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INSURANCE

The New World for Insurance

Business perspectives on Phase II

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The new world for insurance

In the second half of 2010, the IASB released its Exposure Draft *Insurance Contracts* and the FASB issued a separate Discussion Paper containing its preliminary views on the proposals, which collectively marked the next phase to a global insurance accounting standard, which we refer to as 'Phase II'.

Insurers, analysts, investors and rating agencies have long been calling for greater global harmonisation of accounting rules for insurance companies. Although applying a uniform approach to accounting for insurance contracts will be challenging, the potential benefits are significant.

Comment letters on the Exposure Draft and the Discussion Paper are a matter of public record, and highlight insurers' diverse views on the proposals, their criticisms and sometimes their frustration. In this publication we focus on the business issues of Phase II, issues which will be relevant whether an insurer is transitioning to IFRS for the first time, transitioning to a new IFRS insurance standard or adopting potentially revisions to US GAAP. With this in mind, we conducted a series of structured discussions with the CFOs and senior finance personnel of nineteen leading insurance companies headquartered in eleven countries. Using their feedback, together with our own observations, we have developed a picture of the potential business impact on the insurance industry and its investors, whatever the precise form of the final standards.

The changes are expected to have a significant effect on the perception and comparability of financial performance, both between one insurer and another and between the insurance sector and

other industries. They are anticipated to affect how insurers manage their business, with implications for product design, data requirements, systems, controls and tax.

How can you best position your business for these changes? Rather than a burden, can they be used as a catalyst to optimise your finance function, systems and investor communications?

The key to success is planning and tailoring the journey to Phase II to address your issues. Companies need to begin the transition to Phase II – a task that should begin now. We see significant benefits in a structured approach, starting with a rigorous assessment of the differences between current reporting and Phase II. This is more than simply an accounting exercise – the challenge is to unite the strands into a common programme so that all linkages and dependencies between accounting and reporting, systems and processes, people and the business are established.

We hope this publication will assist you in assessing the potential impact of Phase II on your business as you engage with internal constituents, external stakeholders and your audit committee. We welcome the opportunity to discuss the key issues and opportunities with you as you start your planning for these important changes.

Gary Reader

Global Insurance Advisory Sector Leader

Frank Ellenbürger

Global Head of Insurance



Insurers' thoughts

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have been working jointly on a new insurance contracts standard. On 30 July 2010, the IASB released its Exposure Draft 2010/8 *Insurance Contracts* (the 'ED'). The FASB issued a separate discussion paper (the 'Discussion Paper') on 17 September 2010, containing its preliminary views – similar in nature but differing from the ED in aspects of scope and parts of the measurement model. We refer collectively to the ED and Discussion Paper throughout this publication as 'Phase II.'

Between October 2010 and January 2011, KPMG member firms undertook a series of interviews with CFOs and senior finance personnel to capture their views on the potential business impacts of Phase II.

The majority of interviews were undertaken as companies were formulating their responses to the ED

and Discussion Paper. As many participants were digesting the technical proposals and completing their comment letters to the Boards, they were still in the early stages of evaluating the full impact of the proposals. Many insurers who operate in Europe were focused on Solvency II¹ and were in the early stages of evaluating the impacts of Phase II on their Solvency II implementation plans.

Their views are diverse and highlight not only concerns of the insurance industry as a whole but also the complexities and challenges involved in applying a global insurance standard. This publication focuses on the business issues for the insurance industry on transition to Phase II rather than collecting insurers' views on the proposals in the ED and Discussion Paper². Nineteen leading insurance companies with headquarters in eleven countries and operations throughout the world participated, with interviewees providing insights into the project plan needed to convert to

Phase II, the business implications of implementing the proposals, when implementation needed to start and what progress they had made in planning for the implementation of Phase II.

This publication, *The New World for Insurance – Business perspectives on Phase II*, is based on our participants' views at the time of our interviews. We have used these insights, comment letters to the IASB and FASB (the Boards), and feedback from the roundtable discussions held by the Boards to form our analysis of the potential impact of these changes for insurers and to develop a vision of how insurers can best prepare for Phase II. The finalisation of the IFRS standard and FASB exposure draft is currently in process (the IASB is targeting June 2011). As a result, some of the proposals discussed in this document are subject to change. Nevertheless we believe that well prepared companies should start planning now.

¹ Solvency II is a new capital adequacy regime for the European insurance industry. The new regime contains a revised set of EU-wide capital requirements and risk management standards that will replace the current solvency requirements. The Solvency II directive is due for implementation with effect from 1 January 2013.

² For KPMG's analysis of responses to the ED and Discussion Paper, see IFRS - Insurance Newsletter Issue 11 available at www.kpmg.com/ifrs.



Participant	Products	Headquarters
Aetna Inc.	Life, Accident & Health	United States
AIA Group Limited	Life, Accident & Health	Hong Kong SAR
Allianz SE	Multi	Germany
AMP Limited	Life, Property & Casualty	Australia
AXA SA	Multi	France
The British United Provident Association Limited (Bupa)	Accident & Health	United Kingdom
Eureko B.V.	Multi	Netherlands
Intact Financial Corporation	Property & Casualty	Canada
Manulife Financial Corporation	Life, Accident & Health	Canada
MassMutual Financial Group	Life, Accident & Health	United States
Meiji Yasuda Life Insurance Company	Life	Japan
MetLife, Inc.	Multi	United States
Mitsui Sumitomo Insurance Group	Property & Casualty	Japan
Munich Re	Reinsurance	Germany
Prudential Financial, Inc.	Multi	United States
Prudential plc	Life	United Kingdom
Sanlam Limited	Life	South Africa
Sun Life Financial Inc.	Life, Health	Canada
Zurich Financial Services Ltd (ZFS)	Multi	Switzerland

We would like to thank all interviewees for their insights and candour.

Highlights

Phase II is a business issue, not solely an accounting or regulatory issue, as highlighted below from our interviews:

- As a result of Phase II, insurers are assessing the impact of the proposed future reporting requirements and how these proposals may affect capital and reporting financial performance.
- How an insurer manages its transition to Phase II will significantly affect its business.
- To reduce volatility in reported results and day one losses, some insurers may consider changes to their current product offerings, moving out of longer term products with embedded guarantees towards products in which more investment risk is borne by policyholders.
- Insurers may also seek relief from volatility by changing their asset mix, entering into new reinsurance arrangements, and engaging in new hedging strategies.
- Insurers may see greater discipline in their pricing processes as a result of the new model.
- Using less familiar metrics to analyse insurers' results will potentially be a significant change for the industry. The proposed approach to presentation in the ED and Discussion Paper, which is based on insurance margins, eliminates traditional volume metrics (including premiums and claims/benefit expenses) from the of statement comprehensive income.
- If the ultimate model is consistent with the proposals, many interviewees expect that insurers will provide additional non-GAAP disclosures to accompany financial statements prepared under Phase II.
- Insurers may enter into outsourcing arrangements, restructure sales compensation arrangements with their employees and buy more reinsurance to mitigate the impact of the proposed changes to the recognition of acquisition costs.
- Restructuring of the technology landscape is expected to be complex and costly. Many insurers currently do not have the system capabilities to capture information that will be required under Phase II.
- Phase II will place significant demands on skilled actuarial and finance resources. Gaps are likely to be addressed by hiring additional resources, outsourcing to third parties, training and redeploying skilled resources to focus on Phase II.

Financial management and performance reporting

The top issues to impact the business³ identified through our interviews were:

1 Increased volatility of results

2 Changes to performance reporting

3 Revisions to the definition of acquisition costs

4 Impact on relations with stakeholders and capital management

The Phase II proposals are significant for a wide variety of reasons:

- They have a major impact on the presentation of results and on how investors will evaluate performance of the business, compare insurers with their peer group and evaluate the insurance sector relative to other industries.
- They will have a significant impact on internal reporting and how management communicates business performance and potentially compensates senior management.
- They are pervasive and may require significant time and cost to evaluate and implement.
- They involve a complex interaction of accounting policy and business decisions.
- The business decisions may require revision to contractual arrangements.
- They will have a profound impact on processes, data and systems. The impact on closing processes and reporting timetables may be significant.
- They will place additional demands on skilled resources such as actuaries, IT, finance and investor relations, which may need to be supplemented to meet peak demand.

Educating internal and external stakeholders (investors, analysts, regulators, and rating agencies) on the implications of Phase II for financial results and profitability will be important.

For more information on the accounting topics of the ED please refer to KPMG International's publication "New on the Horizon: Insurance contracts" published in September 2010.⁴

³ The business implications contained within this document are based on the current proposals within the IASB's ED released in July 2010 and the FASB's Discussion Paper released in September 2010. The Boards are currently deliberating these proposals, which are subject to change until final standards are released (targeted by the IASB in June 2011). The FASB is expected to issue an exposure draft for comment prior to release of a final accounting standards update.

⁴ Available at kpmg.com/ifrs

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Volatility

As a result of the proposed insurance model, income and expenses may be more volatile.

Factors contributing to increased volatility as a result of the proposals include:

- assumptions updated at each reporting period
- immediate recognition of changes in estimates and assumptions in profit or loss
- assets measured at fair value may not match the measurement of insurance contract liabilities.

