Transcript

Intact Financial Corporation
IFRS 17 & 9 teach-in presentation

April 27, 2023

Shubha Khan, Vice President, Investor Relations:
Hello, and thank you for joining this teach-in presentation to discuss the implications of the new IFRS 17 and IFRS 9 accounting standards. The two standards, IFRS 17 in particular, will drive a number of changes to our financial disclosures, though the impact should be fairly limited in aggregate.

The purpose of today's session is ultimately to ensure that analysts and investors are not unduly surprised by the amount of changes in our financial reporting when we actually announce Q1-2023 results on May 10.

Before we get underway, I am required to refer you to Slide 3 for cautionary language on the use of any forward-looking statements in this presentation.

And to Slide 4 for a note on the use of Non-GAAP financial measures, which of course, we will be referencing quite heavily throughout this session.

I'd point out that throughout this presentation we'll be using numbers to explain certain concepts, but these are illustrative and only meant to convey the impact of the changes.

All of the materials for this teach-in have been posted on our website at intactfc.com, in the Events and Presentation section under the Investors tab.

With that out of the way, let's get right into it. I'll turn it over to Louis Marcotte, Executive Vice President & CFO, to go over the key changes to our financial disclosures.

Louis Marcotte, Executive Vice President & CFO:
Thank you Shubha.

IFRS 17 is finally upon us and I am pleased to share with you a preliminary view of the impacts that the new standard will have on our company, our reports and most importantly our results. Unfortunately, we cannot share too many numbers with you ahead of the upcoming earnings release, but I am hopeful the materials presented today will give you a chance to familiarize yourself with the changes and their impact.

Fortunately, the impact on P&C insurers is fairly limited thanks to the short-term nature of our contracts. There is a fair bit of noise but ultimately, our net operating income per share (NOIPS) and our Operating ROE (OROE) are largely unaffected, except maybe for some timing considerations.

Most importantly, IFRS 17 and IFRS 9, which is implemented simultaneously, don't change how we run our business, the fundamentals behind it, our strategic objectives, or the roadmap we'll use to get there.

You should expect changes to the presentation of earnings, particularly within the combined ratio itself, and between the insurance and investment results. We'll go through those changes in detail in this session.

As we have disclosed earlier this year, the implementation of IFRS 17 has led to a favorable balance sheet impact upon transition. I will provide the break down later.

Finally, we've made some changes to our asset classification under IFRS 9 as of January 1st, 2023, and as a result, we will see our non-operating results, earnings per share (EPS) and ROE become more sensitive to changes in financial markets.

In summary, I see 3 types of impacts: Timing, Presentation, and Conceptual changes with minimal impact.

First, let's talk about Timing changes. These are limited and have an impact on our BVPS at transition. These changes will shift the timing of our earnings pattern, with no impact over the full life of a policy.

With regards to presentation changes, there have generally no impact on NOIPS. The most significant change is the reclassification of the discount unwind between the combined ratio and net investment results. We'll cover that in detail later. And I should not understate the impact of IFRS 17 changes on our balance sheet presentation.

Finally, we have conceptual changes to discuss but they have minimal impact. We'll clarify what these concepts mean to us now, before we move onto the more impactful Timing and Presentation changes.

IFRS 17 introduces two new measurement models: the simplified Premium Allocation Approach, better known as the PAA, and the more complex General Measurement Model, also known as the GMM.

The PAA can be used for contracts that are twelve months or less. Fortunately, our regular ongoing business qualifies for the PAA. This is good news because the accounting is much closer to IFRS 4, which allows a policy to be earned evenly over the life of the contract.

When the PAA model does not apply, the more complex GMM must be used, and with it comes the potential deferral of profits through a Contractual Service Margin, otherwise known as a CSM. Fortunately, the GMM will only apply to IFC in limited circumstances, namely in the case of claims acquired in a business combination.

In terms of reinsurance, IFRS 17 requires that we separate reinsurance results from our direct business results in the financial statements. We will of course follow those requirements and investors will be able to see the outcome in the financial statements, but as we manage our business net of reinsurance, we will continue to report on a net basis in our MD&A.

Shubha, I may be going too fast here, please feel free to ask any questions along the way.

Shubha Khan:
Ok, sounds good.

