Institute of Actuaries of India

Subject CP3 – Communication Practice

November 2023 Examination

INDICATIVE SOLUTION

Introduction

The indicative solution has been written by the Examiners with the aim of helping candidates. The solutions given are only indicative. It is realized that there could be other points as valid answers and examiner have given credit for any alternative approach or interpretation which they consider to be reasonable.

Solution 1:

With many insurance companies across the globe having successfully implemented IFRS 17 accounting framework from 1st January 2023, it has been proposed by the regulator that the standard should be adopted by the insurance companies with operations in the country from 1st January 2026.

Under the new framework, the measurement of insurance liabilities will undergo a significant change thereby expected to give a boost to company's profitability. The companies will now be required to analyse the gross and the ceded book separately. Below are some of the key areas impacting company's financials:

1. Basis the new standard, the liabilities can be valued using three methods namely General Measurement Model, Premium Allocation Approach, and the Variable Fee Approach. Under the default method i.e., General Measurement Model, companies will have to allow for discounting of liabilities which have been incurred and liabilities which are yet to be incurred, with profits being released over the life of the contract il.
2. Only, where the nature of contract is short term, a simplified approach called Premium Allocation Approach can be followed, where the liabilities which are yet to be incurred need not be discounted, similar to the existing framework.
3. Since, general insurance companies do not share returns on underlying assets with policyholders, the variable fee approach is not applicable.
4. Our company writes a significant proportion of Motor third party liability, engineering, and financial liability business where claims take longer time to settle i.e., 7 to 10 years, hence the likely impact of discounting is a reduction in liabilities – basis our initial expectation, the liability may reduce to the extent of 8% to 10%.
5. Companies are required to consider the best estimates of the liability and remove any explicit margins built into the current reserves. Additionally, it requires any volatility i.e., non-financial risk in the underlying experience on expected claims and expenses to be explicitly allowed as a risk adjustment factor. This is likely to increase the total liability, hence expected to reduce the profit by 4% to 6%.
6. Given companies will be allowed to defer the acquisition cost over the life of the contract, this will result in a positive impact on profitability by 8% to 10%.
7. An independent assessment of contracts which are expected to be loss-making will be required, and any loss will have to be recognised in the accounts at the inception of the contract. This requirement is different from the existing accounting regime and is likely to decrease the profits by 4% to 6%.
8. Also, to increase the level of governance, the standard has increased the disclosure requirements and will require companies to publish information at a more granular level with respect to the liabilities of the company.

Overall, there seems to be a potential upside of 10% to 12% for our company. Increased governance will strengthen the belief of the policyholders and shareholders in the insurance industry.

To execute the above seamlessly, the company has broken down the implementation plan into four phases:

Phase I

A high-level impact study will be conducted on key lines of business which constitute 50% of the company's gross written premium. This is to familiarise the company with the financial and operational impact of the implementation of the new accounting standard. A report illustrating the key effects on the financials, data, systems, and processes will help the company design a detailed strategy.

Phase II
During this phase, company shall finalise and document its policy choices with respect to areas like choice of measurement model, discount rate, calculation of risk adjustment factor, deferral of acquisition cost and other accounting and actuarial areas impacted by the standard.
Since, this would also require addition of new data points to the ledger, company will need to evaluate a new sub-ledger solution or modify the existing to allow for the new accounting entries.

Phase III
Based on choices made in Phase II, company will execute the set-up of new accounting system, build actuarial models, develop chart of accounts, and set up reporting templates. Post this, company shall conduct tests on the models and systems that have been set up to ensure that these are correctly set up and there is seamless flow of data.
Once, the results appear reasonable, company shall prepare the opening balance sheet using the new systems and processes.

Phase IV
Constant monitoring of the results to ensure there are no glitches and the system is running smoothly with justifiable output.

In case you need more details, please let me know.

[90 Marks]

Solution 2:

Following are the jargons which are excluded out of the note in part 1:

1. Liability for remaining coverage - LFRC, instead unearned liability has been used which relates to the existing framework.
2. Liability for incurred claims - LIC, instead earned liability has been used which relates to the existing framework.
3. Onerous contracts - for the purpose of the note loss making contracts has been used as a replacement.
4. UAT, user acceptance testing - this has not been used as it is because not everyone would relate to its usability with respect to setting up of models.
5. SIT, system integration testing - same reason as point 4.

[5 Marks]

Solution 3:

Following are the points which are excluded out of the note in part 1 as the information was not relevant:

1. Details of how the cash flows will be calculated and then adjusted for time value of money is considered too granular for the purpose of the note.
2. Top down and bottoms up approach - since the idea was to explain the impact of discounting, how the discount rates are derived was not relevant.
3. Company needs to allow explicitly for the risk adjustment factor, but details of its calculation are not relevant to the note i.e., based on statistical techniques.
4. Sharing excess details on what will be done as a part of financial and operational impact assessment.
5. Discuss details about company’s current performance such as current business growth, profitability numbers for 2023 are not relevant for the note.

[5 Marks]

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