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The EY outlook for Insurance in 2018

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Friends,

Welcome to our EY outlook for Insurance in Ireland in 2018. Here, we examine some of the big themes that will shape our conversations in the coming year.

The Central Bank of Ireland has recently published its first set of results and initial analysis of the new statistical dataset. These statistics portray a robust and diverse industry represented by €303 billion of total assets, including over 200 head office undertakings together with 41 domestic branches. This deeply embedded industry is poised for growth and transformation and in this overview we look to explore the detail of some of those themes.

Whereas social and economic factors support continued optimism in the demand for insurance propositions, the increasing scope, scale and pace of change experienced by insurers continues to place pressure on insurance company executives to prepare for a very different future.

As an executive summary, however, these are the immediate priorities we see in Ireland over the next 12 months:

- Addressing the move from regulatory development under Solvency II to the enhanced supervisory model that it brings, including domestic elements such as the enhanced Domestic Actuarial regime while noting the evolving role of EIOPA in a converging capital market union
- Disruption in insurance through a broad array of innovations from process automation, use of artificial intelligence, better use and application of analytics and more recently understanding the application of blockchain through use case and proof of concept initiatives
- Adapting to a surge in authorisation and application activities as companies respond to Brexit and reshape their operating footprints through mergers and acquisitions
- The second wave of finance change is upon us now as companies get ready for IFRS 17, noting that the industry is expecting the scale of change to be at least on a par with those experienced in implementing the financial reporting changes associated with Solvency II
- Audit and assurance scopes continue to expand and the world of audit is adapting to better use and deploy technology to deliver value beyond the traditional audit for a lower cost
- And finally, there's always tax, notwithstanding the renewed vigour and attention on corporate taxation there is still a way to travel on VAT in insurance, spurred on, to some extent, by evolving business models with wider use of shared services and outsourced models

In this publication, we'll be introducing our Insurance team in Dublin and giving you our thoughts on the big topics on the horizon for 2018, from regulatory changes to digital transformation.

Warmest regards,

James Maher

Sector Leader, Insurance

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IFRS 17

The implementation of IFRS 17 Insurance Contracts for periods commencing on or after 1 January 2021 represents the most significant change to European insurance accounting requirements in 20 years, requiring insurers to entirely overhaul their financial reporting. People, processes and systems will be overhauled to meet the new requirements, and CFOs must assess the strategic impacts of a new reporting framework. In addition, developments in capital management and regulatory reporting will require entities to reconcile between multiple metrics on different reporting bases.

The content and structure of data captured from products, portfolios and business units to support IFRS 17 reporting will change significantly. This will require changes to financial consolidation and reporting systems. In addition, changes to the primary financial statements and disclosures will impact GL and chart of accounts at both the group and business unit level. IFRS 17 will require organisations to ensure data governance, lineage and transparency across the entire reporting chain. This includes a wide spectrum of data that will be used, from historic or current data (e.g. policy and premium data or data to produce the risk adjustment) to forward-looking data (e.g. data used to produce cash flow projections). Insurers should work with internal and external stakeholders to assess the current data flows and identify potential gaps. In doing so, it is critical to have the future state in mind to identify data requirements across the existing data and systems landscape.

To date the majority of insurers have, at most, performed only a limited impact assessment for IFRS 17. Those who have moved beyond IFRS 17 project inception are realising the scale of the challenge, from understanding and presenting their numbers to stakeholders through to impacts on data, processes, systems and reporting timetables in the lead up to and beyond 2021. The major change programme required will extend beyond finance and actuarial teams and its impacts will need to be communicated to a broad range of internal and external stakeholders. One of the top priority activities at the start of an IFRS 17 implementation is to produce an integrated operational design which can direct all of the change efforts.

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GDPR

The EU General Data Protection Regulation is a game changer for organisations. The Regulation will have a significant impact on businesses in the insurance sector, bringing with it both positive and negative changes in terms of cost and effort. Organisations are likely to welcome the harmonisation of laws across the 28 member states which will make the complex data protection landscape easier to navigate for multinational organisations. The introduction of new rights for individuals, such as the Right to be Forgotten and the Right to Portability, as well as the introduction of mandatory breach notification, are likely to increase the regulatory burden for organisations.

Businesses need to review their current data protection compliance programmes to determine next steps and decide on the level of investment they need to make over the next two years to address the changes. The volume of people, process and technology change required by the 25 May 2018 deadline of the GDPR should not be underestimated.

