Gearing up for a paradigm shift

Are you prepared for IFRS17?

- Effective 1 January 2021
- Change of paradigm in profit recognition
- Fundamental changes to data requirements
- Potential operational and systems restructure

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Background

The new International Financial Reporting Standard (IFRS 17) for insurance contract accounting – previously known as IFRS 4 Phase II has now been finalized after many years of research and drafting.

IFRS 17 will be introduced effective January 1, 2021 as a much needed, robust standard. It serves to address the challenges found in the current standard, IFRS 4, which allows a myriad of different accounting policies, thus resulting in a lack of comparability even within insurance groups.

The new reporting standard shares parallels with the European Solvency II capital model, for which insurers in Europe have undergone major implementation projects and made significant investments in systems and processes. Ideally, these and elements of other existing systems will be used as a starting point for IFRS 17. In the meantime, differences between the two frameworks exist, notably the contractual service margin concept under IFRS 17.

The lead time to January 2021, however, is a reflection of the complexities anticipated around the implementation.

There is also some relief for insurers as IFRS 9 is not required to be applied to their investment portfolios prior to adopting the new insurance contracts standard. It is expected that most insurers will be able to apply the temporary exemption from IFRS 9 adoption to bring the two standards into line. However, there remains related disclosure requirements to consider, in addition to building the interaction of both standards into IFRS 17 planning.

The following is an overview of the key features of IFRS 17, the challenges and learning points, as well as suggestions on how insurers can pragmatically approach the implementation of the new standard.

Fundamental changes brought about by IFRS17

The financial and operational implications from adoption of IFRS 17 will vary by entity. However, the new standard is expected to bring about pervasive changes for insurers, especially in the areas of:

- Liability measurement
- Profit recognition
- Data requirements
- Operations and systems
- Reporting timetable
- Product strategy

An overview of the standard

IFRS17 is comprised of three main approaches: the building blocks approach (BBA), the premium allocation approach (PAA), and the variable fee approach. Figure 1 below provides an illustration of the main features of IFRS 17.

Figure 1. Main features of IFRS 17

	Why is it needed?	Key features	Applicable contracts
BBA	To be used as default model for all insurance contracts	• Discounted cash flow model with an allowance for risk • Market-consistent valuation of options and guarantees • Discount rates reflect characteristics of the insurance contracts • No day one profits – recognised as a contractual service margin (CSM) and amortised in profit and loss (P&L) over the contract term (straight line basis) • New income statement presentation and definition of revenue • Other comprehensive income (OCI) option[2] for changes in discount rates to reduce P&L volatility • Transition approach allows some simplifications and judgement	• Long-term and whole life insurance, protection business • Inflation-linked annuity contracts • Immediate annuities • Universal life, certain fixed annuities (BBA with some adjustments) • Reinsurance written (BBA with some adjustments) • Certain general insurance contracts
PAA	To simplify short term contracts with little variability	• Optional simplified model is allowed for short duration contracts (coverage period up to one year) or contracts with reasonable approximation to the BBA • Applied to measure the pre-claims liability – akin to unearned premium accounting • The BBA is applied to determine the liability for incurred claims	• Short-term general insurance • Short-term life and certain group contracts
Variable fee approach	To deal with participating business where policyholder liability is linked to underlying items and thus accounting should reflect this	• Reflects the link to underlying returns for contracts that participate in a clearly identified pool of underlying items, where policyholders are paid a substantial share of the returns and a substantial proportion of the cash flows vary with the underlying items. • As per BBA with additional features, notably: - Changes in insurers' share of assets recognised in CSM Accretion of interest on CSM at current rates - Profit or loss movement in liabilities mirrors treatment on underlying assets with balance in OCI (if policy choice is adopted)	• Unit-linked contracts and equity index-linked contracts • Singapore 90/10 participating contracts • Whole life insurance with participating features

1. PPA – See our publication: General insurers should not ignore IFRS 4 Phase II
2. OCI – comprises items of income and expenditure that are not recognised in P&L