Louis Marcotte:
Ok let's continue. Under IFRS 4, we were already deferring a significant portion of our acquisition costs including those that are specific to a policy, like commissions and premium taxes. We were not generally deferring allocated indirect acquisition costs, like marketing or internal policy processing costs.

Under the PAA measurement model in IFRS 17, it's an "all-or-nothing" approach: either you defer everything, or expense everything as incurred. We've elected to defer, which we feel provides for a better matching of revenues and expenses. As a result, there is a significant impact upon transition of $384 million, driven by the allocated indirect costs that were not previously deferred.

This is purely a timing change. Over the term of a policy, which is generally 12 months, the deferral and amortization will offset each other entirely. Both are reflected in the expense ratio.

Shubha Khan:
Louis, I imagine that the earnings implications of deferring a greater portion of one's acquisition costs will depend on whether the business is ultimately growing or shrinking?

Louis Marcotte
Great point, Shubha. Generally, we would expect that when our business grows, deferred acquisition costs would grow along with it, meaning that the deferral in any one period would be higher than the amortization of prior acquisition costs. The opposite effect, a slightly unfavourable impact, would apply if the business and related acquisition costs were shrinking.

Shubha Khan:
That is fairly straightforward. Let's move to the next topic: onerous contracts on slide 10

Louis Marcotte:
Absolutely - one of my favorites: onerosity. Under IFRS 17, the onerosity concept requires insurers to recognize losses on unprofitable groups of contracts as soon as those contracts are issued. This is earlier than what we do today.

IFRS 17 is also more demanding in terms of the level of granularity required for groups of contracts subject to onerosity tests. This means for example, that a line of business in one country, in one province, one legal entity, might be onerous and require a provision. This will likely lead to earlier and more frequent recognition of losses. But take note, the reversal of this provision will happen over time, as unearned premium balance decreases and if the profitability of that group improves.

Again, this is purely timing since the same loss would previously have been recognized over the life of the contract anyways.

As far as we are concerned, we don't tend to expect groups of unprofitable contracts, so the impact is expected to be limited going forward. There is some noise in the transition period related to the profitability of UK&I Personal lines, which has led us to book an onerosity provision.

Now let's move on to slide 11. Another favorite. I talked about the two measurement models earlier: the simplified PAA model and the GMM. The standard requires that we apply the more complex GMM to account for claims acquired in a business combination.

Fortunately, we only have to apply this model retroactively to the claims acquired with the RSA Acquisition. Claims acquired in prior acquisitions have been exempted for practicality reasons allowed by IFRS 17. Going forward, the model will be used for all acquisitions.

Under IFRS 4, we treated claims acquired the same way we treat our own: we booked favourable or unfavourable PYD in our P&L based on the development of the claims. We continue to run our business that way.

Now, under IFRS 17, the development of the claims acquired with RSA specifically, must be determined on the basis of expected cash flows, actual cash flows and the ultimate view of the fulfilment cash flows. In certain circumstances, the application of the standard could result in timing differences in terms of PYD recognition. If the ultimate expected claim value remains unchanged, there is only a timing impact on earnings.

We will continue to manage our acquired businesses in the same way we did before, and as such, the results of our segments and lines of business will not reflect the impact of IFRS 17 on acquired claims. The net impact will be treated as non-operating and will be fully disclosed in our MDA.

The application of the standard will also cause a significant P&L gross-up between revenues and expenses in our financial statements. The MD&A will remain unchanged as we will exclude the P&L gross-up. Investors will have access to complete reconciliations between our MD&A results and those in the financial statements.

Shubha Khan:
All right. So, if the gross-up is excluded from the MD&A, would it be fair to assume that there is no impact to combined ratios?

Louis Marcotte:
That's right Shubha. The combined ratio will not be impacted by this change. In line with how we manage our business, we will exclude both the revenue and expense gross-up, as well as the net impact of this change, from the combined ratio and NOIPS.

Now let me move on to a change that will have an impact on our expense ratio: the change in classification of in-house claims handling costs and other underwriting revenues.

The new standard provides more guidance on certain classifications within the different components of underwriting income.

First, the standard implies that only costs that are directly related to claims handling, such as salaries and overhead related to adjusters, can be allocated to claims. Previously, we were allocating a larger portion of shared costs to our claims ratio. This change will not impact combined ratio but will decrease the claims ratio and increase the expense ratio by the same amount.