Many insurers are compliant, on paper, with existing legislation, but are yet to face the challenge of implementing the requirements through the entire personal data lifecycle. As business models have been digitised, the volume of data held by organisations has increased significantly, resulting in organisations not understanding how much PI they hold, why they retain it and how it is being used.

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Digital Transformation

For global insurers, digital transformation and disruptive innovation have gone from being vague futuristic concepts to immediate-term action items on senior leaders' strategic agendas. New competitive threats, ongoing cost pressures, aging technology, increasing regulatory requirements and generally lacklustre financial performance are among the forces that demand significant change and entirely new business models.

Other external developments – the steady progress toward driverless cars, the rapid emergence of the Internet of Things (IoT) and profound demographic shifts – are placing further pressure on insurers. A common fear is that new market entrants will do to insurance what Uber has done to cab hailing, Amazon has done to retail and robo advisors are doing to investment and wealth management.

Insurers must move quickly if they are to keep up with the ever-rising consumer expectations, and to survive and thrive in the digital era.

The good news is that many early adopters and fast followers have already demonstrated the potential to generate value by embedding digital capabilities deeply and directly into their business models. The value proposition for digital transformation programmes reaches every dimension of the business and can drive breakthrough performance both internally (through increased efficiency and process automation) and externally (through increased speed to market and richer consumer and agent experiences). Therefore, insurers must move boldly to devise enterprise-scale digital strategies and "industrialise" their digital capabilities – that is, deploy them at scale across the business.

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Solvency II Audit

In tandem with the implementation of the Solvency II regime in 2016 came a new requirement for the audit of the Solvency and Financial Condition Report (SFCR) and certain Quantitative Reporting Templates (QRTs). While the specific audit requirements varied among EU member states, it was noteworthy that the Central Bank of Ireland (CBI) required a relatively extensive range of audit scopes. Given that the audits of Solvency II returns were taking place for the first time, this translated into a particularly challenging first year for both preparers and auditors. Among the key challenges were:

- The Solvency II rules, as set out in the Delegated Acts, may sometimes lack specificity and can even be ambiguous, leading to lengthy discussions and debates about the intent of the rules and how they should be applied in practice
- Many preparers underestimated the time and resources required to complete the Solvency II reporting in an auditable format
- Generally, and understandably, the CBI does not rule on specific interpretations of the Delegated Acts without EIOPA support and guidance, causing some uncertainty for preparers in relation to potentially contentious items

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Solvency II and the Domestic Actuarial Regime

After several delays and with much anticipation, Solvency II went live on 01 January 2016 for most (re)insurance entities in the EU. 2016 was first thought of as the destination of a long journey, but instead proved to be the start of another journey towards development of market practice and EU-wide harmonisation of standards and interpretations.

In Ireland, there is also the added requirement for the audit of some of the public disclosure QRTs in the SFCR that form the annual return to the Central Bank of Ireland. This has led to an increased rigour and focus on the interpretation of the delegated acts and various guidance from EIOPA.

It is clear that Solvency II will continue to evolve, both as market practice and interpretations become more consistent. EIOPA released two consultation papers in 2017 on specific areas under Solvency II, e.g. simplified calculations, risk mitigation techniques and recalibration of a number of standard formula capital risks.

The Domestic Actuarial Regime was introduced in advance of the go-live of Solvency II and helped to prepare entities for Solvency II. The regime places significantly more responsibility on the Head of Actuarial Function, particularly in the area of data. The regime has also introduced an "Actuarial Opinion on Technical Provisions" and a requirement to provide an opinion to the Board on the ORSA process.

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VAT

The VAT landscape for insurers and their service providers is an uncertain one at present. Brexit presents a number of challenges for insurers with UK business in terms of structuring their post Brexit operations in a VAT efficient manner.

Insurers have been assessing the impact of Brexit on their business and have been striving to develop a business strategy for EU and UK activities. This varies from company to company and factors include the different existing entities impacted, type of business and scale of book. The challenge responding to Brexit is the uncertainty over the final deal the UK will get.

From a VAT perspective adding to the uncertainty is a number of Court of Justice of the European Union (CJEU) judgments which, if implemented in Ireland, could lead to significant additional costs for insurers on outsourced services. Ireland has not implemented the CJEU judgment in the Skandia case yet but a future implementation is possible. This would impact negatively on existing or proposed service company branches in Ireland which are VAT grouped with an Irish insurance entity. Insurers considering the use of the cost sharing group VAT exemption to alleviate the impact of a Skandia implementation were dealt a blow by a recent CJEU judgment which precluded the use of that exemption by financial service entities.