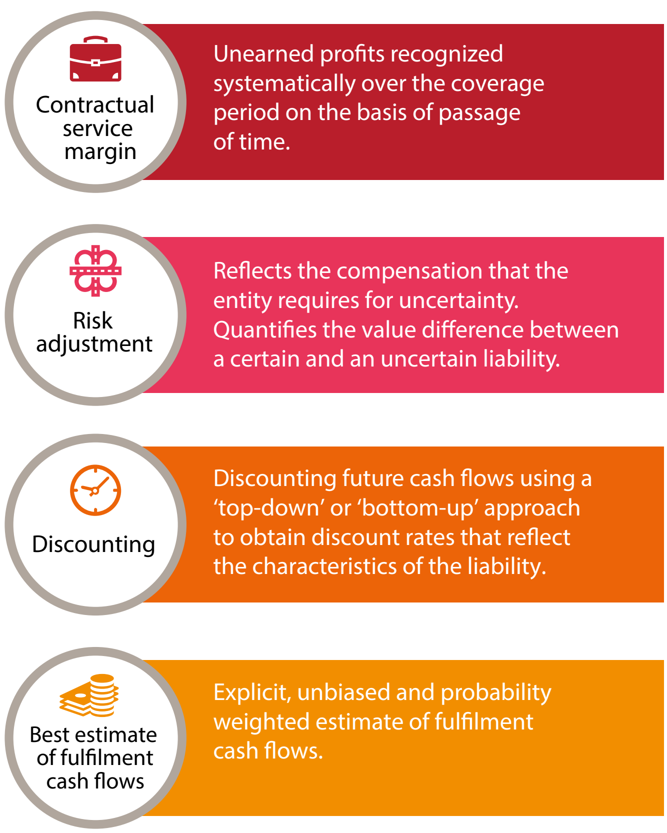
BBA – The general model of measurement

BBA can be summarised into four components (Figure 2) with the approach underpinned by three central ideas:

- Estimates of future cash flows should be based on current assumptions rather than historic 'locked-in' assumptions (discounted best estimates of fulfilment cash flows)
- Liability measurement includes an allowance for risk and uncertainty (a 'risk adjustment')
- Insurers should report earnings that reflect the services being provided, rather than the cash received (through the 'contractual service margin')

The first two concepts will already be familiar to those using reporting metrics such as Embedded Value. However, the devil is in the detail and differences are to be expected in the calculation of 'best-estimate liability' under these metrics. In parts of Asia where regulatory reporting frameworks are still undergoing development, an opportunity exists for closer alignment of the existing and upcoming calculation methods. Nevertheless, the changes to profit reporting will be a significant change for the entire industry.

Figure 2: IFRS 17 liability measurement model



What implications might we expect for insurers?

Increased complexity in operations

Operationally, the mechanisms required to calculate and present liabilities as well as earnings will result in complex modelling and data challenges for most insurers (Figure 3). The key components that will drive significant operational impact include:

- Current estimates of insurance contract liabilities, including an allowance for risks, such as economic risks from embedded options and unhedgeable insurance risks
- Level of aggregation is expected to be more granular with requirements to dissect a portfolio at inception to: onerous contracts, profitable contracts with significant risk of becoming onerous, and other profitable contracts
- A 'contractual service margin' to control the release of profits in line with services
- New presentation and disclosure requirements, most notably the concept of insurance contract revenue under IFRS 17, as well as the new classification and measurement rules under IFRS 9
- A separate model will be required to measure the liabilities for participating contracts which is accounted for under the variable fee approach

Figure 3. The implementation of each aspect of IFRS 17 - level of difficulty

Key component	Minimal	Low	Medium	High
1 Scope	●			
2 Contract boundary		●		
3 Unbundling		●		
4 Best-estimate cash flows			●	
5 Acquisition costs			●	
6 Discount rate			●	
7 Risk adjustment			●	
8 Contractual service margin				●
9 Participating (asset linked) contracts				●
10 Reinsurance			●	
11 Premium allocation approach			●	
12 Transition				●
13 Presentation & disclosure				●

IFRS 17 will need to be applied retrospectively for all contracts that are in-force at the date of transition. This will create significant challenges for many insurers in estimating the effect of historic assumptions and experience on the opening balance sheet.

As the volume of data that needs to be tracked and stored will increase significantly as compared to today, implementation costs could be significant for some insurers. As ever, there will be a trade-off between cost and accuracy, but even analyzing the choices and understanding their impact will not be straightforward for most.