Our interviewees commented that the expected volatility in the proposed model may lead them to:

- investigate changes to product strategy
- re-evaluate product pricing
- restructure reinsurance programmes
- revise investment allocations and asset-liability management.

Product strategy

Insurers are increasingly focused on providing products to meet the needs of an ageing population demanding a secure income in retirement. Finding appropriate investment assets to match very long duration insurance obligations is challenging as there are few fixed income investments that have durations that extend beyond 20 years to match those of the liabilities. Investments that have long durations are often not traded in deep and liquid markets. Matching is imperfect and so the impact of volatility may be significant. Although this volatility exists regardless of the insurers' accounting framework, this pre-existing volatility may sensitise investors to further volatility that arises as a result of the proposed accounting model.

Long-term savings products are attractive to customers seeking a smoothed investment return over a long horizon, under-pinned by a minimum guaranteed return. Our interviewees

expect that increased volatility in reported results is unlikely to prove attractive to investors, as well as those participating policyholders who may also share in increased earnings volatility. Approximately half of our interviewees expect some impact to their current product offerings to mitigate some of the volatility introduced by the proposals. Interviewees believe the impact to be greater for life products than for property and casualty or accident and health products. This arises primarily from interest rate guarantees.

Our interviewees commented that there may be a shift in focus from longer-term products with embedded guarantees, such as universal life products, life products with guaranteed minimum death benefits and deferred annuities, towards products in which more of the investment risk is borne by the policyholder, such as unit-linked products and other types of variable products, or towards more traditional

protection products. Additionally, products that lock in a guaranteed interest rate or investment return may be significantly shortened in duration to reduce interest rate exposures.

A significant minority of our interviewees commented that while Phase II may trigger them to think about their product offerings and asset mix, they would not restructure their current products. In addition, many interviewees were already engaged in hedging strategies to mitigate some of the economic risks and short-term volatility in their life insurance products. These interviewees considered that hedging strategies would be unlikely to change significantly.

One of our interviewees noted that long-tailed lines of business, such as longer-term liability insurance, accident and disability insurance and worker's compensation insurance, which tend to have higher deviations in ultimate losses, may also display greater earnings volatility.

KPMG observations

- Many insurers have identified the need to review their product portfolio to determine the profit signature of their products under Phase II, as well as considering adjusting product design in order to reduce the volatility stemming from movements in discount rates on long-term products.
- Insurers may also need to consider the impact of the ultimate unbundling requirements when contemplating product structure.

Greater transparency of product pricing

Some of our interviewees expressed concern that their product pricing strategy might become more transparent because there is a



requirement for greater disclosure of pricing and margins, sensitivities to assumptions and the concentration of risk. Interviewees were concerned that this transparency may result in increased competitive pressure.

Some of our interviewees thought that the proposed current measurement model would result in further alignment of financial reporting with management practice and that the added transparency in measurement may add further discipline to pricing life products. The costs of embedded guarantees and options may become more transparent which may, in turn, lead to more adequate prices for long-duration products with guarantees and options.

KPMG observations

- As a result of the potential focus on pricing, insurers may need to re-evaluate and review controls and processes around pricing.
- Effective communication between pricing actuaries and reserving actuaries, as well as management, may have more importance under Phase II.

Changes to reinsurance buying

Some interviewees commented that they are rethinking their reinsurance programmes in order to reduce volatility in profit or loss. At the time of our meetings, interviewees were still analysing how the technical proposals on reinsurance in Phase II might apply as many considered that the proposals lacked depth in this area.

The overhaul of Financial Instruments accounting

The classification of financial assets will assume even greater significance in future years as entities are required to adopt new standards on financial instruments in IFRS 9 *Financial Instruments* or under US GAAP. These changes are fundamental to the manner in which entities report their financial assets. Under IFRS this will either be at amortised cost, fair value through profit or loss (FVTPL) or, in limited circumstances, fair value through other comprehensive income (FVTOCI). Under current US GAAP, the measurement of financial assets is determined based on their characteristics and the entity's business strategy and would fall into one of the following classifications: FVTPL

for trading securities, FVTOCI with any impairments and disposal gains or losses recorded in earnings for available-for-sale securities, or amortised cost for held-to-maturity securities. The FASB is currently deliberating changes to accounting for financial instruments, which at this time would differ from IFRS 9.

“A ‘current/current’ approach will allow us to communicate to investors on a basis that is broadly consistent and reconcilable with future regulatory reporting.”

– Dieter Wemmer, CFO,
Zurich Financial Services

The approach to managing volatility in the statement of comprehensive income may depend on how underlying assets are classified, i.e. FVTPL, FVTOCI, or amortised cost.

Some of our interviewees commented that they already use a reporting model that marks financial assets to market and that volatility in earnings does not cause them undue concern. Insurers that measure assets at fair value and value their underlying liabilities with current assumptions, e.g. interest rates, often refer to this as a 'current/current' approach. These interviewees believe the proposed model, in its current form, aligns with internal management practices and future regulatory models.

Asset-liability management

Several interviewees find the proposals difficult to reconcile with a business model that holds investments for the longer term. Such interviewees are concerned that this may place them at a disadvantage compared with other financial services entities, which measure the bulk of their financial assets and liabilities at amortised cost, and so may be expected to experience more predictable earnings. Some interviewees also commented that short-term market movements

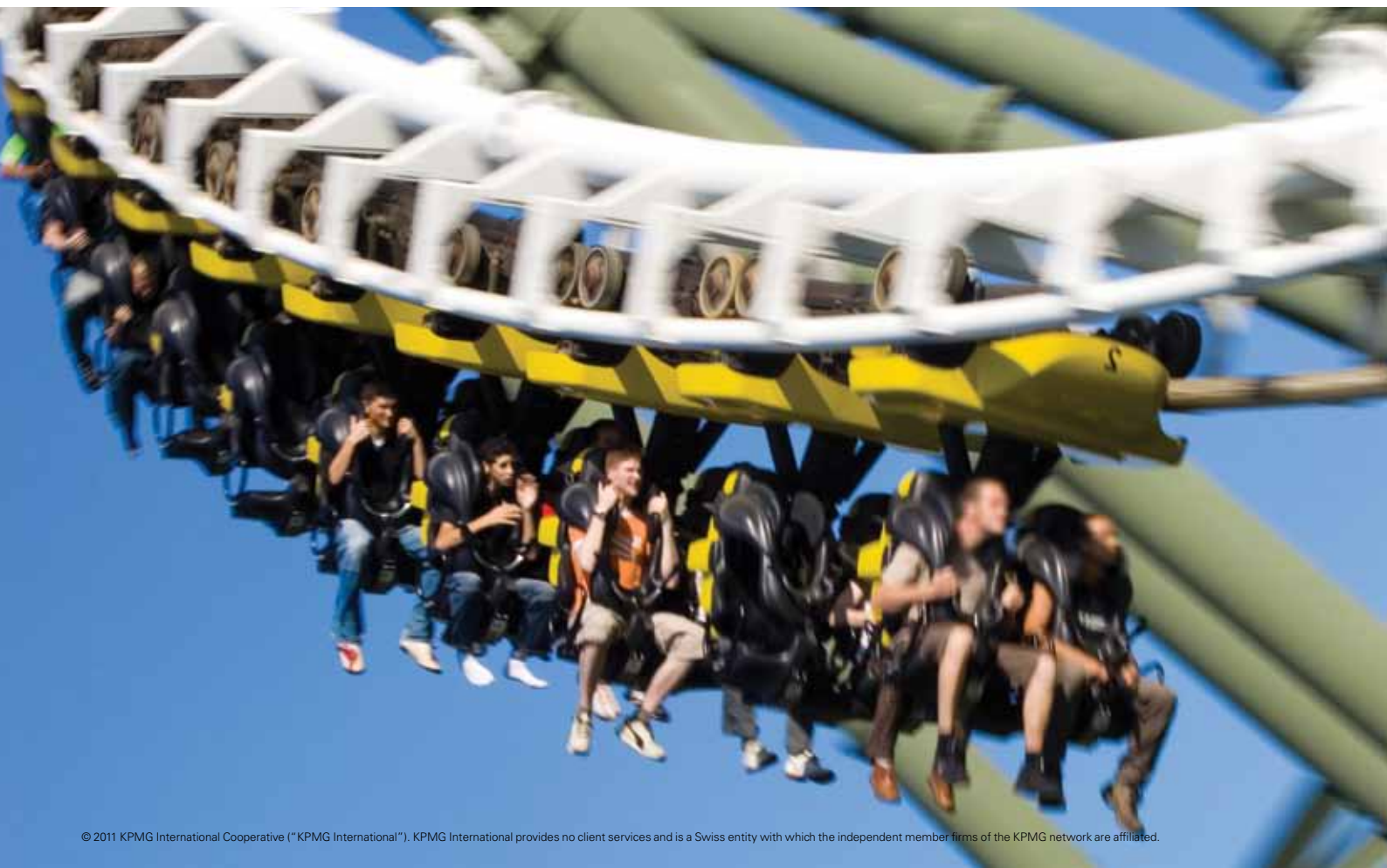
should not be overemphasised since insurance liabilities are generally illiquid, (i.e. insurers generally have a lower burden as compared to that of other entities that have more liquid liabilities that can be withdrawn by a creditor at any point in time). These interviewees generally supported alternative forms of measurement that they believe would limit the effects of volatility in the earnings including a model that locks in financial assumptions and the use of other comprehensive income for recording some or all changes in liability measurement.