Second, the standard requires that insurance-related income, such as installment fees, now be reported within revenues. As such, they will now be included in the denominator used in the combined ratio calculation. Previously, we were reporting this income against our underwriting expenses, so this change will increase the expense ratio. This reclass increases total earned revenues, with no impact to underwriting income, leading to a slight uptick in total combined ratio.

The combination of these two adjustments will cause an increase to our expense ratio of roughly 1.5 to 2 points overall, with no impact to underwriting income or NOIPS.

Before moving on, I'll also add that IFRS 17 requires the exclusion of certain indirect expenses from insurance results in the financial statements. These indirect costs, which mainly represent internal shared functions that we feel are underwriting-related expenses, will remain within our underwriting results and expense ratio, with no impact to our MD&A KPIs compared to IFRS 4.

Shubha Khan:
Louis, it's clear that these changes impact the numerator of the combined ratio or its components, but perhaps we should point out that the denominator is changing too.

Louis Marcotte:
Yes, that's true. The denominator of the combined ratio, which used to be operating Net Earned Premium, will now become Operating NEP plus the addition of other insurance revenues, which we will report together in one line. The impact of the higher denominator is not expected to be material on overall combined ratio but will impact the claims and expense ratios as I described earlier. Keep in mind, we have restated our 2022 figures and therefore, it should be an apples-to-apples comparison when reading our Q1-2023 MD&A.

Speaking of revenues, you may also know that Direct premiums Written, or DPW, which is our key metric for measuring growth, will no longer be an IFRS metric presented in the financial statements. That said, DPW, which is a more forward-looking measure than earned premiums, will continue to be our main growth indicator and as such we will continue to present it in our MD&A.

Now, onto the fun stuff! Reserving and underwriting performance.

Please excuse me as I review a couple of fundamental concepts that are important to a smooth understanding of the transition to IFRS 17.

Concepts like risk adjustment and discounting are not new to us. We were applying them long before IFRS 17 came into effect.

The Risk adjustment, shown in green on slide 13, is essentially an additional reserve to account for uncertainty. It is created at inception, and then released over time, as claims are settled. The concept is similar to a PfAD, or provision for adverse deviation.

The Discount, shown in red, brings a claim to its present value. It is created at the claim's inception and then unwound over time.

The Discount build is favourable and mostly benefits the current accident year, while the Discount unwind is unfavourable and mostly impacts the prior accident year.

The MYA, or market yield adjustment, represents the effect of changes in discount rates throughout the year. This impact is removed from the combined ratio, in order to isolate market fluctuations in the period.

Because we were already applying these concepts, the impact of IFRS 17 on our reserving is limited. The standard now prescribes a specific methodology for the calculation of each element, which creates a few timing differences. It also prescribes a significant change in presentation with respect to the discount unwind.

Slide 14 summarizes the methodology refinements required under IFRS 17.

The risk adjustment is still required but the margin for financial risk is eliminated. That has an immediate positive impact on transition.

The Discount and MYA methodologies are fairly similar to before, but the methodology used to determine discount rates is now somewhat prescribed. The methodology itself is not a material change but the impact of rapidly rising rates in 2022 has materially impacted the discount values and their related offsets.

One other element to understand is that the methodology prescribed by IFRS 17 to calculate MYA captures slightly less of the movements in rate changes throughout the year. The new method could allow for more volatility in operating results in years where there are significant changes in discount rates.

The impact of methodology changes on our opening balance sheet is a favourable $163M, driven by the elimination of the financial market risk margin and also by the fact that discount rates were slightly higher under IFRS 17 upon transition.

Over time, we expect these impacts to be minimal, as the build of the risk adjustment and the discount will be offset by their unwind and release, for a minimal overall effect.

Louis Marcotte:
As I mentioned before, the standard also introduces presentation changes, particularly with respect to the unwind of the discount. The impact is important to understand.

As discussed earlier in the fundamentals, we will continue to record both a risk adjustment and discount build when a claim is created. As time goes by, assuming no change to the ultimate claims expected value, we will release the risk adjustment and discount, to bring the claim back to its expected payment value. The claim's payment value does not change with IFRS 17.

What does change is where the different elements are presented in the P&L:

Under IFRS 4, both the favourable build and the unfavourable unwind of the discount were presented within the combined ratio.