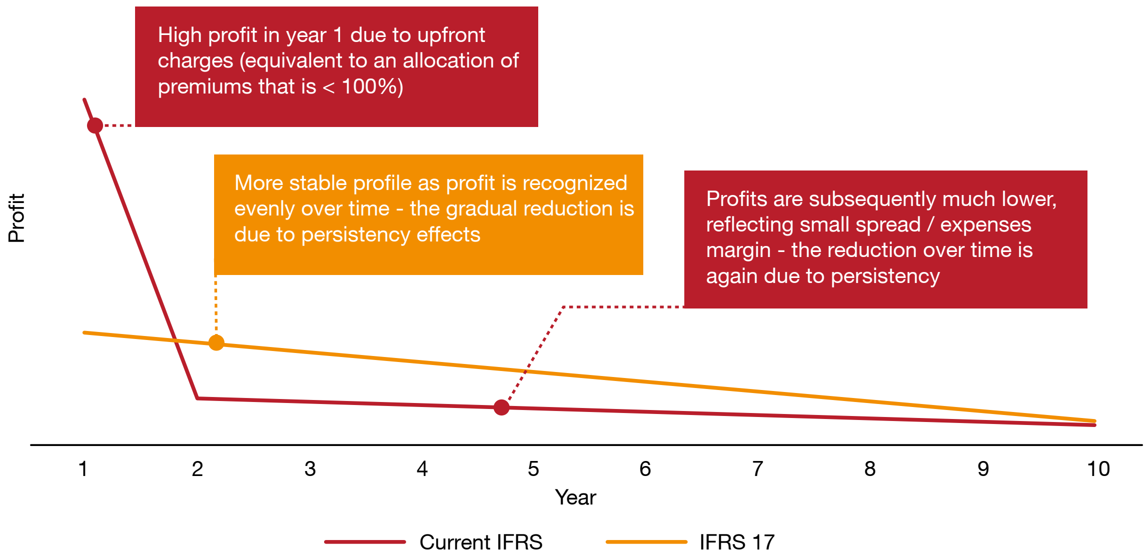
Fundamental changes in recognition and presentation of profit

Profit recognition: Earnings that reflect services provided

Today, companies recognise profits in different ways, with some insurers recognising profit in advance of it being 'earned' through up-front premiums and charges. Under IFRS 17, earnings from profitable insurance contracts will be determined and presented in the income statement as services are provided. In practice, this means that moving forward, earnings will be recognised in a more consistent and often smoother pattern (Figure 4).

Figure 4. Profit profile

Comparison of the profit profile for a traditional single premium savings contract (with significant insurance risk) under current IFRS 4 and IFRS 17



P&L statement: A revamped reporting format

Arguably, the biggest change brought about by IFRS 17 is the reporting of profit. The systematic recognition of profit is new to many. Furthermore, the format used to present the results will be unfamiliar, which may risk confusing investors (Figure 5). However, this is likely to be outweighed in the longer term by the benefits expected from the increased comparability of results and the more predictable profit recognition profile.

Figure 5. New P&L statement under IFRS 17

Today's P&L

Revenues

- Gross written premiums
- Policy fees
- Gross written premiums and policy fees
- Less premiums ceded to reinsurers
- Net written premiums and policy fees
- Net change in reserves for unearned premiums
- Net earned premiums and policy fees
- Farmers management fees and other related revenues
- Net investment result on Group investments
- Net investment income on Group investments
- Net capital gains/(losses) and impairments on Group investments
- Net investment result on unit-linked investments
- Net gain/(loss) on divestments of businesses
- Other income

Total revenues

Benefits, losses and expenses

- Insurance benefits and losses, gross of reinsurance
- Less ceded insurance benefits and losses
- Insurance benefits and losses, net of reinsurance
- Policyholder dividends and participation in profits, net of reinsurance
- Underwriting and policy acquisition costs, net of reinsurance
- Administrative and other operating expense
- Interest expense on debt
- Interest credited to policyholders and other interest