The industry may also be affected by any future implementation of the CJEU's judgment in the Aspiro case which could affect the current VAT exemption for outsourced insurance related services. The CJEU has held that in order for the VAT exemption to apply the provider must be involved in finding prospective customers and introducing those customers to the insurer. Irish Revenue are still considering the implications of the judgment and the industry will be keeping a keen eye on developments.

In this environment to remain competitive it is imperative that insurers, insurance intermediaries and service providers to the insurance industry take steps to minimise their VAT costs and effectively manage their VAT risks. If not already done, insurance industry players should be modelling the impact on their business, from a VAT perspective, of Brexit and the implementation of the above CJEU decisions and have plans in place to mitigate any adverse impacts.

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US Tax Reform

The overall thrust of the US tax reform was not only to reduce the federal corporate tax rate (from 35% to 21%), to switch the US corporate tax system to a territorial system but also, and importantly for international insurance operations, to encourage activities in the US with both a carrot and a stick.

On 22 December 2017, the US Tax Cuts and Jobs Act was signed into law representing the most significant US tax reform in 30 years. This reform potentially has significant impacts for international insurers operating in Ireland. Most provisions take effect from 1 January 2018 and insurance groups impacted by the new rules are already taking action to minimise the adverse impacts.

On the positive side, dividends received in the US from 10% owned non-US subsidiaries will be exempt from US tax going forward; making the US a territorial system for the first time. This will facilitate foreign subsidiaries moving funds efficiently back to the US where required and where permissible from a regulatory perspective. A one-time transition tax, which can be paid over 8 years, of 15.5% for cash or other liquid assets or 8% for illiquid assets will apply on undistributed, non-previously taxed post-1986 earnings of a CFC (controlled foreign company). To the extent that unrepatriated earnings, of Irish insurance companies with US parents, are held in cash or liquid securities to support insurance reserves, the earnings of the Irish insurer are likely to be subject to the higher rate of tax in the US.

As well as the general corporate tax rate reductions, the carrots to encourage activity in the US, include the foreign derived intangible income (FDII) provisions which encourage the provision of services from the US with a lower tax rate of 13.125% applying to exported services. While eligible income does not include insurance income, US headquartered insurance groups may look to take advantage of this provision and evaluate what cross border services could be provided from the US as opposed to elsewhere.

On the other side, one of the provisions likely to immediately create difficulties for international (re)insurers located in Ireland is the provision around Base Erosion and Anti-Abuse Tax (BEAT). Broadly, where certain thresholds are exceeded, this measure requires the calculation of an alternative minimum tax in the US that may disallow a deduction in the US for foreign related party payments. The legislation seeks to deny a deduction for gross premium payments out of the US without relief for any payments made by the foreign affiliate to the US such as ceding commissions or benefit payments. This could impact significantly on international (re)insurers located in Ireland receiving premium payments from affiliated companies in the US, from 1 January 2018. If the impact is significant enough for particular groups, we are likely to see restructuring of business between the US and Ireland in Q1 and throughout the remainder of 2018.

New provisions for global intangible low taxed income (GILTI) effectively impose a global minimum tax on US parented or owned group companies outside the US. This provision essentially seeks to impose additional tax on CFC income in excess of a pre-determined return (10%) on tangible assets. Most foreign insurance CFC's hold limited amounts of tangible assets. Therefore, many insurance company CFC's that meet the Active Financing Exemption (AFE) in the US could still be subject to the GILTI rule because the new rules do not include a carve out for AFE qualifying income. It will be important for Irish subsidiaries of US entities to be involved in the exercise to model the impact of GILTI.

These more onerous rules, mean that many global groups with international operations under their US subsidiaries are looking to move those lower tier subsidiaries out from under the US.

It is clear from the above that the potential impact of US tax reform on international (re)insurers in Ireland could be far reaching and 2018 at the very least will see an assessment of the impact of US tax reform on overseas operations and could see restructuring of Irish operations, particularly, and most immediately, where the impact of the BEAT provisions is significant.

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Point of view

Authorisations

"Don't believe all you read" is a common phrase and in the case of Brexit and authorisation activity in Ireland, this statement is absolutely appropriate. We have seen a significant uptick in authorisation and change of control activity prompted by the industry continuing to restructure and not solely because of Brexit, but that is by no means a minor factor. The authorisation wave stimulated by Brexit started with the ceasing of branch conversion activity in Ireland and (re)domestication of previously branched activities. Thus without any new clients there has been a stemming of companies folding and a reversal of that trend.

