2018 IFRS 17 Preparedness Survey
Turkey and Europe highlights

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Introduction

At the end of 2018, Milliman conducted a global survey to measure the preparedness of insurers and reinsurers for the new accounting standard, International Financial Reporting Standard 17 (IFRS 17). The survey aimed to gauge the progress that firms have made in translating the standard into business as usual (BAU) processes and to compare the progress made in different markets.

THE CONTRIBUTORS

The survey was sent to companies around the world that are impacted by the introduction of IFRS 17, and we received responses from actuaries and other insurance professionals representing 118 companies across the globe.

Of those 118 companies that responded to our survey, 86 write life insurance, with a further 21 composite or general insurance firms also responding. The survey ran for two months from 17 September 2018 to 20 November 2018, therefore we note that responses do not reflect reactions to the announcement of the one-year delay to the implementation date or other updates to the standards since that period. However, as the majority of the questions that we asked relate to current levels of readiness instead of expected readiness at the implementation date we do not expect that the delay would have materially changed the results. We would like to thank all those who contributed to our survey.

The following report focuses on Turkey, comparing the preparedness of Turkish firms to European. It also summarizes the responses received from nine companies in Turkey and 36 companies across Europe.

References made to EU results also include the UK and Switzerland.
Preparedness

TURKEY VERSUS EUROPEAN NEighbours
We asked firms to consider the different elements of IFRS 17 preparedness and how much progress had been made in each of these areas.

Q1: WHAT PERCENTAGE OF THE FOLLOWING ELEMENTS HAS YOUR COMPANY COMPLETED TO DATE?

It seems that a majority of firms in the EU (among respondents) are taking the approach of carefully ‘designing’ their IFRS 17 solutions before moving ahead with the practical aspects of implementation. This can be seen in the graph showing results for Q1 (What percentage of the following elements has your company completed to date?). More progress is being made on valuation methodology, valuation assumptions and strategic considerations than on actuarial models and accounting systems. On the other hand, the composition of these elements of IFRS 17 in Turkish firms (among respondents) is more homogeneous.

It seems that Turkish firms that answered the survey made the most progress in valuation methodology. But, compared to the EU firms, there is still a significant gap in progress of methodology. Besides the methodology element, Turkish firms are also behind the EU firms in terms of strategic consideration, data quality requirements and valuation assumptions. When it comes to progress in actuarial models, accounting systems and transition methodology, Turkish firms and EU firms are almost head-to-head. It can also be seen from the graph for Q1 that Turkish firms are a bit ahead of EU firms in terms of governance process and reporting and disclosure templates. Despite some progress in all 10 of the implementation aspects surveyed, both Turkish and EU firms were at less than 50% for all 10, suggesting that the one-year delay is likely to have come as welcome relief to many firms.
The Turkish Firms graph shows Turkey results in relation to the same Q1, demonstrating the variation in the level of preparedness across Turkey by showing the minimum, average and maximum completion percentages for each aspect. According to the survey results, three of the eight Turkey respondents stated that they had not yet begun any aspect of preparations and were just following at distance. Furthermore, for the remaining five respondents, the preparedness was as follows: scoping activities are underway in two of them, gap analysis is underway in one of them and implementation project is underway in two of them.

For whole elements of the preparation, the minimum completion percentages were all zero and the average completion percentages were less than or equal to 30%. The average completion percentages were highest for valuation methodology (30%), followed by transition methodology (30%) and valuation assumptions (30%).

Furthermore, there is a big spread between the average and maximum completion percentages. The difference between maximum and average completion percentages are more than 60% for valuation methodology, valuation assumptions and transition methodology; more than 50% for governance process, data quality requirements, reporting and disclosure templates and accounting systems. The smallest difference is in strategic considerations, at 33%.
Turkey and Europe highlights

The majority of EU companies older than three years will have had experience implementing a new reporting system as a result of the introduction of Solvency II, which came into effect on 1 January 2016. Results of the survey show that 57% of EU respondents expect the implementation of IFRS 17 to be more complex than that of Solvency II, although Turkey respondents appear more optimistic, with the minority of the respondents believing the IFRS 17 implementation will be more complex than Solvency II. According to a survey conducted by the analytics firm SAS\(^1\) in early 2018, 97% of senior insurance professionals expected IFRS 17 to increase the complexity and cost of operating in the insurance industry, and 90% were expecting IFRS 17 implementation to be more costly than Solvency II. Please note that Solvency II has not been implemented in Turkey, except for some foreign-owned companies.