Total benefits, losses and expenses

Net income before income tax

Minimum requirement P&L and OCI under IFRS17

Income statement

- Insurance contract revenue
- Claims and benefits incurred
- Expenses incurred
- Amortization of acquisition costs
- Experience adjustment
- Changes in estimates that do not adjust the contractual service margin
- Day one loss
- Unwind losses when claims are incurred
- Discount unwind

Underwriting result

- Other costs
- Investment income

Profit or Loss

Other comprehensive income

- Changes in ins contract liabilities due to discount rate
- Changes in FVOCI assets

Capital strain from writing new business will be reduced

Under IFRS 17, it is likely that the capital strain from writing new business will reduce. This is because the liabilities will be determined on a 'current best-estimate' basis — which takes into account all eligible expected future cash flows — rather than on a 'prudent basis', which is the case currently. At point of sale, the profit margin that is priced into the contract is then broadly reflected by the contractual service margin, after allowing for the risk within the contract. However, some capital strain will remain, with the size likely to vary by company. In particular, certain overhead expenses, such as product development and training costs, cannot be reflected in the insurance contract liability and need to be expensed as incurred.

Capital strain is likely to be the lowest for insurers who pay commission to external agents, such as IFAs. Conversely, those with large agency networks and overheads maybe at a disadvantage. While the contractual service margin directly defers attributable expenses, it also defers the recognition of profits, which means that there could be cash strain.

Reassessment/ recalibration of product strategy will be required

The best-estimate measurement basis will shine a light on the economic cost of embedded options and guarantees. In low interest rate environments, the cost of these features will be brought into sharper focus for the shareholders. We have already seen companies in Europe pull back from offering high guarantees due to the combination of market-consistent valuation practices and the low interest environment there, but such products remain common in the US and Asia today. With the cost of options and guarantees needing to be fully recognized on the balance sheet under IFRS 17, this trend in Europe may spread elsewhere.

Other areas of potential focus in product design include:

- Changes to influence the accounting classification from insurance to investment or vice versa (for example, the timing of profit recognition might be brought forward if unit-linked contracts are classified as insurance contracts rather than investment)

- Consideration of alternative measurement approaches permitted under IFRS 17 (for example, general insurers may be able to use a simplified approach for short-duration contracts, and life insurers may be able to use the 'variable fee for service' model for direct participating contracts)

- Changes to adjust the cash flows that are included in the measurement of the liability (for example, companies may wish to shorten or extend the scope of cash flows included within the 'contract boundary' of the current best-estimate. This can affect the timing of profit or the size of the contractual service margin that is established when new business is sold. We have recently observed European insurers pay significant focus on this area as a result of the Solvency II regulations)

Key questions to consider

- Have you considered the implications of IFRS 17 to your existing portfolio of products?

- How well do you understand the IFRS 17 profit profiles of your products and the overall impact on your published numbers?

- Do you know how much of your business is eligible for the PAA simplification? Would you chose to adopt the PAA where possible?

- Have you considered the accounting options: PAA vs BBA, risk adjustment, OCI, discount rates and their interaction with IFRS 9?

Mergers and acquisitions: Weak balance sheets will be exposed

The change in liability valuation under IFRS 17 will expose weak balance sheets. This is because the value of liabilities will be more transparent – being on a current best-estimate basis, including the cost of options and guarantees. This may lead to stronger companies seeking deals at opportunistic prices.

Stronger measures to manage volatility

Hedging strategies are likely to remain a key tool in managing profit volatility, and will also need to be revisited. This means it is important to consider how the presentation of movements in hedging instruments under IFRS 9 compares to the presentation of the corresponding change in the insurance contract liabilities.

Accounting choice will be available in IFRS 17 to help align the presentation of changes in assets and liabilities due to interest rate movements either in the P&L or OCI. This requires careful alignment between the presentation of liability movements under IFRS 17 and asset movements under IFRS 9, but provides insurers with an opportunity to minimise the effect of interest rate volatility on the measurement of insurance profits.

Areas of challenges and learning points from early adopters

A number of insurers have begun their IFRS 17 implementation effort with projects at a variety of stages, ranging from initial gap analysis and project sizing to group-wide technical or systems and data impact assessments. Meanwhile, some have begun looking into systems design. Below, we detail some of the common issues and learnings:

Estimated time needed for project implementation

Based on the impact assessment conducted, and after drawing parallels with other major projects (notably Solvency II) — including time required for designing, building new systems, and doing parallel runs — some insures are suggesting that they will need more than 3 years to fully implement IFRS 17.