The majority of our interviewees thought there would be some impact to their business strategy and commented on various alternatives that they may elect in order to curb or limit volatility in the statement of comprehensive income.

Approximately half of interviewees indicated that they expected either a change in their asset mix, or a change in investment accounting policies in order to limit volatility to the statement of comprehensive income.

“The short-term focus on spot rates does not reflect the underlying economics of insurance: the illiquidity of insurance contract liabilities provides insurers with a stable source of financing and allows for investment in illiquid instruments, enabling insurers to weather the short-term volatility of financial markets.”

– Oliver Bäte, CFO,
Allianz



KPMG observation

- The extent of change in an insurer's investment policies will be dependent on final measurement proposals for insurance liabilities in a future insurance standard under IFRS or US GAAP.
- A new US GAAP financial instruments standard continues to be developed as part of the FASB's financial instruments project and may be subject to future changes. This consequently will have an impact on an insurer's investment policies when finalised. Additionally, the IASB may consider further refinements to IFRS 9 once the FASB completes its deliberations on a new financial instruments standard. The expected effective date of the final insurance standard is expected to be aligned with IFRS 9.

If interest rates change, fluctuations in asset values may not fully offset changes in the measurement of liabilities, causing a mismatch in

earnings. This mismatch in earnings may be attributed to economic factors such as when assets and liabilities cannot be perfectly duration-matched or due to different measurement bases for assets and liabilities, e.g. under Phase II the measurement of the insurance liability does not reflect changes in prices for credit risk.

An accounting mismatch may occur if financial assets are held at amortised cost while liabilities are measured at current fulfilment value. An insurer may avoid part of this mismatch by electing to carry assets at FVTPL. Our interviewees expected that many insurers may partially address earnings volatility by changing their investment policies on adoption of IFRS 9. Several of our interviewees thought that a currently liability measurement model and the election of FVTPL for underlying assets would reward those insurers that have an effective asset-liability management programme and may highlight ineffective asset management policies.

Some of our interviewees already measure their assets at FVTPL and expect to continue to do so, even though this may not eliminate all volatility in profit or loss.

Other interviewees expect to elect to carry financial assets at FVTPL on adoption of Phase II, except when unbundling of financial components is required.

“Unwarranted volatility that is not representative of the underlying economic risk, rather than providing improved transparency and reliability, would result in the reverse – an increase in the use of non-GAAP measures.”

– Donald Guloiien,
President and CEO,
Manulife

General KPMG observations:

- Volatility in results arises generally through economic or accounting mismatches. An economic mismatch may result if the values and ultimate cash flows of insurers' assets and liabilities respond differently to changes in economic conditions. An accounting mismatch may result if the economic conditions affect insurers' assets and liabilities to the same degree, but their carrying amounts do not respond equally because of different measurement bases. The Boards have expressed concerns about accounting mismatches, such as those created when assets are carried at amortised cost and liabilities are carried at current value, but have also expressed the need for transparency of economic mismatches, such as those caused by duration mismatches in assets and liabilities. The Boards are currently deliberating how the proposals might be revised to limit accounting mismatches while highlighting economic mismatches.
- As insurers investigate how to manage increased volatility in a post-Phase II world, they will need to evaluate how best to explain the impact of market value movements on their results based on the final presentation of the statement of comprehensive income.

2 Performance reporting

The combination of rights and obligations arising from an insurance contract would be presented as a single insurance contract asset or liability.

Each portfolio of insurance contracts would be presented as a single net item on the balance sheet. A summarised presentation model for reporting income and expenses arising from insurance contracts based on margins is proposed, instead of traditional measures of premiums, claims and benefits.

Measurement and communication of operational performance cuts across all parts of an organisation. The way a company's financial performance is presented is important to the market's perception of its value.

Interviewees commented that the presentation proposals in Phase II are expected to change the communication of performance because:

- performance metrics will be less familiar
- multi-line businesses may become more complex to explain
- reporting processes may take longer.

As a result, investors and analysts will need help to understand the impact of Phase II, and further help to understand the drivers of results.

Less familiar metrics

One of the proposed presentation changes in Phase II is to show results using a margin-based approach, rather than using traditional measures of premiums, claims and benefits⁵. Interviewees, predominantly property and casualty and some life insurers, commented that they found this unhelpful as they manage their business using measures such as written and earned premiums, benefits and claims expenses and underwriting profit. Our

interviewees were most concerned with the loss of certain volume metrics from the statement of comprehensive income. These are used both internally and by analysts for the calculation of key performance indicators ('KPIs'), such as combined, loss and expense ratios for property and casualty insurers and certain revenue metrics for life insurers. Ranking within major financial indices and by rating agencies may also be affected by the change to performance metrics.

KPMG observations

- Should the final standard include the loss of traditional volume measures, insurers may need to identify new KPIs. A number of European insurers disclose capital and free cash flow generation, which analysts regard as important performance measures.
- There is not a consistent view as to what metrics are wanted by users. For example, life products contain various cash flows from both deposit and insurance components. In many long-duration models, premiums are treated as earned on the due date and there is a reserve provision recorded in the financial statements. It is not clear whether these traditional measures or more of an 'earnings' analysis is needed. Insurers should start analysing metrics that are critical to understanding their performance and Phase II for effective communication to stakeholders.

Some interviewees have commented that they will continue to use non-GAAP measures for management reporting and to supplement financial statement disclosures to communicate with investors and analysts. Approximately half of interviewees said that they have begun considering additional non-GAAP measures.

⁵ Except when using the modified measurement model for short-duration contracts.



KPMG observations

- The proposed standard was introduced to harmonise the insurance industry. However, many insurers appear likely to increase the use of non-GAAP measures to explain their financial results if the performance presentation does not change from the proposals.
- Insurers will need to consider how non-GAAP measures, if used, can be reconciled to GAAP measures when presenting their results to the market.
- Many non-GAAP measures are derived from various source systems, including those that may not be used for financial reporting. The potential importance of these measures may lead insurers to increase their focus on controls and processes for accumulating data and reconciling these amounts to financial results.

Some life insurers were more receptive to the proposed presentation approach, as they believe it better reflects the economic impact of their activities. One interviewee indicated that the proposed approach to presentation shares features in common with an embedded value approach to earnings.

Another insurer noted that if insurance companies continue to be managed using traditional metrics, in future there may be a disconnect between the drivers of their business performance and their financial statement results. This company was considering using its local statutory basis financial statements to convey information about the company to shareholders and regulators.

Interviewees also noted that traditional metrics are used to calculate performance-related executive compensation and incentives and so

there will be a need either to recalibrate score cards or to retain the old metrics.

KPMG observation

- The way paying bonuses and executive compensation are determined may need to be changed. Insurers will therefore need to communicate the drivers of executive compensation clearly, both internally and externally.

“IFRS Phase II will not reduce the need for the insurance industry to communicate on non-GAAP measures.”

– Laurent Clamagirand,
Group Chief Accountant Officer,
AXA

“Differentiating noise from trend will be difficult using a margin presentation.”

– Pat Coyne, *Corporate Finance, Mass Mutual*

Analysts and shareholders will require a lengthy period of familiarisation

A new insurance standard will demand refreshed communication with analysts and investors to help them understand how and why the accounting and presentation changes will affect reported results. Some interviewees have already begun to hold discussions with analysts to educate them on the impact of Phase II on their company. These discussions help to gauge potential market reaction to Phase II. Many analysts have forthright views on Phase II.

KPMG observation

- It will be important to ensure that information used is easy to find by analysts since presentation may change and disclosures will be new. Insurers will need to consider preparing a detailed pack for analysts mapping out how to find the information they require to build their models, and holding separate training sessions for analysts.

Canadian interviewees indicated that they have experience in presenting source-of-earnings analysis that is similar to the Phase II proposals. They also have experience in explaining these disclosures to analysts in a way that is understandable.

KPMG observation

- Finding the right balance of what to disclose will be key. Too much information will lead to overload and may be commercially detrimental,

while too little information will make the financial statements opaque. If the presentation and disclosures are too complex – a criticism often leveled at current insurance reporting – there is a fear that generalist investors will avoid insurance stocks.

Comparability

Phase II proposes different presentations for short and long-duration business⁶. Insurers writing both types of business can present the two components separately in the statement of comprehensive income⁷. Some of our interviewees are concerned that a combination of the contract boundary concept and the proposed definition of short-duration contracts could lead to some contracts currently regarded as short-duration being regarded as long duration and vice versa, making it more difficult to compare the results of products that have been considered similar in nature. They were also concerned that this may make the financial statements more confusing for readers.

“The ED may require many short-term health contracts to be accounted for as long-duration contracts. To us this is counter-intuitive and potentially confusing for our customers because, unlike life insurance, health insurance contracts are renewed annually.”

– Tom Singer,
Group Finance Director, Bupa

Some insurers are part of larger groups or have significant non-insurance operations, such as asset management

or consumer finance. Some interviewees commented that the Phase II approach to presentation may lead to a lack of comparability between insurers that have other financial service operations and those that do not. They also have concerns that the proposals may make it more difficult to compare the insurance sector with other industries (a criticism of current insurance reporting).