Under IFRS 17, the new standard is clear that the unwind of discounting should now be considered an insurance financing activity, recorded outside of insurance results. This is a major change because it improves the lifetime combined ratio permanently.

We will therefore move the unwind of discount within our investment results. We will continue to present our net investment income separately, meaning that previously stated investment income guidance will continue to apply, and comparability will be maintained over time. The unwind will be presented separately.

Though our actual reserving remains unchanged, there will be a slight favorable impact on our reported PYD metric, given that most of the unfavourable unwind pertains to prior year claims. As previously communicated, we have increased our mid-term PYD guidance from 1 to 3% to now 2 to 4%.

Shubha Khan:
Louis, how will investors be able to compare combined ratios under IFRS 17 given all the changes?

Good question Shubha. Let's look at slide 16.

As I explained before, under IFRS 4, we were reporting both the favourable discount build and the unfavourable discount unwind within the combined ratio. These two elements completely offset each other for one claim over its lifetime. This means that under IFRS 4, the undiscounted and discounted results were identical over the lifetime of a claim.

We also know that under IFRS 17, the removal of the discount unwind from our underwriting results will have significant favourable impact on the lifetime combined ratio of any one claim. This is the equivalent of the 95% discounted lifetime combined ratio shown on the right-hand side of the page.

What that means, is that the undiscounted combined ratio under IFRS 17 now effectively becomes more comparable to the way we were presenting our segments under IFRS 4, where the discount build and the unwind largely offset each other for an overall minimal effect. Excluding both the discount build and the unwind is the same as including them both, for any one claim over its lifetime. Obviously, because we have many claims of different sizes and durations, its not a perfect offset in any one period, but in a stable interest rate environment, they do broadly offset each other.

We have therefore decided to change our combined ratio disclosures a bit to facilitate comparison with past performance and also to eliminate the noise from interest rate movements in underwriting.

Slide 17 summarizes the changes. Essentially, we will provide undiscounted combined ratios for each of our segments. The explanations we provide within our segments will thus be focused on the fundamentals of that business, rather than changes in discount rates. That is consistent with our management of the segments.
The total impact of the discount build will be reported separately in Corporate underwriting income.

Practically speaking, this means that the ambitions that we gave at our recent Investor Day remain unchanged. This also means that undiscounted combined ratios for our segments and lines of business, will remain comparable to historical ratios reported under IFRS 4.

Shubha Khan
Louis, I suppose it remains to be seen how peers report their underwriting results. Any thoughts on what analysts should take into consideration when comparing our results with those of our peers?

Louis Marcotte:
When comparing our ratios to those of our peers, it will be important to ensure that combined ratios are on a comparable basis. That is either discounted but excluding the unwind of discount, or undiscounted.

Shubha Khan
It makes sense that the undiscounted combined ratios we will be showing for each line of business are comparable to the discounted combined ratios under IFRS 4. Nevertheless, we are increasing the level of disclosure by reporting both the discount build and the unwind. How should analysts and investors think about modeling both these items?

Louis Marcotte:
I'll start by saying that the two should largely offset each other in a stable interest rate environment. However, as I mentioned before, this isn't always perfect, especially in a market environment like 2022, where there were very significant increases in the interest rates. The discount build on current accident year claims essentially uses the average yield at the time the claim is booked. By contrast, the unwind on prior year claims, which makes up most of the unwind, is calculated based on a static yield curve fixed at the beginning of the calendar year. This means that the two amounts will not perfectly offset each other in the 2022 transition year given the significant increase in rates we experienced throughout the year.

On an ongoing basis, in a more normal or stable interest rate environment, a simple rule of thumb to calculate the unwind in any one year would be to take our total claims liability, which was about $21B as at December 31, 2022, and multiply that by the average yield curves in effect, which currently stand somewhere just shy of 5%. This would give you a discount unwind somewhere close to $1B, with an equivalent and offsetting build, in stable environment. This example is meant to be illustrative, but the overall result of the calculation is in line with what we're expecting for 2023, if things remain stable.

Let's move on to the impact on transition.

IFRS 17 requires retrospective application as if we had always used IFRS 17. This means that we will have restated our January 1st, 2022, opening balance sheet, as well as all of our 2022 comparative quarters.

