take a strategic approach to Pillar 3 reporting. Such an approach will:

- Seek to integrate Pillar 3 with the other reporting by the finance function.
- Enable greater use of systems and automation to meet reporting deadlines.
- Focus on how to change the future finance operating model.
- Result in a reduction in cost and inefficiency to help the Chief Financial Officer ensure that their department continues to add value to the organization of which it is a part.
Why dig up the road twice?
Roy O’Neil, Partner, Ernst & Young LLP (UK)

The best way to address new insurance accounting and Solvency II challenges is through planning an aligned response, taking into account the increased demands on the finance team.

The more that senior insurance executives assess the ramifications of new IFRSs and Solvency II requirements, the more they appreciate the scale of the challenge. Solvency II delays, however, provide the opportunity to take stock and consider how the demands of both IFRS 4 Phase II (insurance contracts) and IFRS 9 (financial instruments) can be addressed in combination with those of Solvency II. It’s much better to dig up the road once than to have to dig it up twice.

A “single dig” approach involves assessing the impacts of IFRS 4 Phase II and IFRS 9 to inform plans for Solvency II – priorities can then be set and resourcing needs clarified. It includes considering the potential for incremental solutions (rather than entirely new ones) to satisfy IFRS, as well as Solvency II, requirements.

Organizations need to appreciate that IFRS compliance will impact the finance operating model in numerous ways. It will trigger investment in systems and finance architecture, and significant process changes, with resulting governance and control impacts. For example, there will be major changes to group consolidation and reporting processes due to the new balance sheet and profit and loss account formats, new charts of accounts and additional disclosure requirements (including estimation approaches and risk information).

The content and structure of data captured from business units to support group reporting will also alter significantly. Planning and performance management processes will similarly need attention – management information and key performance indicators must be consistent with financial results. Processes associated with control and audit, and with financial close activities, will also be affected.

Optimizing the finance operating model
The new accounting and regulatory regimes will necessitate substantial organizational change. Finance functions will face increased cost pressures, so making more effective use of people and eliminating duplicated activities should be key goals. The arrival of Solvency II and IFRS 4 Phase II could therefore provide a stimulus for organizations to review and modify their finance operating models to increase efficiency, while achieving consistent governance and control around finance and actuarial processes. The optimal answer is likely to be found in the three-tier finance model, based on local finance functions acting as business partners, centers of excellence providing complex services (such as actuarial input and group reporting) and shared services consolidating standardized, low complexity processes.
Last, but not least, successfully navigating the IFRS and Solvency II challenge depends on effective people management. It is not just a technical accounting challenge. The new accounting regime imposes transformational change on finance, and needs to be addressed in a clear people agenda, including all members of the finance (and actuarial) team, wherever they are located. Success requires early communication and awareness raising, structured training and development, and an effective resourcing strategy to ensure required skills are available.

Achieving the single dig won’t necessarily be easy. It requires coordination, communication across the business (finance, actuarial and risk teams) and careful planning. But it will prove the most cost-effective way to address the IFRS and Solvency II challenge.

Contacts

EMEIA
David Foster
T: + 44 20 7951 5687
E: dfoster@uk.ey.com

Belgium
Nicole Verheyen
T: + 32 2 774 98 05
E: nicole.verheyen@be.ey.com

France
Pierre Planchon
T: + 33 1 46 93 62 54
E: pierre.planchon@fr.ey.com

Amaury de la Bouillerie
T: + 33 1 46 93 65 80
E: amaury.de.la.bouillerie@fr.ey.com

Germany
Maren Hausmann
T: + 49 6196 9962 9684
E: maren.hausmann@de.ey.com

Italy
Matteo Brusatori
T: + 39 02 7221 2348
E: matteo.brusatori@it.ey.com

Nicola Panarelli
T: + 39 02 8066 9738
E: nicola.panarelli@it.ey.com

Paolo Ratti
T: + 39 02 7221 2440
E: paolo.ratti@it.ey.com

Netherlands
Jasper Kolsters
T: + 31 884 071 218
E: jasper.kolsters@nl.ey.com

Hans van der Veen
T: + 31 88 4070800
E: hans.van.der.veen@nl.ey.com

Spain
Ana Belen Hernandez
T: + 34 915727672
E: anabelen.hernandezmartinez@es.ey.com

Switzerland
Stefan Schmid
T: + 41 58 286 3416
E: stefan.schmid@ch.ey.com

Brian Edey
T: + 41 58 286 4224
E: brian.edey@ch.ey.com

UK
Roy O’Neil
T: + 44 20 7951 5598
E: roneil@uk.ey.com

Kevin Griffith
T: + 44 20 7951 0905
E: kgriffith@uk.ey.com
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