KPMG observations

- The current presentation proposals include metrics that are new and appear to differ from those adopted by other industries. This will result in additional upfront costs to educate management, investors and analysts.
- Insurers will need to educate investors and analysts on the final presentation standards, providing an understanding of how the different components of their business interact and how to measure the profitability of the entity as a whole. This continues to emphasise the importance of early communication with investors and analysts.
- The proposed disaggregation principles for disclosures will make segment reporting more important.

Reporting

Many interviewees consider that re-engineering their close process to report Phase II financial information may be as challenging as determining how to present the information.

Some commented that they expected reporting under Phase II to take longer than is currently the case as reported results will be dependent on current estimates, some of which cannot be updated until the reporting date and because iterative model runs may be needed. This may prove challenging since regulatory deadlines and market expectations of timely reporting are not expected to change.

⁶ For the purposes of Phase II, short duration is generally defined as when the coverage period of the insurance contract is approximately one year or less. For the purposes of this publication, contracts with a coverage period greater than one year are referred to as 'long duration'.

⁷ The ED allows the detailed breakdown of the underwriting margin for short-duration contracts to be presented either on the face of the statement of comprehensive income or in the notes to the financial statements.

“Running two systems concurrently during the phase-in period of the new standard is to be expected. This will result in some duplication of effort and cost.”

– Wikus Olivier,
Head of Group Financial Reporting,
Sanlam

Some of our interviewees expect that they may be asked by investors to present their results under previous GAAP for some time after Phase II comes into effect.

One interviewee noted that the new insurance model was expected to simplify their close process as consistent modelling methods would be used by all their business units.

KPMG observation

- Dual reporting under the old basis and under Phase II, to the extent an insurer elects to do so, will increase the reporting effort and will also require legacy systems to be maintained. It may persist for longer than the mandatory transition period. During this period insurers will need to track and reconcile the differences between the two bases.

To offset a longer close process, interviewees are considering closing general ledgers early and/or running parallel systems.

KPMG observation

- Even those companies that already close their ledgers early in order to meet regulatory deadlines will need to identify a feasible close date – particularly as legacy systems may have constraints on when systems can close.

Regulators may still require local GAAP for financial reporting, statutory filings, taxation or solvency purposes. Those interviewees who currently report their IFRS results by consolidating local GAAP results are considering running parallel systems in order to meet these requirements. Maintaining multiple reporting systems may allow insurers to meet deadlines, but will cost more to maintain and may lead to duplication of effort by IT and Finance.

Even if parallel processes are introduced, many interviewees are aware that they may have less time to analyse their results.

KPMG observations

- While Phase II offers the hope of a common global standard for insurance, it will not eliminate regulatory reporting requirements. Multi-GAAP ledger systems may continue to aid efficiency, speed of reporting and maintaining effective controls in the short term.
- Insurers that maintain multiple reporting systems may need to implement additional controls to ensure consistency of financial information.
- The additional time initially required to prepare results under Phase II may reduce insurers' speed of reporting results in the short term. Those companies having initially accepted a longer close calendar may want to accelerate reporting once Phase II is implemented and bedded down.

Consistency

Many interviewees believe that the most compelling advantage of Phase II will be increased comparability under a globally unified standard – although many are concerned about the extent of change that achieving this will require.

Some of our interviewees commented that they expect Phase II to make it easier for them to analyse cross-border targets, whether for potential acquisitions or for competitor analysis.

KPMG observation

- While Phase II is evolving the implementation challenges can appear daunting. Early high level planning, even while the standards are still being finalised can help break down the challenge of implementation into more manageable components.

General KPMG observations:

- The Boards plan to deliberate further on the alternative presentation models and are attempting to find a solution.
- Phase II gives insurers the opportunity to implement an integrated reporting function covering finance, actuarial and risk competences.
- Internal reporting will see major change. Depending on the final presentation model, there is potential for a significant disconnect between how performance is measured and reported within the management team and what is reported under IFRS and US GAAP.
- Increased disclosure requirements will make pricing and profitability information and the long-term risk exposure of the insurance industry more visible. Insurers will need to find the right balance in communicating their results and financial position to analysts, investors and rating agencies.
- Those insurers that integrate internal management practices and regulatory requirements, such as Solvency II in Europe, into their transition plans for Phase II will likely incur less system costs in the long term.
- Insurers that efficiently integrate Phase II may be better equipped for 'real time' reporting.

3 Acquisition costs

Under the Phase II proposals only incremental acquisition costs for contracts actually issued are included as contractual cash flows in the initial measurement of the insurance liability and implicitly deferred over the coverage period. Incremental cash flows would be measured at the level of an individual contract.

Several interviewees agreed that the treatment of acquisition costs will lead them to review the operation of their business, such as reconsidering:

- distribution arrangements, in particular whether to use intermediaries and external agents as compared with distribution via a direct sales force or direct marketing;
- sales compensation arrangements; and
- greater use of reinsurance.

We expect many insurers to review the operation of their business to optimise the treatment of acquisition costs, although a minority of our interviewees thought that the accounting proposals would not have a major impact on their business or distribution model.

Distribution arrangements

Insurers usually have one or both of two distribution models: either direct distribution, via direct marketing or a salaried sales force; or intermediated distribution, through tied agents or independent intermediaries.

The current proposals mean that different distribution models may result in different accounting outcomes even if insurers distribute identical products and incur identical costs. Salaries of a sales force will not meet the definition of incremental acquisition costs as they cannot be linked to the successful sale of a specific insurance contract. Commission payable to tied agents or independent intermediaries will



meet the definition of an incremental acquisition cost, as it can be linked to the successful sale of a specific insurance contract.

Some interviewees indicated that they are already beginning to review the impact of Phase II on their distribution arrangements and, depending on the final standard, may consider restructuring their sales forces, including considering the use of third party agents to replace salaried employees to distribute their products.

Sales compensation arrangements

Instead of changing to an outsourced distribution model, some interviewees are considering whether a better solution may be to restructure sales compensation arrangements.

Insurers that have base salary arrangements may incur a greater immediate expense regardless of volume (including decreasing volumes) than under commission arrangements. As a result, interviewees are considering changing sales force compensation to a more volume-linked, i.e. commission-based, structure.

KPMG observations

- Compensation arrangements – and changes to them – are highly emotive. Changes to compensation arrangements need to be approached with extreme care and sensitivity.
- Distribution is at the heart of how many insurers generate value both for their customers and their investors. We expect much deliberation of the impact of Phase II on distribution arrangements once proposals are more certain.
- Based on current deliberations of the Boards, key concerns in this area are likely to be addressed.

Reinsurance

As discussed in the 'Volatility' section, the lack of application guidance on reinsurance has participants still analysing how the ED might apply in this area. Some interviewees are exploring entering into arrangements to help offset the effect of expensing non-incremental costs in profit or loss. In certain reinsurance arrangements, a cedant is able to recognise a gain at inception⁸ under the proposals. In these cases, an insurer that buys reinsurance for a given portfolio may be able to recognise ceding commissions that compensate for acquisition costs (both incremental and non-incremental) at inception.

This view is not universal – several interviewees noted that they did not expect Phase II to impact reinsurance buying significantly.

General KPMG observations:

- The Boards are deliberating acquisition cost proposals and are considering broadening the definition to include direct costs at a portfolio level and removing 'incremental' from the criteria. The impact of these changes may have far reaching impacts, including design of IT and accounting systems, consideration of outsourcing arrangements, and relationships with brokers/agents and reinsurers.
- Several analysts have commented that including acquisition costs in the measurement of the insurance contract, rather than expensing these costs immediately, best reflects the economics of the insurance business.
- The proposed measurement model, which reflects a net margin including some acquisition costs, creates a need for management to further explain how balance sheet items will convert into cash.
- The Phase II treatment may vary significantly from current/ future regulatory frameworks and may result in substantial differences between regulatory capital and equity.

⁸ When the reinsurance premium less any ceding commissions is less than the cedant's expected recovery of losses and expenses under the contract, a gain is recognised on inception.

4

Stakeholder and capital management

Our interviewees highlighted the potential impact of the Phase II proposals on the market's perception of insurers.

Although concerned about unintended consequences and implementation issues, many of our interviewees agreed with the need for a global insurance standard. In the words of the introduction to the ED, "Many users of financial statements describe insurance accounting today as a 'black box' that does not provide them with relevant information about an insurer's financial position and financial performance."

As well as offering greater global consistency, Phase II offers the opportunity to eliminate considerable duplication of effort, both as regards external financial reporting and internal performance reporting. Some of our commentators identified the opportunity that this provided for a much more holistic and joined-up view of the business, identifying the opportunity to bring external reporting, solvency and internal economic measures more closely together.

However, some of our interviewees also identified some practical concerns about the impact of Phase II on stakeholders.

Profit recognition and the impact for dividends

Some of our interviewees are concerned about the impact of the proposals on profit recognition as it is expected that profits may emerge more slowly than under current accounting. This is because, under current Phase II proposals:

- no 'day-one' profits can be recognised
- the amortisation of the residual margin may be slower than the current profit recognition profile
- non-incremental acquisition costs are expensed immediately
- the contract boundary and discount rate proposals may cause day-one accounting losses.

As proposals become firmer, understanding the impact for distributable profits is an important

issue for interviewees as this may determine dividend payments to shareholders and policyholders.