With respect to IFRS 9, we have adopted it as of January 1st, 2023 and we have elected not to restate 2022 comparatives.

The timing changes I described earlier will have an impact of $2.39 on our Book value per share (BVPS) as at January 1st 2022, and an immaterial additional amount is expected for the restatement of 2022 comparatives.

Moving on to the balance sheet. IFRS 17 also requires significant changes here. We now need to net all the assets and liabilities related to insurance contracts against each other, and same goes for reinsurance contracts held. This presentation change will have the effect of significantly reducing overall assets and liabilities, though no impact on a net basis.

Though this change significantly impacts the face of our balance sheet, our financial position and capital management strategy remain unchanged.

IFRS 9 will also have an impact on our results going forward. The standard introduces classification changes, with the underlying principle that equity investments should be measured at their fair value through P&L, except in specific cases where the mark-to market is recognized in OCI and never reclassified to P&L. This is the case for most of our preferred shares that are held for the long-term and for their dividend income.

But let's focus on our $5B common stocks portfolio.

Under the old standard, IAS 39, our common shares were classified as Available For Sale (AFS), which meant that they were marked-to-market through OCI, with gains or losses recycled to the P&L only once they were sold or impaired.

Under IFRS 9, this will no longer be the case. Classifying our equities as Fair Value through P&L is aligned with our strategy to outperform the industry's ROE, as we strive to capture total after-tax returns.

The impact of this change will be increased volatility to EPS and ROE, which will now capture all changes in the market value of our common stocks. This will not impact BVPS or capital since we were already measuring our investments at their fair value on our balance sheet.

Shubha Khan:
With gains and losses in our common equity portfolio now flowing the P&L, does the concept of impairment still apply?

Louis Marcotte:
Well, the concept of impairing our common shares will no longer exist, since all their market fluctuations will now be recorded through the P&L.

That said, it is worth mentioning that the standard also introduces the Expected Credit Loss model, or ECL, for debt securities, but given the high quality of our investment grade portfolio, the impact for us is expected to remain immaterial.

Shubha Khan:
Thanks, Louis. I think that covers all of the key concepts related to IFRS 17 and IFRS 9. We covered a lot of ground. What, in your mind, are the key takeaways?

Louis Marcotte:
Well, Shubha, hopefully we have been quite clear that the overall impact of these accounting standards on our financials is limited.

The standards introduce changes in timing of earnings, which will have no impact over a full policy cycle, or economic cycle on the investment side.

Presentation changes are more significant, especially with respect to the discount unwind. But the good news is that our choice to present our segments undiscounted from now on, will limit the impact as well.

Hopefully, following the teach-in, and accompanied with the MD&A, Financial Statements and Statistical Supplement, investors will see through these changes and understand our performance.

Shubha Khan:
That's very clear, Louis. I think this presentation will clarify a lot of the main changes to our disclosure going forward.

Louis Marcotte:
Shubha, sorry for interrupting here. But as we are on the Thank you slide, I will take the opportunity to thank our teams, who have been working for a couple of years on IFRS 17 and we are quite happy to be at the end-state of the project. We are finally going live with this. I will express my deep gratitude to our teams in Actuarial, IT, and Finance. Having gone through a fairly long project, while integrating acquisitions at the same time. It's been a lot of work for all of those teams, and I'm very happy to be here today and sharing the outcome with investors. So, a deep felt thank you to al the teams that who have work on the project.

Shubha Khan:
Absolutely! There's one final item I'd like to address before we wrap up. A number of analysts have been asking me whether we'll be providing a restated Supplementary Information pack before we publish Q1 results.

We've posted an Excel template of the Supplement on our website, which doesn't contain any numbers, but clearly outlines the key presentation changes.

And I'd note that when we publish the full Supplement on May 10, we'll be providing Q1 and full-year 2022 comparatives, on both an IFRS 17 and IFRS 4 basis.

And finally, just a quick reminder that we'll be publishing our first quarter 2023 results after market close on Wednesday, May 10th, with the earnings call taking place the following day at 11:00 am Eastern Time.

In the meantime, should you have any additional questions with regards to the impact of the new accounting standards, please don't hesitate to reach out to the Investor Relations team. We'd be happy to take your questions by email or, if you prefer, schedule a call to discuss any follow ups in more details.

Thanks again for joining this session and we look forward to speaking with you soon.