While those companies may not be as they were, the confidence to recommit to Ireland and, in many cases, the ambition to extend the reach and scope of those authorisations has been a positive step. Moving on into the new entrants, we see a primarily non-life specialty market attraction to Ireland with companies again looking to adapt, by extending existing footprints in response to Brexit plans. The primary aim of clients is to ensure that they are preserving market access for their companies which is achieved through establishing a European footprint.

Whereas there has been a lot of press regarding a hard regulatory approach to acceptance of new applications, it is safe to say that the questions of applicants are transparent and fair and the expectations around demonstrating how activities will be delivered in a future structure are reasonable. In practice, the greatest uncertainties lie in the status of activities that remain in the UK and thus outside of the EU in this future landscape. There is a legal and regulatory road to travel to satisfy stakeholders as to an acceptable and appropriate footprint, and in particular unpicking questions around where regulated activities are being performed.

Finally, there has been a significant movement in the underlying landscape, not as a result of Brexit but as a result of the industry realigning itself in a cost conscious low interest rate world. There is a clear role for acquisitions of sub-scale and run-off portfolios as well as resolving companies that are no longer attractive or viable in this low interest rate world. Through our unique One FSO structure we have been able to work seamlessly between our service areas and markets to bring the depth and breadth of EY to bear in managing these complex transactions and transitions and to being able to provide clear and expansive market viewpoints.

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Meet the team

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James Maher is a Partner in EY's Financial Services Organisation, having joined the European Actuarial Services practice in September 2010. He is head of both Insurance and Actuarial Services for Financial Services in Ireland. James has over 20 years' experience in reinsurance, delivering innovative risk solutions to clients throughout Europe and beyond. James specialises in capital and risk management for insurance and reinsurance companies.

Ciara McKenna is a Partner in EY's Financial Services Organisation, in our dedicated Insurance Assurance practice in Dublin. She has worked with EY since 2001 during which time she has served several of our global priority clients. She is responsible for the provision of assurance and accounting services to insurance and reinsurance clients primarily, with experience in IFRS, Irish and US GAAP. Ciara is leading our assurance services in relation to Solvency II prudential reporting. She directs assurance services for clients in areas such as regulatory compliance, securitisation transactions, due diligence procedures, process improvement projects, identification and resolution of internal control weaknesses in all aspects of financial control and reporting.

Dargan FitzGerald is an Assurance partner in EY's Financial Services Organisation. He specialises in financial reporting for insurance companies and has provided Assurance services and accounting advice to insurers and reinsurers for over 30 years. He has lectured extensively on financial reporting for the Insurance Institute of Ireland and the Dublin International Insurance and Management Association, amongst others.

Sandra Dawson is an Associate Tax Partner with EY who leads the Insurance Tax practice within the Financial Services Organisation. She has 20 years' experience advising domestic and international insurance companies on structuring and Irish tax matters. She has assisted many international insurance companies to establish operations in Ireland to sell into the EU. Since joining EY, Sandra has been involved in a number of large projects involving insurance company and related service provider set-ups, international tax structuring, demutualisation, mergers as well as the provision of day-to-day advice.

Edward Taggart is a Director in the Dublin office leading Insurance and Technology consulting within the Performance Improvement practice. He has 18 years Consulting experience across Financial Services, Health and Public Service clients. Teddy has extensive experience delivering large scale systems integration and technology programmes for clients. Examples include legacy platform replacement, claims workflow, insurance 'quote and buy', IT strategy and multiple large programme recovery jobs. Teddy has also led major business and systems integrations for clients in both the general insurance and international life sectors.

Ciara Fitzpatrick is a Director in Insurance Risk and Actuarial Services. Ciara joined EY in 2001 and is based in the Dublin office. Her previous experience spans a variety of roles with Irish life insurers covering financial reporting, pricing and defined benefit solutions. Her areas of particular experience include Economic Capital - Solvency II, Audit and Assurance, Financial reporting IFRS, MCEV, local and US GAAP, Structuring and Optimisation, Actuarial Transformation and Regulatory.

Eric Brown is a senior manager in the Life Actuarial practice in the Dublin office. He has over 12 years consulting experience with EY including a number of years based in the London office. Eric leads a number of projects in the risk and regulatory space including authorisation support and is chair of the ERM Committee of the Society of Actuaries in Ireland. He has extensive experience across all Pillars in Solvency II and has led a number of internal model engagements, including developing, challenging and validating internal models.

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