Meeting year end reporting timetables

Decisions will need to be made around adherence to year end reporting timetables. Entities are suggesting that it is likely to be challenging to meet the current timetables given the complexity of IFRS 17.

Knowing which policy option to apply

IFRS 17 is likely to provide a number of policy choices and options not least around the use of OCI to manage profit and loss volatility, and the usage of the PAA for short duration business. In choosing the preferred policy or option, it will be important to take into account the impact on the tax position. Insurers who have begun to assess these options are finding that choices are not as clear cut as they might have envisaged.

Furthermore, transition to IFRS 17 is likely to provide both a challenge and an opportunity as the standard will allow various simplifications and judgements, and decisions made around the CSM at transition are likely to impact profit emergence over many subsequent years.

Resource planning

IFRS 17 will present demanding resource needs. Internally, there will be a need for increased finance, actuarial, IT and risk management coordination. Externally, there will be a limited pool of skilled resources to call upon, and early efforts to secure appropriate resources will be important.

Securing the budget ahead of time

There is undoubtedly a great deal of complexity in IFRS 17 and the implementation cost could be substantial for some insurers. In addition to assessing the resources, systems and development time needed to complete the process, it is also important to factor in and secure the budget required to fund the transition over the coming three to four years before the standard comes into effect.

Managing market expectations

Investors and analysts have expressed concerns that the IFRS 17 proposals will be more complex with more optionality than they had originally hoped for. If the insurance industry is to reduce its cost of capital compared to other industries, then insurers will need to carefully consider their 'IFRS 17 story' in the run-up to adoption as well as the key metrics they will apply under the new order.

New KPIs built off the IFRS 17 position are likely to be developed and may indeed replace existing metrics. Such changes will need to be carefully considered to ensure that their calibration is appropriate and that incentives remain aligned. Furthermore, the new reporting format may be confusing for to investors. To be truly effective, insurers will need to explain how IFRS sits alongside and indeed complements other reporting metrics, such as risk based capital, cash and embedded value.

Key questions to consider

- Do you have the capability to produce historical comparatives at sufficient granularity to determine your opening balance sheet?
- How much can you leverage on your existing systems?
- Should investment in a new system architecture extend beyond the minimum requirements?
- How will you react to the need for greater collaboration, understanding, knowledge sharing and consistency across the actuarial, risk and finance functions?
  - Do you need to redefine your operating model for these functions?
- What future KPIs would you use to manage the business and communicate with investors?
  - How might this impact the systems landscape?
- Will you be able to handle the reporting timetable challenges?

Not just a technical issue – understanding the pervasive impact of IFRS

The impact of IFRS 17 will be well beyond the finance, actuarial and systems development functions. It will also extend to areas such as product design and distribution, the development of revised incentive and wider remuneration policies, as well as reconfigured budgeting and forecasting methodologies feeding into business planning. There could also be an impact on the cash tax position, and on both transition and ongoing tax profile. As a result, groups may wish to lobby for special tax rules to deal with the new standard.

Redefining how data is used

As IFRS 17 shifts the basis of data analysis from prospective to retrospective, insurers are realising that they will need to fundamentally change the way data is collected, stored and analysed. Furthermore, the new standard is expected to introduce a more granular level of measurement.

Next step forward

Approaching IFRS 17 implementation with confidence

Achieving minimum compliance with IFRS17 is likely to require significant investment in systems and processes. That being said, forward-thinking management teams could leverage this transformation opportunity to re-shape their existing operating model and finance function, with improved efficiency reducing the longer term cost base. Deploying new technologies may result in a competitive advantage and could even disrupt the market (Figure 6). This opportunity is likely to be greatest in Asia, with many national regulators looking to update their capital frameworks in the coming years.

To get ready for IFRS 17, insurers need to address potential pitfalls that lie ahead, which is difficult to accurately identify without conducting some form of impact assessment and project planning.