One interviewee noted that they did not expect the impact on distributable profits to be significant given the closer alignment of cash and profit emergence.

KPMG observations

- **Determining the impact for dividend policy, if any, may require clear communication with investors. This is an important goal of an assessment of the impact of Phase II on the business.**
- **Profit emergence may not impact the calculation of dividends in all jurisdictions. For example, in Australia dividends are payable based on an assessment of solvency rather than profits.**

“The current fulfilment value as proposed will allow us to bring external reporting, solvency and internal economic measures more closely together. However, this is a significant paradigm shift in external reporting, and a sufficient transition period must be granted so that preparers and users get time to familiarise themselves with the results.”

– Jörg Schneider, CFO,
Munich Re

Cost of capital – to increase or decrease?

Some interviewees commented that a deferral of profit recognition may reduce investor appetite for the insurance sector as well as potentially creating a need for more capital to meet regulatory requirements. Several interviewees were concerned that insurance companies may face a competitive disadvantage raising capital because their profits would be more volatile. Some of our interviewees fear that this could have a significant impact on investor benchmarks, for example price-earnings multiples.

Some commentators are concerned about the impact of volatility on their capital position, particularly when the starting point for determining regulatory capital is the financial statements.



KPMG observations

- Phase II will have a profound impact. Like all significant change, it will require a lengthy process of familiarisation.
 - Insurers will need to devote more effort and resources to communicate with investors and other stakeholders and will have to disclose more information than in the past, furnishing stakeholders and analysts with better guidance to help them correctly interpret the results, as well as helping them to make meaningful comparison with past performance and other industries.
 - Significant regulatory developments are taking place, generally focused on making capital requirements more sensitive to risk and embedding sound risk and economic capital management at the heart of the business. Against this backdrop we expect to see increased focus on solvency and capital disclosures in future periods.
-

General KPMG observations:

- Some of our interviewees were concerned with potential day one losses as a result of applying the new measurement model. They also commented that future profits will likely be reduced as a result of applying the transition proposals in their current form, which do not allow for a residual margin for contracts in existence at transition. Some of our interviewees thought that these items may impact market capitalisation and potentially increase financing costs. The Boards took note of these concerns in their outreach and will be deliberating on the measurement and transition proposals. The transition proposals are expected to change dramatically from their current form.
- In 2010, as financial market conditions improved, there was an increased focus on reporting new business measures amongst insurers in most geographic markets. However, profitable growth, rather than growth at all costs is increasingly taking centre stage, with greater disclosure of persistency as well as cash and free surplus generation.
- Insurers would like to have consistency across the insurance industry in order to make decision-making easier, increase the quality of information provided to the market, reduce administrative expenses and avoid contradictory messages to the outside world.
- Phase II was introduced to harmonise and make understanding the insurance industry easier. However, the changes it introduces are profound. A lengthy period of familiarisation is needed while resistance to change is overcome.



Systems and processes

Based on our discussions with interviewees, feedback from other discussions with insurers and through our own internal analysis, we have identified the systems and processes that are likely to be most directly affected as a result of the proposals in Phase II. These impacts will vary based on current accounting, regulatory, and internal reporting frameworks.

The changes required by Phase II will undoubtedly have a significant impact on the insurance technology landscape. The greatest impact is expected to be on actuarial modelling and valuation systems and financial reporting systems. Policy administration systems will also need to be adapted to reflect the requirements relating to contract boundary, which will change when contracts are recognised.

A comprehensive programme

The type and amount of data needed for Phase II may differ substantially from current reporting, whether the transition is from current IFRS or whether the company is adopting IFRS for the first time. Insurers will also have to tackle system changes relating to the reporting of financial instruments,

although the IASB has indicated that whatever the timing of an eventual insurance standard, companies will be permitted to implement IFRS 9 at the same time, to avoid two successive rounds of substantial reporting changes. European insurers will need to tackle these changes in conjunction with Solvency II. Many of our interviewees commented they were concerned that their current systems could not capture the information that would be required for Phase II, although one interviewee mentioned that they were undertaking a major finance and IT transformation programme that would place them in a significantly better position from which to meet the challenge. Not surprisingly, while the Phase II proposals continue to evolve, most interviewees had considered the impact for systems and processes only at the very highest level.

One of the particular issues that insurers face is the need to support multiple reporting platforms for local statutory, IFRS, US GAAP and internal reporting. As a result, many are dependent on an intricate web of legacy systems and have significant and extended close processes. Transition planning will need to address the

type of enterprise resource planning system that an insurer uses, whether the system has been kept current, the level of customisation and the use of outsourcing. Significant customisation, particularly if insurers use local statutory reporting as the basis of current IFRS reporting, may increase the challenge.

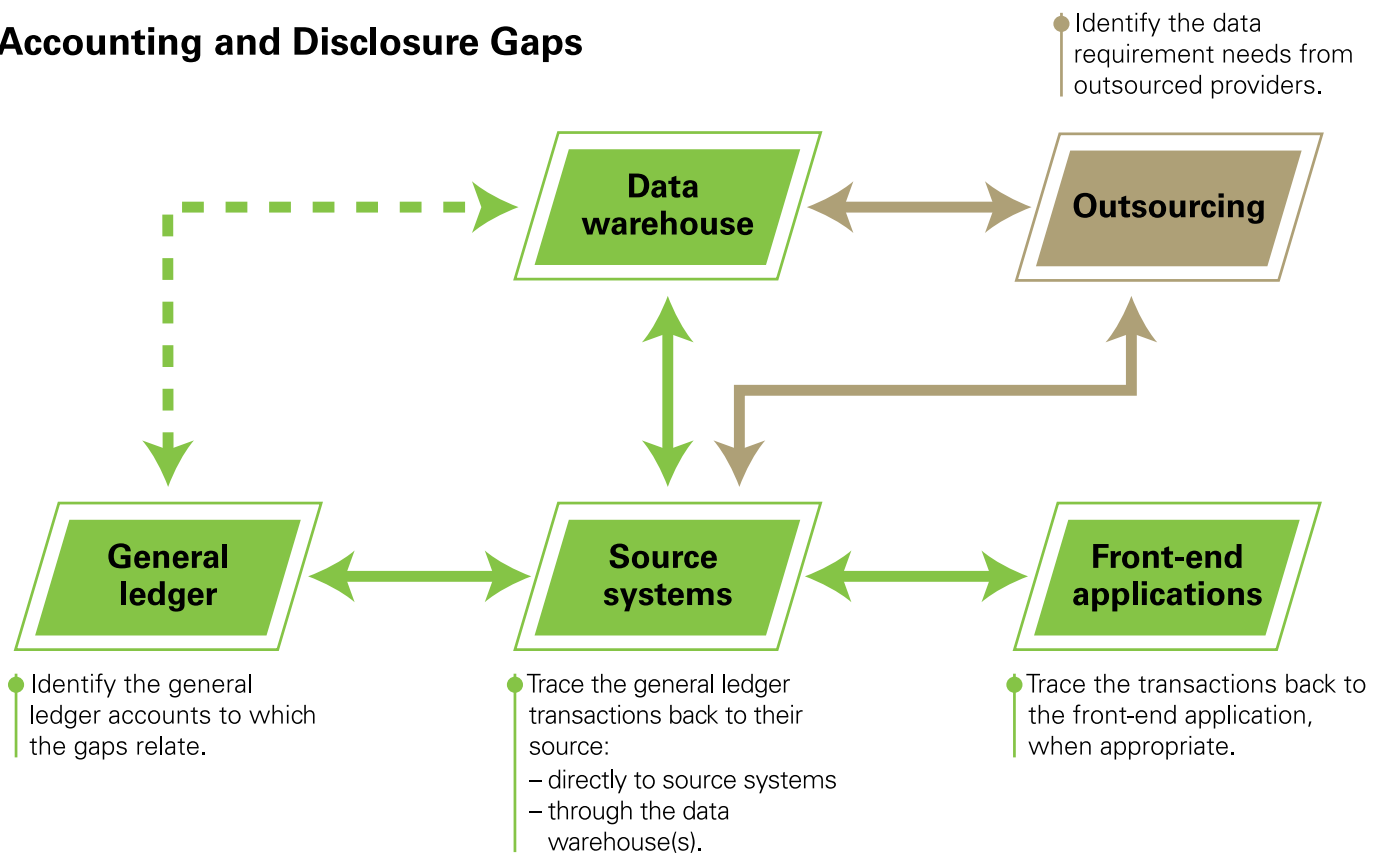
KPMG observations

- The key to identifying the impact of Phase II on current systems is to adopt a structured approach to understanding the gaps between the data requirements of Phase II and the current reporting framework.
 - Like all transitions, we expect insurers will first need to work out what the changes mean, then work to quantify the changes and then re-design and implement updated processes to fully optimise and embed the transition.
-

So how can organisations go about identifying the impact on their systems and processes? The simplified diagram to the right outlines a process that organisations can adopt to identify the impact on information systems.



