The wait is over!

IFRS 17 ‘Insurance Contracts’ is published, are you taking the right actions?

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The new IFRS 17 'Insurance Contracts' accounting standard has been issued with an effective date of 2021.
Belgian insurance companies are among the most impacted.
Insurers need to start now to best address the expected far-reaching impact of the Standard on their policies, people, processes and systems.
A structured approach to IFRS 17 project planning will help overcome challenges and maximise opportunities.

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Background

- Started in April 1997, IFRS 17, formerly known as IFRS 4 Phase II, has been twenty years in the making.
- IFRS 17 is expected to increase both comparability and transparency by replacing the existing interim Standard IFRS 4, which still allows insurers to apply their local GAAP for the measurement of technical provisions.
- However comparability and transparency come at a price of increased complexity with three different measurement models depending on the nature of insurance contracts: the Building Block Approach (BBA), the Variable Fee Approach (VFA) and the Premium Allocation Approach (PAA), resulting in significant system and operational challenges.
- There is some similarity to Solvency II in certain areas, but IFRS 17 is significantly different from Solvency II.
- Effective on 1 January 2021, but you will need restated comparatives as from 1 January 2020.

Key IFRS 17 challenges

The financial and operational implications of IFRS 17 adoption will vary by entity. However, it will represent a fundamental change in most insurers' accounting practices and provide a major challenge for large parts of the industry. There are, however, opportunities to optimise adoption, both operationally and in terms of financial performance:

- Length of implementation project required – Is three years enough?
- Challenges to year-end reporting timetables – Extend or work around?
- Data collection and storage issues are likely to be fundamental.
- Resource planning (internal and external) will be key given scarcity of skills.
- Managing market expectations before and after adoption will be crucial.
- Informing policy choices and options – Opportunities to optimise outcomes.
- Other areas of the business will be impacted such as product design, remuneration policies and business planning.

Industry activity and what should you be doing now

Insurers are now kicking off their IFRS 17 projects in Belgium with a focus on:

- Education and awareness training.
- Impact assessment (financial and operational).
- Project planning, allowing the securing of budgets and resources.
- Considering interaction with ongoing or planned projects, specifically finance transformation work.

A structured approach to IFRS 17 implementation project planning will help you overcome the challenges it presents but also build on the opportunities it provides.

An overview of the standard

Background

IFRS 17 applies to all insurance contracts. The general model is the Building Blocks Approach (BBA) and is based on a discounted cash flow model with a risk adjustment and deferral of up-front profits through the Contractual Service Margin (CSM) which cannot be negative.

- → Changes in the initial building blocks are treated in different ways thus determining profit recognition.
- → Changes in cash flows and risk adjustment related to future services are recognised by adjusting the CSM, whereas those related to past and current services flow to the P&L.
- → The CSM amortisation pattern is based on the passage of time and drives the profit recognition profile.
- → The effect of changes in discount rates can either be recognised in OCI or P&L.

The IASB has recognised the diversity in insurance contracts and have introduced alternative approaches (PAA and VFA) to address particular features, subject to eligibility criteria as illustrated.

	Background	*Key features*	*Types of contract*
BBA	Default model for all insurance contracts.	→ Discounted cash flow model with 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 CSM and amortised in P&L over contract term (straight line basis). → New income statement presentation and definition of revenue. → OCI option1 for changes in discount rates to reduce P&L volatility. → Transition approach allows significant simplifications and judgement. → Aggregation by product line, annual cohort and profitability. → More transparent disclosures.	→ Long-term and whole life insurance, protection business. → Reinsurance written (BBA with some adjustments). → Certain non-life insurance contracts.
PAA	To simplify for short-term contracts with little variability.	Optional simplified model allowed for short duration contracts (coverage period up to one year) or reasonable approximation of 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 non-life insurance. → Short-term life and certain group contracts.
VFA	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 taken).	→ Unit-linked contracts (i.e. Branch 23). → Segregated funds. → Certain Branch 21 products subject to eligibility criteria.

Areas of challenge

The technical requirements set out on the previous page give rise to some clear financial and operational implications:

- Complexity of application
  - Assessing applicability of different approaches.
  - Making informed policy choices.
  - Applying relevant approach.
- Changes to system and data requirements:
  - More retrospective.
  - More granular.

- Some fundamental changes to profit recognition pattern.
- Increased volatility of profitand equity.
- Greater transparency through disclosure.
- OCI option provides linkage to asset accounting (IFRS 9).

