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INSURERS – PREPARING FOR IFRS 17

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MINI-ROUNDTABLE

INSURERS – PREPARING FOR IFRS 17

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David Anderson is a director in KPMG's risk consulting practice and has extensive experience developing customised solutions to solve the largest and most complex operational, regulatory and accounting-driven changes in the banking, insurance and asset management industries. He has proven leadership experience driving finance transformation projects throughout the financial services sector, including the rollout of risk and credit-based frameworks for CECL and IFRS 9. Additionally, Mr Anderson leads global IFRS 17 adoption projects, overseeing workstreams including technical accounting and actuarial change, data management, solution development and implementation, and regulatory and audit management.

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Jim Zhang is a senior consultant for the insurance solutions at SAS. He had more than seven years of experience in the insurance space. Mr Zhang specialises in measurement techniques, treatments and reporting for IFRS 17. Prior to joining SAS, he was an actuary at Manulife.

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Agustin Terrile has over 10 years of experience in financial services industries, with a focus on actuarial modelling, economic capital, IFRS17 and IFRS9. Prior to joining SAS, he was an actuarial manager at Deloitte.

R&C: Could you outline the main reasons behind the introduction of IFRS 17? What impact do you believe it will have on companies?

Anderson: IFRS 17 was introduced by the International Accounting Standards Board (IASB) to bring consistency and increased transparency to insurance accounting. Under IFRS 4, insurers were permitted to use a broad variety of practices which commonly amounted to local generally accepted accounting principles (GAAP) and accounting for similar contracts under different accounting policies, depending on the jurisdiction. Under IFRS 17, which represents the first international accounting model specifically for insurance contracts, insurers are required to apply consistent accounting policies for all insurance contracts which will make it easier to compare results across products, geographies and companies that apply the standard.

Zhang: The reasons behind IFRS 17 are to improve transparency and comparability in the measurement of insurance contracts, ensure consistency in the recognition, as well as in the timing, of profits earned, ensure revenue from insurance servicing and investment income is clearly segregated, and standardise the presentation of financial statements and disclosures. In addition, the IASB has also tried to ensure insurers use updated assumptions and discount rates in the valuation of insurance liabilities – thus continuing to move towards a market-consistent valuation approach. We also see similar themes in the Financial Accounting Standard Board's (FASB's) targeted improvements to the accounting for long-duration contracts – that standard is also pushing for updated assumptions, fair value treatments for market risk benefits and more transparency around judgements embedded in financial statements. As regards impact, both standards will have a dramatic impact on accounting policy, financial disclosure, data requirements and exposures held – but, most importantly, the new accounting approach will shed more light on the risks and performance of insurance contracts held.

Terrile: The standard in 'Reasons for issuing the Standard' states that IFRS 4 allowed the use of a wide variety of accounting practices "making it difficult for investors and analysts to understand and compare insurers' results". To overcome this situation, the IASB is proposing a "unique framework" on how to recognise, measure, present and disclose insurance contracts. The introduction of IFRS 17 will affect the entire information system, but the main impact will be related to how earnings are measured and recognised, based on patterns.

R&C: What challenges does IFRS 17 present? What steps should affected companies take to prepare for its

introduction, scheduled for 1 January 2021?

Zhang: IFRS 17 is a radical change to the way insurers' measure and report on their liability. There are challenges in the interpretation of the standard, challenges in the implementation and there will likely be challenges post adoption – so it will be some time before the dust settles. First, interpretation of the standard has been difficult and there are several decisions to make – for example, deciding the right grouping criteria to use, the discount rate approach to use and the right pattern to use for contractual service margin (CSM) release. There are still several open items that industry and the Transition Resource Group (TRG) are debating, such as treatment of reinsurance contracts. So, several accounting and actuarial challenges remain. Implementation is equally challenging – from change in accounting policy, actuarial models, business assumptions, data requirements, technology requirements, and audit and governance requirements. The widespread impact has also created organisational challenges, accelerating the need for greater alignment across functions, to ensure there is a common set of assumptions and interpretations of the standard. One insurer joked that IFRS 17 has led to the creation of a new 'accountuary' role and has helped break some internal silos. Last but not least, resourcing is a critical challenge for the industry at large.