Accounting and Disclosure Gaps





● Significant change
 ● Moderate change
 ● Minor changes
 ● Low impact expected

Topic	Systems impact							Processes									
	Modelling capability	Data requirements	Modifications/re-design	Interfaces and mapping	Capacity and run times	Chart of accounts	Reporting	Product development	Channel management	Sales	Underwriting	Customer services/policy admin	Claims management and benefits	Investment operations	Financial reporting	Actuarial	Reinsurance
Building block one – fulfilment cash flows	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Building block two – discount rate	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Building block three – risk adjustment	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Building block four – residual margin	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Recognition	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Acquisition costs	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Modified approach	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Reinsurance	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Unbundling	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Presentation	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Transition	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●



“ Multiple model runs and the need to calibrate models with period-end market observable data means information for management and investors will initially be less timely. In contrast, investors and securities regulators are generally pressing for more accelerated reporting. So we will firstly have to work out what this means for our processes and then work to optimise them. ”

– Jon Nielsen,
Senior VP and Regional CFO,
AIA

Phase II is expected to significantly change data capture requirements. Our interviewees were most concerned about the IT and process impacts of using current estimates of cash flows, including gathering data for actuarial modelling and transition requirements.

Upgrading actuarial modelling capabilities is expected to be expensive, but is considered by many to be a worthwhile investment with wider benefits. Interviewees involved in Solvency II preparations are investing heavily in upgrading their modelling capability and governance, identifying data sources and refining reserving methodologies. Other interviewees have invested heavily in systems, particularly in building data warehouses. The cost may be lower for insurers headquartered in countries that already have actuarial valuations and financial reporting based on current assumptions, such as Canada, Australia and the United Kingdom.

Some interviewees have already begun performing high level gap analysis between the ED and Solvency II; this includes trialling data sources and analysing their company's ability to draw on models and methodologies designed for Solvency II for the purposes of Phase II.

As the proposals in Phase II evolve, developing a common understanding of their impact will involve many different functions within the organisation, including client-facing functions and processes, as well as the back office. Clear and open communication with IT will be vital. Making strategic and tactical decisions about the potential impact on information systems and business processes early on in the transition project will help limit both costs and risks arising from duplication of effort or changes in approach at a later stage, and needs to be incorporated into the IT development budget.

To help insurers focus on developing a project plan for implementation, we have highlighted the key systems and processes that are likely to be impacted.

Topic	System impact								Processes								
	Modelling capability	Data requirements	Modifications/re-design	Interfaces and mapping	Capacity and run times	Chart of accounts	Reporting	Product development	Channel management	Sales	Underwriting	Customer service/policy admin	Claims management and benefit	Investment operations	Financial reporting	Actuarial	Reinsurance
Building block one – fulfilment cash flows	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●

Insurers will need to design new processes to calculate insurance contract liabilities and populate financial statement disclosures. Internal controls over the new processes will also need to be developed. For many insurers this may entail upgrading modelling capabilities and scenario analysis. In many cases, analysing fewer but well chosen scenarios rather than weighing an infinite range of options may help focus the process. In some jurisdictions, experience studies may need to be performed more frequently, which may enable more frequent re-pricing.

Interviewees expect a significant increase in the time it takes to perform the valuation of liabilities and this will likely increase system run times, unless the opportunity is taken to upgrade technology. Those who invest upfront in management review are likely to be rewarded with higher quality output.



Topic	System impact								Processes								
	Modelling capability	Data requirements	Modifications/re-design	Interfaces and mapping	Capacity and run times	Chart of accounts	Reporting	Product development	Channel management	Sales	Underwriting	Customer service/policy admin	Claims management and benefit	Investment operations	Financial reporting	Actuarial	Reinsurance
Building block two – discount rate	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●

The proposals for the discount rate will require a large number of new data inputs and significant actuarial and finance involvement. For insurers using a bottom up approach, there will be a significant amount of judgement involved in determining the discount rates and illiquidity adjustments. Top down approaches that develop the discount rate by reference to an asset rate as a starting point will need to be adjusted for various items that would not be reflective of the characteristics of the liability. Identifying and quantifying these amounts is expected to be complex. In addition, as many insurers currently use ‘locked-in’ rates, systems will need to be re-designed to use current rates. Many of our interviewees are concerned about the need for significant estimation in constructing discount rates for their longest duration liabilities, and, for many companies, quantifying an adjustment for illiquidity will require new techniques and is expected to be time intensive. The proposals in the ED and Discussion paper require an insurer to discount property and casualty reserves. Depending on the ultimate form of the presentation requirements, the unwinding effects of discounting potentially may be presented outside of underwriting results. If this is the case, an insurers’ combined ratio may significantly decrease. On the other hand the underwriting result may become subject to volatility resulting from changes in interest rates. Insurers will need to explain any changes in ratios to stakeholders and evaluate any potential impacts in their pricing processes.

Building block three – risk adjustment	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
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Determining an explicit risk adjustment may be a new process for some insurers and systems may need to be customised or re-designed to enable risk adjustments to be calculated and maintained at a portfolio level. Addressing the complete product taxonomy is important (estimating and modelling the risk adjustment to cover different products, risk groups, and the effects of diversification) and is likely to reward those who have invested in upgrading actuarial modelling capability. Calculating and disclosing explicit risk adjustments may introduce further discipline to underwriting processes.

Topic	System impact							Processes									
	Modelling capability	Data requirements	Modifications/re-design	Interfaces and mapping	Capacity and run times	Chart of accounts	Reporting	Product development	Channel management	Sales	Underwriting	Customer service/policy admin	Claims management and benefit	Investment operations	Financial reporting	Actuarial	Reinsurance
Building block four – residual margin	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●

Calculating the residual margin will require evaluating products to determine portfolio groupings sharing common characteristics. The judgement involved in determining what constitutes a portfolio assumes greater significance under Phase II and will require careful consideration and possibly some iteration. Product portfolios are not usually monitored by inception date and coverage period and so additional data fields may need to be added.

Recognition	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
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For the purposes of Phase II, insurers would begin recognising the contract when they are bound to the coverage, which could be prior to the effective date or the date on which a contract is signed. Systems at present may not record when risks are bound. When the binding date is before the inception date additional data, fields may need to be added. Administration systems in particular may require re-design.

Acquisition costs	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
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The business impacts of revisions to acquisition cost accounting are significant and this aspect of the proposals may affect many frontline functions, such as product design, channel management and sales.

Modified approach	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
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Contracts that are currently defined as short duration may not be so designated under Phase II, leading to new data requirements. Charts of account and sub-ledgers may need to be re-designed as short and long-duration contracts are measured differently from current reporting. Modelling efforts may increase to reflect additional discounting that does not currently exist for insurers that do not apply discounting.

Reinsurance	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
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Systems and data requirements may need to be revised to ensure that reinsurance treaties are recognised based on the date the insurer is bound, which could be prior to the date of the coverage period. Data fields may be needed to flag when a gain is recognised on day one to ensure that the underlying insurance obligation has been properly measured.



Topic	System impact								Processes								
	Modelling capability	Data requirements	Modifications/re-design	Interfaces and mapping	Capacity and run times	Chart of accounts	Reporting	Product development	Channel management	Sales	Underwriting	Customer service/policy admin	Claims management and benefit	Investment operations	Financial reporting	Actuarial	Reinsurance
Unbundling	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●

Further data may be needed to identify when to unbundle and to determine how to account for unbundled components, including consequential changes to the treatment of acquisition costs and sources of earnings, such as the allocation of fees and expenses to investment and insurance components. Actuarial modelling may be more complicated for products in which benefits are more interrelated, such as universal life.

Presentation and disclosure	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
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Insurers will need to evaluate data requirements for financial statement disclosures, including those required to be provided by product portfolio.

Modification may be needed to:

- reporting tools used by subsidiaries and branches
- mappings and interfaces from the general ledger
- consolidation systems, to deal with segmental reporting and analysis by portfolio.

Phase II may not entirely supersede existing reporting systems, which may need to be retained for regulatory reporting and to provide non-GAAP metrics familiar to users, as well as supporting dual reporting during the changeover process.

Transition	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
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Under the proposed transition approach in the ED and Discussion Paper, an insurer would not recognise any residual margin for contracts in existence at transition. This would depress the net income reported for these contracts in periods post-transition compared to a full retrospective approach. As the Boards are aware of these issues, the ultimate transition requirements are likely to change from their current form. If the final transition requirements allow for full retrospective application, insurers who have more access to historical data may have a competitive advantage at transition.

Communication and interaction with IT are needed to ensure systems are equipped to deal with Phase II.

General KPMG observations:

- Optimising automation in accounting systems and financial processes can have a major impact on the ability to forecast and communicate results with confidence, and free up resources to focus on financial analysis rather than generating the numbers.
- An integrated change programme may facilitate compliance with the new insurance model, reap the benefits of standardisation in terms of cost reduction and efficiency goals, and be sufficiently flexible to cope with a situation that is dynamic, complex and evolving rapidly.
- History – not least the experience of the 2005 IFRS transition – tells us that addressing change late is costly. Many companies that extensively used workarounds ultimately chose to undergo major transformation projects after implementation.
- If the final standard to be issued by the Boards is similar in nature to Phase II, it is likely not only to have significant impact on data requirements and systems but also closing processes and reporting timetables. This is because, if implemented in its current form, it will require significantly greater use of actuarial techniques that will need to be calibrated using market observable data as at the reporting date and extensive footnote disclosures.
- Preparation of disclosures may actually be easier under Phase II because insurers can design and build their new measurement system to produce the required disclosures, such as movement analysis. Under IFRS many insurers use spreadsheet applications because the current disclosure requirements were superimposed on top of their existing GAAP measurements.
- Without significant forward planning and reengineering of close processes, speed for releasing results may be constrained by limited modelling capacity and lengthy run times.
- Inefficient manual workarounds and excessive use of spreadsheets are generally not a long term solution to managing the changes going forward.
- IT costs could easily make up the majority of the overall transition costs.