A number of common issues have begun to emerge from work done to date:

- **Length of implementation project** - Some insurers are suggesting they will need more than three years based on their impact assessment work and drawing parallels with other major projects, notably Solvency II.
- 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 IFRS 17 complexity.
- 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 use of the PAA for short duration business. Insurers who have begun to assess these options are finding that choices are not as clear cut as they might have envisaged.
- **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.
- It is apparent that IFRS 17 will present **demanding resource needs.** Internally there will be a need for increased finance, actuarial and risk management coordination. Externally there will be a limited skilled resource pool to call upon, and early efforts to secure appropriate resources will be important.
- **Managing market expectations** - Investors and analysts have expressed concern 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 in the new world.
- **It's not just a technical issue** - There is a recognition that IFRS 17 will impact across businesses well beyond the finance, actuarial and systems development areas, such as product design and distribution, development of revised incentive and wider remuneration policies and reconfigured budgeting and forecasting methodologies feeding into business planning.
- **Data is key** - Insurers are realising that they will require a fundamental shift in the way data is collected, stored and analysed with IFRS 17 changing the emphasis from a prospective to retrospective basis of analysis as well as being expected to introduce a more granular level of measurement.

Next steps - Approaching IFRS 17 implementation with confidence

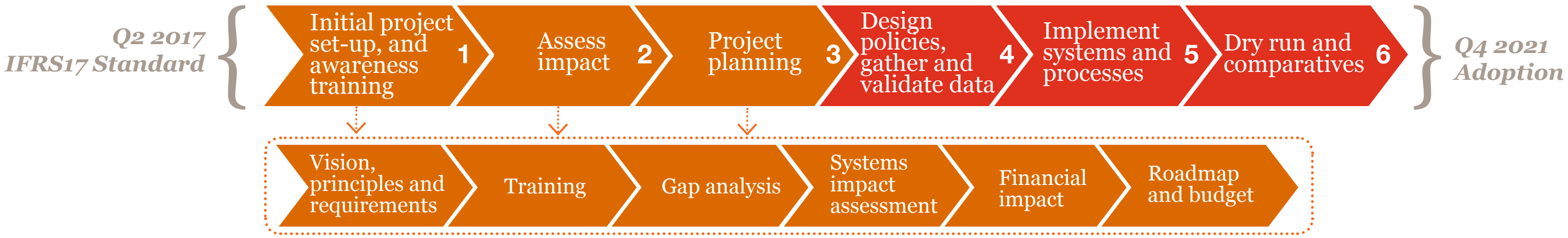
You need to start now!

An impact assessment will tell you how long the transition process might take and will enable you to plan effectively.

How can you get ready for the changes IFRS 17 will bring and address potential implementation pitfalls?

It is impossible to know without carrying out some form of impact assessment and project planning. Belgian insurers are among the most impacted. You need to start now to best address the expected far-reaching impact of the Standard on their policies, people, processes and systems.

We suggest that there are several component parts to an impact assessment project and 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. These elements can be seen to represent component parts of steps 2 and 3 in the chart below.



A roadmap with milestones, resource planning and a budget forms a solid basis for the next stages of the implementation project.

- An element of awareness training (tailored around your current products as impacted by IFRS 17) will provide a context for subsequent gap analysis and impact assessments.
- Scoping decisions for this initial piece of work can be made by identifying key business units based on aspects such as current or planned volumes of business, profitability and expected IFRS 17 implications.
- Gap analysis can be done using workshops or diagnostic tools, or both, and would aim to identify gaps between future and current systems, process and data requirements.
- Impact assessments could then be carried out on both systems (IT architecture from feeder systems through actuarial modelling to financial reporting systems. including the general ledger and chart of accounts) and financial and tax impacts. The latter could range from considering profit profiles for specific products under IFRS 17 to a wider assessment of impact on profit, equity and volatility.
- The ultimate deliverable for the impact assessment would be a roadmap setting out major milestones and deliverables as well as a resource plan and project budget thus enabling the detailed implementation project to begin.

Let's talk

Dirk Vangeneugden
Insurance Partner

t. +32 2 710 45 56
dirk.vangeneugden@be.pwc.com

Patrice Schumesch
IFRS Partner

t. +32 2 710 40 28
patrice.schumesch@be.pwc.com

Sebastian Harushimana
IFRS Director

t. +32 2 710 45 44
sebastian.harushimana@be.pwc.com

Martijn Cuypers
Insurance Senior Manager

t. +32 2 710 41 05
martijn.cuypers@be.pwc.com