Terrile: There are several challenges when implementing IFRS 17 related to data preparation, measurements, reporting, process orchestration and auditability. An analysis gap for each individual task, as well as together, is key to being well-prepared when the standard comes into effect. Examples include understanding the variety of sources and the availability of information. Data quality rules are also important to ensure that all relevant information is used. In addition, companies should ensure they have the capability to measure all possible scenarios, including onerosity and its reversion – a key aspect in validating the correctness of the valuation. Otherwise, remedy action should be put in place, including analysis of its materiality.

Anderson: IFRS 17 introduces more granular estimates, assumptions and data requirements that are not part of insurance accounting today. The primary concern for many insurers is the availability and sourcing of quality, controlled data required to derive the estimates and complete the calculations used in the preparation of the financial statements. If they have not already, companies should conduct an impact assessment to evaluate how the change will affect their accounting, operations, data, actuarial modelling and, ultimately, their financial statements. Companies should plan for a year of parallel runs prior to the effective date to understand and master the full impact on their business and operations,

working their implementation plans backward from there.

R&C: What governance and oversight considerations do companies need to make, to manage the risks associated with IFRS 17 implementation?

Anderson: There are multiple layers of governance and oversight for such a broad reaching standard. Companies need to appoint a steering committee with appropriate executive leadership and oversight to ensure consistent messaging and to drive progress across the company. Risks include implementation risk, audit risk and timing risk. Due to the complexity of CSM calculations, more technical skills are also needed to produce and interpret results, which will require tight interactions between, and oversight of, cross-functional accounting, actuarial and technology teams.

Terrile: IFRS 17 is an accounting process and, as such, certain requisites are required to guarantee the reasonability of each accounting statement. Validating the integrity, existence, measurement and exposure are key elements in ensuring the correctness of each statement. A robust process also needs to ensure data traceability and generate auditable evidence of the work done by each employee so that they can be accountable for their actions. The highest risk associated with an IFRS 17 implementation is to end up with a process that cannot provide values with a certain 'degree' of accuracy. In this sense, the implementation process is as important as the accounting process itself, and as such, top executive involvement is key to guaranteeing suitable governance. Clear plans with defined responsible, expected outcome and cross-controllers by task are essential in order to achieve this.

Zhang: The broader impact of IFRS 17 requires governance across the entire programme. First, governance around the accounting policy and decisions on materiality, as well as implications around the methodology applicable for these portfolios, for instance portfolios that may qualify for the premium allocation approach (PAA). Second, governance around the models, scenarios and cashflow assumptions used for different products. Third, governance around ensuring that insurers' interpretation of the standard is properly relayed and implemented by their data, IT and vendors. Finally, it is important to ensure the software implementation of the standard is built with the right controls and transparency to ensure governance and auditability of all the pieces that go into the financial reporting and disclosures.

R&C: What benefits and opportunities might conversion to IFRS 17 present to proactive, forward-thinking companies?

Terrile: The inclusion of a risk adjustment (RA) in the reserving process could help entities in the decision-making process, by showing the performance of each business unit under a risk-return basis as opposed to only return. An onerous contract could be profitable in absolute terms, but not in terms of the risk it is generating. The RA reflects the compensation that the entity requires for bearing no financial risk, being the best representation of the cost capital method. In this context, the CSM could be considered as excessive profit in relation to the risk the entity is exposed to, and could provide a good view of those businesses that are adding or destroying value from a risk perspective. The use of CSM for business planning, strategic decisions or risk premiums definition could be the first step in using risk as a decision driver.

Zhang: It is still a bit early to know the broader impacts of IFRS 17. That said, what is clear is that IFRS 17 is driving institutions to rethink a number of their internal processes, business drivers, product strategy, pricing, data landscape and implementation approaches. We see two broad trends: institutions that view IFRS 17 as a minimal compliance exercise and institutions that view IFRS 17 as an opportunity to modernise their processes and systems. Some institutions see IFRS 17 as purely a compliance exercise, necessary but with no long-term benefits. That said, these institutions do plan to leverage the IFRS exercise to achieve greater operational efficiency through improved data, processes and automation capabilities and look to reuse these for other parts of the business. Other institutions view IFRS 17 as an opportunity to modernise. In addition to operational efficiencies, these institutions seek to integrate the IFRS 17 measures and approaches in the financial planning process. This means aligning pricing and business decisions based on their IFRS reporting structures and hierarchies. These institutions will also look to drive business decisions using the data as well as analytics developed as part of the IFRS 17 exercise – from product redesign to internal cost transfers and asset-liability management (ALM).