People: education, knowledge, capacity and creativity

The heart of any organisation is its people. Successful transition to Phase II will depend on the people involved. An actuary pricing a product differently under Phase II and the Audit Committee approving disclosures for Phase II reporting are both examples of people who may be impacted by the implementation.

Discussions with our interviewees highlighted that many acknowledge that resources and education will be vitally important to the implementation. Given the relatively early stage of the proposals, interviewees have not yet begun to formulate the specific resource and education needs for implementing a new insurance standard.

KPMG observation

- The success or failure of the transition depends heavily on how effectively you inform, mobilise and educate your people. Clearly defining responsibilities will also be a factor in a successful transition.
-

Resources

The majority of our interviewees acknowledged that Phase II will place a heavy demand on experienced actuarial and finance resources.

One interviewee has been trying to address actuarial shortages over the past year. However, they also indicated that there are no current plans to make significant changes to headcount until there is more clarity about the final standard.

Other interviewees mentioned that:

- while actuarial and accounting resources may be sufficient to meet the demands of Phase II, transition will divert skilled resources away from other business priorities
- they are more concerned about shortages of IT resources to address

actuarial valuations and system developments

- they may outsource routine actuarial work. Interviewees mentioned that gaps in required skills may be addressed through the following:
 - hiring additional resources
 - outsourcing to third parties
 - training within the organisation
 - mobilising and redeploying existing resources within the organisation.

KPMG observations

- Retention of existing employees will be just as important for insurers as identifying new resources to fill gaps.
 - The basis of your people strategy should be a well thought-out plan that assesses what resources you need, identifies which individuals are impacted, and determines what they need to know.
 - Changing processes and procedures means also having to change roles and develop new skills for your people.
-



Education

Interviewees had mixed views as to when education on Phase II should begin. Some believe that Phase II is at too early a stage to justify education outside the inner circle of executive management, while others have already begun running awareness sessions. Most of the European interviewees have begun these sessions in the context of Solvency II.

“The performance reporting requires additional training and education, first of all within the company, then to other stakeholders.”

– Gerard Frank Sollman,
Head of Competence Centre Finance,
Eureko

Interviewees identified the following constituencies that will require training initially:

- Accountants – to improve understanding of actuarial concepts and accounting changes
- Actuaries – to gain further understanding of accounting issues and constraints
- Senior management and investor relations – to explain the financial statements, particularly any new presentation and the potential for increased volatility.

KPMG observations

- Ensuring adequate investment in education and training is both an issue and a solution.
- An important factor contributing to the success of the transition will be engagement with external stakeholders, such as analysts, shareholders and rating agencies. Involving analysts early in the process will help ensure that they understand the changes to come and will be able to communicate those changes to the market.

Some of our interviewees have already held discussions with analysts about the potential impact of Phase II, noting that further ongoing dialogue is expected.

We see training and education needs typically falling into two distinct phases:

1. Training and education needed to equip people during the transition as they investigate the impact of Phase II on the business
2. Training as Phase II become business as usual and staff need to learn how to operate new systems and processes.

Similarly we expect to see peak resource needs during the transition, particularly while staff are investigating the impact of Phase II, performing trial runs and reporting under both their existing reporting framework and in accordance with Phase II. European insurers will also be working on Solvency II, so entities will need to address resource conflicts.

Thereafter, resourcing requirements will need to reflect business as usual in the new Phase II reporting environment.

“To ensure a smooth transition it will be key to engage stakeholders early and educate them about the implications of the ED. The more touch points we have with key stakeholders the quicker the requirements will get embedded. We need to integrate this with the other regulatory challenges we face – we see the need for at least 2 years after the Solvency II regime becomes effective in order to manage change in an orderly fashion.”

– Tom Singer,
Group Financial Director,
Bupa

Based on our discussions with interviewees, feedback from various outreach activities we have undertaken with insurers and through our own internal analysis, we have identified the support functions that will be most directly impacted as a result of the proposals in Phase II.

● Significant change ● Moderate change ● Minor changes ● Low impact expected

Topic	Education impact	Support functions											
		Strategy	Marketing	Finance	Actuarial	IT	Investment management	Legal	HR	Risk management	Compliance	Investor relations	Internal Audit
Building block one – fulfilment cash flows	●	●	●	●	●	●	●	●	●	●	●	●	●
Building block two – discount rate	●	●	●	●	●	●	●	●	●	●	●	●	●
Building block three – risk adjustment	●	●	●	●	●	●	●	●	●	●	●	●	●
Building block four – residual margin	●	●	●	●	●	●	●	●	●	●	●	●	●
Recognition	●	●	●	●	●	●	●	●	●	●	●	●	●
Acquisition costs	●	●	●	●	●	●	●	●	●	●	●	●	●
Modified approach	●	●	●	●	●	●	●	●	●	●	●	●	●
Reinsurance	●	●	●	●	●	●	●	●	●	●	●	●	●
Unbundling	●	●	●	●	●	●	●	●	●	●	●	●	●
Presentation	●	●	●	●	●	●	●	●	●	●	●	●	●
Transition	●	●	●	●	●	●	●	●	●	●	●	●	●

Many insurers currently struggle to find actuarial, tax and accounting personnel with an understanding of insurance business, regardless of Phase II. The implementation of Phase II will almost certainly increase the cost of hiring additional resources, retaining employees, as well as educating existing employees – costs that will be borne by the whole business. These costs will be spread throughout the organisation as Phase II does not just affect the accounting and actuarial function, but also impacts the operations of the business.

As insurers think through the components of Phase II and develop a project plan for transition, we have highlighted the key topics driving training and resource requirements.



Topic	Education impact	Support functions											
		Strategy	Marketing	Finance	Actuarial	IT	Investment management	Legal	HR	Risk management	Compliance	Investor relations	Internal Audit
Building block one – fulfilment cash flows	●	●	●	●	●	●	●	●	●	●	●	●	●

The most significant impact is expected to be on actuarial and finance staff carrying out new processes and using new systems. Actuarial staff may also need to carry out more model iterations and experience investigations.

Building block two – discount rate	●	●	●	●	●	●	●	●	●	●	●	●	●
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Actuaries and risk managers will have to determine the discount rate at long durations and calculate and monitor the adjustments from observed rates. Investment management professionals may need to further scrutinise their asset-liability management as economic mismatches may become more transparent under the new model. Risk management and finance will have to perform regular assessments of the impact of changes to capital requirements as the new standard is implemented. In addition, there may be consequent impacts on product design and pricing.

Building block three – risk adjustment	●	●	●	●	●	●	●	●	●	●	●	●	●
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Actuaries will have to:

- determine how the risk adjustment will be quantified
- continuously monitor and analyse the risk adjustment to ensure that it properly reflects the portfolio of contracts and business.

This may add additional time, effort and costs to the reporting process.

Building block four – residual margin	●	●	●	●	●	●	●	●	●	●	●	●	●
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Resources will be needed to monitor the amortisation of the residual margin to determine whether it is being released in line with the exposure from providing insurance coverage.

Recognition	●	●	●	●	●	●	●	●	●	●	●	●	●
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Staff may need to be trained to review contracts and record the binding date.

Topic	Education impact	Support functions Support functions											
		Strategy	Marketing	Finance	Actuarial	IT	Investment management	Legal	HR	Risk management	Compliance	Investor relations	Internal Audit
Acquisition costs	●	●	●	●	●	●	●	●	●	●	●	●	●

Insurers will need to analyse which costs qualify as incremental acquisition costs. In some jurisdictions, insurers do not defer acquisition costs, which may require insurers to obtain additional resources to gather this information.

Modified approach	●	●	●	●	●	●	●	●	●	●	●	●	●
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Determining the contract boundary will require the exercise of judgement and hence skilled and experienced staff. Actuarial employees may be needed to perform the onerous contract test. For those GAAPs that do not discount, further education will be required to bring discounting into short-duration calculations.

Reinsurance	●	●	●	●	●	●	●	●	●	●	●	●	●
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Reinsurance and legal staff will be needed to review reinsurance treaties to determine their accounting treatment under the new standard. Reinsurance agreements may need to be re-designed or re-negotiated. Processes and controls for accounting for reinsurance may need to be re-designed.

Unbundling	●	●	●	●	●	●	●	●	●	●	●	●	●
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Employees will need to be trained to understand the unbundling concepts and analysis. They may also be needed to review insurance contracts to determine if there are any unbundled components. Actuarial resources may be needed in order to determine the break-out of cashflows between unbundled investment and insurance components, including determining allocation of contract fees and expenses to respective components.

Presentation	●	●	●	●	●	●	●	●	●	●	●	●	●
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Extensive training, both internally and externally, will be required to understand the new presentation and disclosures.

Additional time and resources may be needed for:

- preparation of more detailed disclosures
- maintaining and monitoring non-GAAP measures
- dual reporting, in the period before Phase II becomes business as usual, as well as afterwards if stakeholders demand information on the previous basis.