**THE BIGGEST CHALLENGE**

The complexity expected by firms was highlighted in responses to the further question, ‘What do you consider to be the main challenges of implementing IFRS 17?’ There was a large variation in responses. Each firm looking to prepare for IFRS 17 will face challenges that are unique to the products managed and organisation of its business, but the four main challenges highlighted by our respondents were:

- Level of data required under IFRS 17
- Implementation of the new method
- Building of new systems
- Interpretation of the new standard

In relation to the first point, firms noted that the challenge was not just sourcing and processing the data required for disclosure purposes, although it was suggested that this will be a challenge in itself, but also linking the actuarial and accounting data together along with the granularity of data required.

**ADAPTATION OF EXISTING BASES FOR USE IN IFRS 17**

We asked firms to discuss the extent to which they believed they could adapt existing Solvency II assumptions and processes for the purposes of IFRS 17.

![Q2: IF YOU REPORT UNDER SOLVENCY II, DO YOU EXPECT THE IFRS 17 ASSUMPTIONS TO BE THE SAME AS UNDER SOLVENCY II?](image)

A high proportion of EU respondents (63%) stated that they expected assumptions used for reporting under IFRS 17 to be mostly the same or identical to those used for Solvency II reporting. On the other hand, only 33.3% of the Turkey respondents stated that they expected these assumptions. The others responded that it varies only in granularity of assumptions (33.3%) or that it is different for most assumptions (33.3%).

The same question was asked in relation to firms’ intentions of leveraging the assumptions used for embedded value (EV) reporting, and firms gave very similar results. Of those who reported under both Solvency II and EV, 67% described having assumptions mostly similar or identical to the assumptions they intended to use for IFRS 17. Of the remaining respondents, the majority thought that neither reporting basis would provide appropriate assumptions for IFRS 17, with 24% responding in such a way.

**Q3: WHICH OF THE FOLLOWING CALCULATION PLATFORMS DO YOU PLAN TO LEVERAGE FOR IFRS 17?**

We also asked firms whether they expected to be able to adapt existing regulatory reporting or EV calculation platforms for IFRS 17 purposes. Of the Turkish firms that responded, 67% intended to purchase new systems, while 33% intended to adapt their regulatory reporting (i.e., Solvency II) platforms for IFRS 17 purposes.

Insurers typically tend to be cautious about implementing new software solutions, largely due to concerns about high costs and difficult transition periods, as the lead time from first gathering information on a new software or calculation system to the point of signing the contract can take over a year. Therefore, it is surprising that a high ratio of Turkish respondents was intending to purchase a new system instead of adapting an existing one.

We have seen our clients face a range of issues as a result of the use of legacy systems, particularly in relation to the challenging data and calculation requirements of IFRS 17. In addition, despite best intentions, ‘piecemeal’ models, which are modified from their original purposes and subject to multiple changes over time, often become difficult to navigate and understand, posing a significant model risk. Now the implementation date has been extended to 2022, providing an extra year to prepare for the new standard. If the expected cost and resource efficiencies of adapting existing models have not been materialising in practice, firms may become more disposed towards the idea of implementing a new, clean system, which is likely to have a better chance of optimising their IFRS 17 processes.
Contract boundaries

FIRMS OPT FOR INTERNAL VIEW

The concept of a contract boundary will be a familiar one for any insurer that has reported under the Solvency II framework. However, the definition under IFRS 17 is subtly different. We asked firms 'When determining contract boundaries, do you expect to apply existing definitions you currently use for IFRS or regulatory reporting?' Seventy-five percent of Turkey respondents stated that they intend to apply the same contract boundary definitions as they do under IFRS 4 or Solvency II reporting. This suggests that there is high consensus in the industry as to whether the definition of contract boundaries under IFRS 17 is consistent with previous standards.

In addition, 50% of respondents stated that the intended treatment of renewals would not be significantly different from the treatment applied on a shareholder value basis.

Q4: DO YOU PLAN TO INCLUDE CASH FLOWS AFTER A FUTURE RENEWAL DATE WITHIN A BOUNDARY FOR YOUR RENEWABLE PRODUCTS? (TURKISH FIRMS)

There appears to be some correlation between firms’ plans to include cash flows after a future renewal date within a boundary for individual and for group business. This may indicate that the approach of firms in this regard tends to result from their interpretations of the standard rather than underlying differences in the nature of the products.
Discount rates

(DON'T) TAKE IT FROM THE TOP

Discount rates will need to be derived for IFRS 17 that reflect the characteristics of the liabilities in question. A requirement for the best estimate discount rates under IFRS 17 to be applied to future cash flows is that they reflect the following:

- Time value of money
- Characteristic of the cash flow
- Liquidity characteristics of the contract

With this in mind, there are two methods by which undertakings can derive these rates—‘top down’ or ‘bottom up’—both of which are valid and have their own advantages:

**Top down:** Start with the reference portfolio yield and remove ‘yield’ in respect of factors not relevant to the contract such as credit risk.

**Bottom up:** Start with the ‘risk-free’ rate and add an illiquidity premium, which is dependent for example on the mortality risk and other factors like surrender values.