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Agustin Terrile
SAS

Anderson: Companies are encouraged to move beyond a minimal compliance model that adds few incremental benefits to the organisation and look instead toward tangible, value-added approaches which improve management ability to monitor and operate the business. The incremental data and processes required by IFRS 17 provide a significant opportunity to maximise value and look at the business from a fresh perspective. Industry analytical tools can provide a vehicle to assess trends and forecasts for products, and link forward-looking predictive results to underwriting, accounting policy and reinsurance decisions. IFRS 17 offers a once-in-a-generation opportunity to modernise data sourcing and analysis tools, while leveraging the non-negotiable investments required to achieve compliance. Carriers that make this strategic incremental investment today will realise lower operating costs and more closely aligned financial and operational business decisions tomorrow.

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>
> *David Anderson, KPMG*

R&C: With some of the most significant accounting changes in the history of the insurance industry all going into effect at the same time – for example, IFRS 17, IFRS 9, CECL, LDTI, and so on – what are companies doing to streamline accounting and reporting processes across the organisation based on the breadth and scale of these new standards?

Zhang: Global multinational insurers reporting under GAAP and IFRS have a rough road ahead, with several new standards emerging, from IFRS 17/long duration targeted improvements (LDTI) to current expected credit losses (CECL) and IFRS 9. In terms of IFRS, there has not been adequate debate or consensus on the interactions between IFRS 17 and IFRS 9. It is quite common to see these standards being addressed and solved separately. However, some leading institutions are starting to look at things more holistically to ensure there are no accounting mismatches between the assumptions and allocations between the asset and liability side. For example, is there any impact of electing to flow

interest rate changes on the IFRS 17 side via other comprehensive income (OCI)? What is the interaction, if any, of similar elections on IFRS 9 for Fair Value through OCI (FVOCI)? If we now layer on CECL and LDTI, there is additional complexity for consistency in measurement across the standards, reporting across different accounting regimes, consolidation and, more importantly, profit and loss (P&L) impacts. What is clear is that it is important to get the foundational design structures right from the start. It will be important to make longer term design and platform decisions that allow insurers to analyse impacts across the standards.

Anderson: One of the greatest and most immediate opportunities to maximise efficiency and value is to leverage concurrent workstreams for accounting-driven change – IFRS 17, IFRS 9, CECL and LDTI – rather than completing each in a silo. Software solutions in the industry provide the opportunity for a centralised approach which can handle data sourcing through the requisite calculations and financial reporting, all within a common platform. Entities will be able to configure separate workflows within a centralised solution to encompass the specific requirements of each standard, but the usage of a common interface across the organisation leads to synergies from a reduction in redundant training and technology or IT support to streamlined process and controls.

Terrile: Entities have different strategies to comply with busy timelines generated by the new standards. Nonetheless, there are two things worth mentioning. First, entities that have existing platforms to cover one of the standards are trying to extend functionality by adding new content, such as IFRS 9 and IFRS 17, so that they can leverage existing knowledge. Second, entities are trying to cover more than one standard with one platform, so that the learning curve is done only once. These strategies are based on the idea that most standards compliance processes – data management, engine provision and reserving, accounting and process orchestration and most of the time relay on the same persona and manager – are similar.

R&C: What is the current state of implementation with IFRS 17? What is the impact of the one-year delay on implementation plans?

Terrile: The two main drivers that affected the state of the IFRS 17 implementations were the size of the entity and jurisdiction. Tier 1 entities were most concerned about the complexity of implementation and started the process of selecting software earlier. The delay partially affected implementation plans, because IFRS 17 teams were already in place and they decided to continue with the process. Mid-size entities, on the other hand, were just starting the selection process when regulation was delayed

and, in general, decisions were delayed for around six months. Regarding jurisdiction, those with high expectation of adoption by local regulation, like Canada and Europe, started the process earlier, unlike Latin America and the US. The delay gave them time to re-evaluate their plans, but also to review controversial topics such as mirroring, allocation, risk mitigation and analysis of change.