Topic	Education impact	Support functions Support functions											
		Strategy	Marketing	Finance	Actuarial	IT	Investment management	Legal	HR	Risk management	Compliance	Investor relations	Internal Audit
Transition	●	●	●	●	●	●	●	●	●	●	●	●	●

Insurers will need to monitor the transition adjustment, so that they can analyse the results of the business before and after transition. This will add an additional step to the reporting process.

General KPMG observations:

- For some insurers, the implementation of the new global insurance model will be a catalyst for a variety of cost savings and efficiency improvements related to the finance function, including shared services, outsourcing, cosourcing, offshoring and automation.
- Insurers should build a comprehensive picture of the training required, in order to close the gap between current and desired skill-sets.
- Do not underestimate the magnitude of change when moving from a familiar GAAP to Phase II should not be underestimated, in particular during the transition period when reporting under two bases. Understanding the 'bridge' between the old and new reporting bases is a key to making Phase II more familiar.
- Leaving people considerations to the last minute risks a disengaged workforce that does not fully understand the impact of Phase II.
- When determining staff needs, it is important to think not just about the quick fix but to plan for the company's long-term needs, taking into consideration current and future projects and the demands these will create on the organisation and its people.
- Tax resources should also be included in the transition plan and educated on the new insurance standard. The proposals will have an impact on the calculation of deferred taxes, and there may ultimately be tax ramifications in some jurisdictions due to the changes.

Bringing it all together

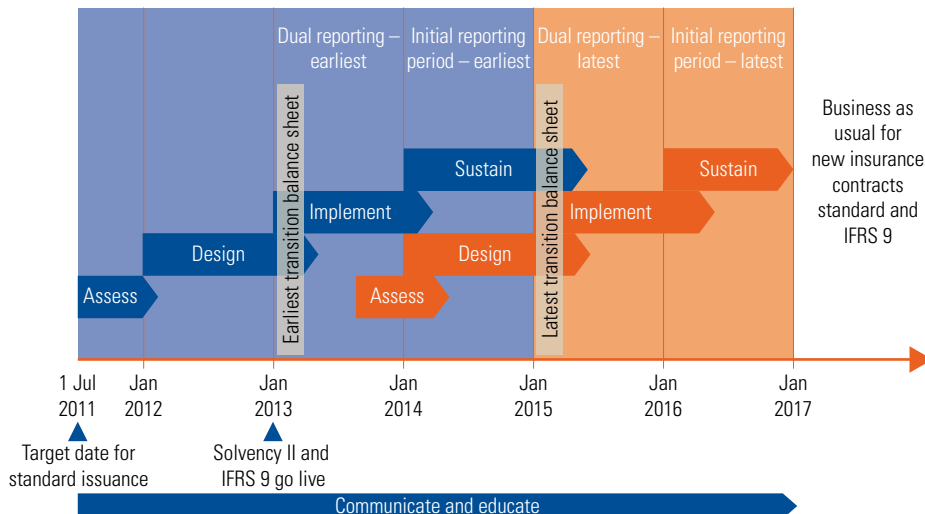
Many of our interviewees tell us that they are already considering the strategic implications of Phase II for their business, even though there are many moving parts that still need to fall in to place before we see a clear outcome. This is particularly relevant for our European interviewees who are currently meeting the challenges of Solvency II. Solvency II and the planned changes to Phase II open up opportunities for synergies in areas such

as modelling capability and investment in systems.

A clear message from our interviewees was that how an insurer manages its transition to Phase II will affect its business. Companies need to begin the transition process while the standard continues to evolve so that synergies and dependencies with other initiatives can be addressed and confidence can be maintained.

Most companies expect to need between 3 and 5 years for implementation.

The following is an implied timeline⁹ assuming a mid-2011 date for issuance of the final IFRS standard an effective date that aligns with IFRS 9¹⁰.



As can be seen above, a timeline that aligns with the current effective date for IFRS 9 only gives insurers 2½ years for implementation.

Most interviewees favour an extended transition period to enable themselves and their stakeholders to become familiar with the new requirements. The timeline above includes time for companies to report under their existing GAAP and Phase II, i.e. dual

reporting, so that they can understand the impact of the changes on their business to Phase II. As the IASB and FASB hold discussions over the next few months, the above timeline may change. As this publication identifies, the business implications of transitioning to Phase II (whether under IFRS or US GAAP) are significant and an early start is beneficial.

⁹ Timeline assumes 31 December year-end reporting.

¹⁰ IFRS 9 effective date is for annual periods beginning on or after 1 January 2013.

This early start is important for two reasons. Firstly, it means that the impact on major strategic developments can be assessed and planned for. This is particularly relevant for European insurers tackling Solvency II, but is equally pertinent for other companies as they address strategic decisions. Secondly, if some insurers adopt the new standard early, then this may lead analysts to question the impact of Phase II on other companies.

Phase II is a major reporting change programme. Key to its success is tailoring the transition specifically to your issues, the engagement of your stakeholders and your governance framework. While, insurance companies may be similar there will always be differences in the corporate DNA that will make your transition your own.

1. Assess

An effective process begins with a detailed assessment of the differences between the accounting standards currently in use and those required under Phase II, identifying the major areas of impact for your organisation. The heat maps presented earlier reflect our current thinking of likely areas for focus based on the current ED and Discussion Paper.

Our interviewees were agreed that the impact for their organisations would be far reaching.

This is more than simply an accounting exercise and the challenge is to unite all the strands into a common programme. An assessment is needed of how the new information requirements will affect information systems as well as the impact on the business and its key processes.



This helps to ensure that all linkages and dependencies are established between accounting and reporting, systems and processes, people and the business. The assess stage needs to address the company's appetite for change – some organisations will want to use this as the catalyst for more major organisational and finance change, whereas others will simply want to adopt Phase II as part of business as usual in the most efficient way possible.

Once the team has made an assessment of where the company is now and where it needs to go, it can develop a master plan and budget for the transition process.

2. Design

The next step is to mobilise the company to design the implementation plan and close the identified gaps. These efforts will include the following:

- Addressing the impact on the main areas of the business. This is likely to involve modelling the impact on the results before moving to implementation. Analysing the impact using a financial model helps to identify business impacts and to provide an inventory of key data requirements. We find that building up a picture of what the results will look like on an iterative basis is the best way to design a robust implementation plan.
- Identifying resource and training needs – initially this will need to address the core team, but will need to expand to address all parts of the business and then all external stakeholders.
- Developing a rigorous programme management plan and governance framework.

3. Implement

During the implementation stage, plans are put into action and the business starts to make Phase II part of its day-to-day operations. Embedding the controls early in the process so that they are integrated from the start, as opposed to addressed later in a less comprehensive fashion, is an important step to implementation. Since the process of

producing financial statements under the new insurance standard is unlikely to work perfectly the first time, the team should carry out dry runs of the procedures to enable weaknesses to be identified and eliminated before 'go live'. This may incorporate building and implementing new systems or amendments to existing systems, designing or re-designing key processes (an opportunity to seek performance improvements), training users, incorporating the new insurance standard into the accounting manual, redeveloping reporting packages and management reporting and developing a shareholder/analyst communication plan for transition.

4. Communicate and educate

Ongoing communication with employees, analysts, investors and other stakeholders is essential to a successful transition process. Internal education needs to precede external efforts. In our experience, this is best addressed early so that Phase II becomes a shared collective endeavour, starting with awareness sessions that are supplemented as the project ramps up. Various constituencies may have different concerns. Management should plan to hold special meetings or conference calls to educate analysts about how performance reporting could change under Phase II, influencing reported earnings and asset bases, and consequently, analysts' valuation models. Such efforts could make an important difference to analysts' and investors' understanding of the company and, ultimately, how they value it.

5. Sustain

Finally, the sustain phase ensures that the required changes continue to work effectively in a 'business as usual' environment. This involves addressing issues such as ongoing employee education, ensuring appropriate resources are in place, processes are still relevant and evolve as the business develops, systems are monitored and updated, and stakeholders are getting relevant information.

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Your transition to Phase II

As a global network of member firms with experience in more than 1,500 IFRS transition projects around the world, we can help you identify the issues early, and can share leading practices to help avoid the many pitfalls of such projects. KPMG firms have extensive experience and the capabilities needed to support you through your Phase II assessment and transition process.

Our global network of specialists can advise you on your preparation for the forthcoming insurance contracts standards, including training company personnel as well as identifying a coordinated approach for Phase II and other regulatory requirements, such as Solvency II. We are committed to providing a uniform approach to deliver consistent, high-quality services for clients across geographies. Our multi-disciplinary experience in accounting, actuarial, risk and asset-liability management, regulatory, IT and tax

topics can assist you in analysing what the new insurance standard will mean for you. Subject to independence constraints, we can assist you in:

- performing a readiness and impact assessment
- reviewing selected products modelled on a Phase II basis
- performing a gap analysis addressing current systems and processes
- managing and executing the transition project
- training and education of employees.

A Phase II readiness assessment is an entry-level analysis of the standard's requirements and their impact on your company. The assessment forms the basis for the development of further options to proceed. Project interdependencies with Solvency II, developments in financial instruments accounting and other projects all need to be taken into account to the extent they are relevant.



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