We are aware of several large insurance groups — the IFRS 17 market leaders — that would consider themselves well set in terms of having assessed the financial and operational impacts and begun to plan their implementation projects. Others have carried out high level gap analysis and project sizing exercises but have not fully assessed group wide impact. The remainder of the industry has yet to undertake any significant activities and are likely to begin their considerations over the next year, but time is rapidly running out.

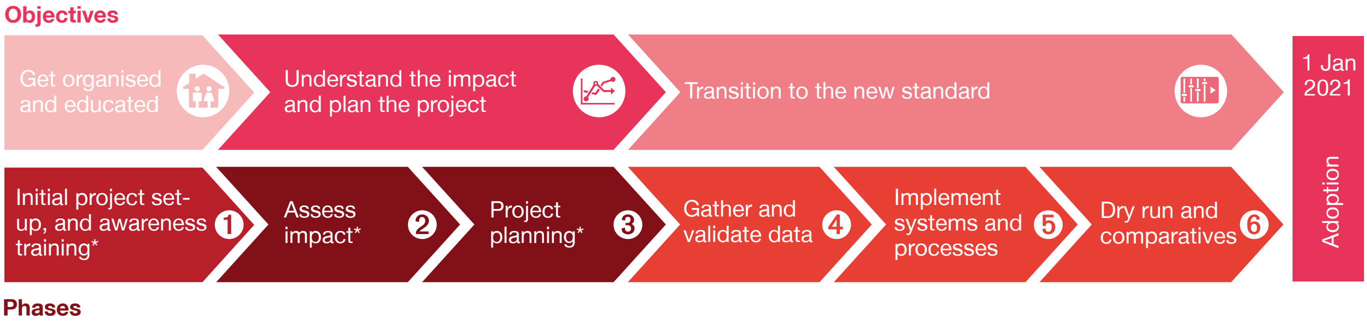
Figure 6. Approaches for meeting new IFRS requirements

Path A - Strategic Path
Some firms are taking this opportunity to transform their finance function - redefining finance, actuarial and risk functions and establishing the operating model, tools and capabilities to support the business, using the new metrics that are emerging.

Path B - Compliance Path
Some firms may seek to address the requirements in a low-cost compliance manner, either through work-around solutions or by increasing resources.

Figure 7 further illustrates the roadmap to IFRS 17 implementation.

Figure 7: IFRS 17 implementation roadmap



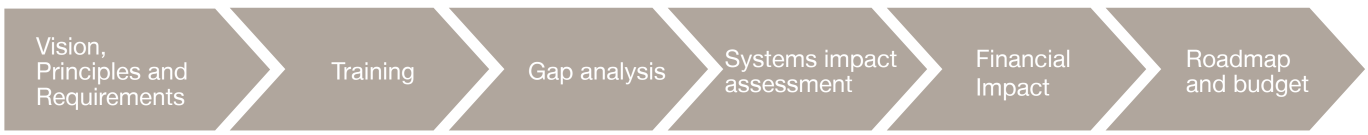
**Phase 1, 2 and 3: Initial set-up phase, impact assessment and project planning*

Conducting awareness trainings during the initial set-up phase (Phase 1, Figure 6) will provide context for subsequent gap analysis an impact assessment (Phase 2). The impact assessment will then enable insurers to gauge how long the implementation process might take in order to plan the implementation effectively (Phase 4). Among the key factors imperative to the next phases of project implementation include establishing milestones, as well as managing/securing the budget and resources required.

There are several components to any impact assessment project – a detailed breakdown is illustrated in Figure 7. These could either be seen as a sequential framework to be worked through or a series of activities with a degree of independence from each other.

The ultimate deliverable from the impact assessment would be a roadmap setting out major milestones and deliverables, as well as a resource plan and project budget to kick start/catalyse the project implementation.

Figure 8: Impact assessment and project planning component



Key questions to consider

- Which phase in the roadmap are you at?
  - How long do you think your implementation process will take?
  - What is your implementation strategy?
  - Have you secured a budget for the implementation?
  - Do you have sufficient internal and external resources with the expert knowledge and skills required?
- Could time/cost be saved in the future by integrating you IFRS 17 implementation plans into existing software and system enhancement projects or process modernisation?

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