Anderson: The IASB delayed implementation by a year due to reopening the standard, and insurers should capitalise on this time to optimise their implementation efforts. Many insurers were significantly behind in their assessments and implementation planning. This delay provides issuers with the opportunity to get back on track and optimise their implementation plans. There is a significant risk that certain insurers will try to de-prioritise IFRS 17 and will end up in the exact same situation the following year. Carriers that wait face higher implementation risk, and may find that 'A-team' talent has been committed to projects that stayed the course. Optimising implementations will allow companies to add value to their organisations through more productive enterprise finance transformation activities rather than relying on minimal effort now, which will often lead to higher expenditure in the long run.

Zhang: Some insurers started implementation early last year while others are only now performing their impact analysis. The early adopters have completed their impact analysis, established an initial view on accounting policy, and identified products for which the applicability of IFRS 17 is clear. For other products, such as reinsurance or products that may or may not qualify for PAA, there are ongoing policy and methodological discussions on the best way to classify and measure liabilities. These insurers have also completed their IFRS 17 solution selections and are in the process of installing and testing their initial set of use cases and portfolios using their platform of choice. The emerging best practice is to use a sandbox-type environment to test out multiple use cases end-to-end; that is, take a single product and go from grouping to measurement to postings. This allows insurers to not only effectively test their technology solutions, but also gives them a better understanding of all flows and control points that will need to be implemented in their final business as usual (BAU) process. The end-to-end run also gives insurers a better understanding of the desired level of information needed to support various reporting and analytical requirements.

R&C: What are the big implementation challenges that you see with IFRS 17? How are insurers approaching reporting and analytics needed for IFRS 17?

Anderson: Producing more granular source data will strain many carriers, as will the need to link accounts receivable to specific policies for asset-liability presentation. The standard's requirement to more tightly link financial reporting, reserving and underwriting views in the portfolio-grouping decisions also represents a new interconnectivity requirement. Efficiently flowing this underwriting information into the financial close and controls frameworks is needed to maintain operating costs and close calendars. On the plus side, these requirements will allow underwriters and local managers to access more relevant financial information that is composed 'bottom up' from their policy portfolios, compared to current processes which rely on more 'top down' allocations.

Zhang: There are several implementation challenges with IFRS 17 – from interpretation of guidance to actuarial models, systems, data, processes and resources. First, fixing data gaps will be time consuming. This ranges from availability of data – historical data as well as going forward – granularity of data, the number of source systems and the structure of the data. For example, many companies may have expenses at a different aggregation level and this needs to be reallocated to their IFRS 17 grouping hierarchies. Second, depending on the methodology selected, actuaries will have to update their models to reflect new scenarios, assumptions and outputs required for measurement.

"The standard is still evolving, and hence flexibility to change drivers and orderings for reporting on movements or analysis of change (AoC) will be important."

Jim Zhang,
SAS

Third, decisions need to be made about the measurement components – from the approach to calculate discount rate to the valuation of the time value of the guarantee (TVOG) and embedded guarantees for the variable fee approach (VFA). Fourth, converting actuarial output into accounting events and postings that roll into the IFRS 17-specific chart of accounts will require reengineering. Fifth, a configurable framework for reporting will be critical. The standard is still evolving, and hence flexibility to change drivers and orderings for reporting on movements or analysis of change (AoC) will be important. Finally, automating all the processes in a governed and automated fashion will require the right technology solutions.

Terrile: One of the main challenges during the implementation phase is the definition of the groups of contracts (GoC), because it affects the entire process: input data, the number of extract, transform and load (ETL) processes, methodology, the allocation of RA and reporting. If the GoC is calculated at a low level, the number of ETL processes that are required to feed the engine could be problematic. Also, the time required to process the information could increase exponentially if the software cannot scale horizontally. From a methodological point of view, allocation could be a big challenge, such as expense risk adjustment. On the other hand, when GoC is selected at a high level, other challenges could come up, such as detailed information and analysis of change of CSM. Low granularity may be required for internal reports, such as by channel and region. In these cases, a reporting problem is transformed into a post-measurement allocation problem, and approximation methodology is required. R&C

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