We asked firms whether they intended to use a top-down or bottom-up process to determine their IFRS 17 discount rates. Forty-four percent of Turkey respondents were still undecided on this issue. A big proportion of respondents (83%) was opting for the bottom-up approach, while only 17% was opting for a top-down approach.

Globally, firms appear to be indicating a preference for the bottom-up approach, with only 15% of respondents having decided to apply the top-down approach.

Of the respondents globally that did have a view on what the high-level approach would be (i.e., top-down or bottom-up), 55% of them stated that they had not yet determined the process they will use, suggesting that they had yet to decide on the specifics of the calculation.

There does appear to be some concern in the industry that the different approaches could result in discount rates applied by different firms not being comparable, although in theory both approaches should give similar results. In 2018, the Institute and Faculty of Actuaries (IFoA) in the UK launched a working group on the ‘future of discounting’ under IFRS 17, which (amongst other aspects) is looking to produce a research paper comparing and contrasting the benefits and theoretical soundness of various approaches to producing discount rates for IFRS 17. The results may help to inform firms’ decisions in this regard.
Risk adjustment

DECIIONS STILL TO BE MADE

The risk adjustment within the IFRS 17 framework can be thought of analogously to the risk margin within Solvency II, i.e., an amount of compensation that is added to the present value of expected future cash flows and is intended to capture uncertainty in the amount or timing of the cash flows. As with the risk margin, the IFRS 17 risk adjustment only reflects nonfinancial risks such as changes to mortality, claims inflation or lapse rates.

Unlike Solvency II, however, IFRS 17 does not prescribe a method that firms must use to calculate this figure; each firm has the freedom to decide the method that it uses. We asked firms which methodology they expected to use to determine the risk adjustment. Only 22% of Turkey respondents had settled on a methodology to determine the IFRS 17 risk adjustment at the time of completing the survey. EU respondents, however, seemed slightly more comfortable in this area, with 39% of firms having made a decision.

Q5: HAVE YOU DEFINED A METHODOLOGY TO DETERMINE THE RISK ADJUSTMENT?

Twenty-five percent of Turkey respondents had made a decision intended to take a Cost of Capital (CoC) approach, while almost 40% of EU firms that had made a decision intended to take a CoC approach; this is perhaps due to the familiarity of EU firms with the Solvency II risk margin. As firms are looking to be able to leverage existing Solvency II systems and methodologies (as discussed earlier in this report), this approach may be relatively straightforward to implement, with the added benefit that it is already well understood within the EU.
Respondents also indicated that a Value at Risk (VaR) approach may also become common. Both 25% of Turkey respondents and EU respondents had chosen the VaR method. In addition, a confidence interval approach was chosen by 25% of Turkey respondents and 13% of EU respondents. Conversely, no Turkey respondents and only 6% of EU respondents indicated that they planned to leverage the provisions/margins for adverse deviations (PFADs) currently used within IFRS 4 reporting, suggesting a widespread view that they are either not appropriate or not practicable under the new standards.

### Q6: AT WHAT CONFIDENCE LEVEL DO YOU EXPECT THE RISK ADJUSTMENT TO BE SET?

We asked firms at what confidence interval they were calibrating the IFRS 17 risk adjustment. Half of Turkey respondents stated that they had not decided yet. One-quarter (25%) said they intended to use a confidence level between 90% and 99% and the remaining 25% said they intended to use 60% and 70% confidence levels. When it comes to EU firms, 25% of them had not decided yet and 22.5% intended to use a confidence level between 70% and 80%, materially lower than the level used to determine the risk margin under Solvency II, suggesting that many firms are intending to focus more on their internal views in this regard instead of aligning assumptions with Solvency II.
Contractual service margin (CSM)

COULD BECOME ONEROUS

The contractual service margin (CSM) is a measure of the profit expected to be received in relation to the contract being measured. It is not recognised immediately, and instead is released over time as the entity satisfies the obligation of the contract. The CSM can be thought of as the remaining value of the contract once the best estimate of the contract liabilities and the risk adjustment have been accounted for, and the release of any CSM will have a significant impact on the profit profile of contracts under IFRS 17.

The CSM is measured at the initial recognition of a group of insurance contracts. If a contract is expected to be onerous at initial recognition then the CSM is required to be zero and the loss is recognised immediately.

We asked firms how they intended to define (i.e., identify) contracts that are onerous at initial recognition. We got various responses from Turkish firms such as through new calculation, value of new business (VNB) reports, actuarial estimations and projections of ultimate loss ratio and technical profit and loss analysis.

As with many other aspects of IFRS 17, this survey has highlighted that a large proportion of firms are still undecided on the approach they will take.

There is still a great deal of uncertainty over the level of aggregation to be used to determine onerous contracts at initial recognition (such as policy level, product level, homogeneous risk group level or some other level yet to be determined). This is one of the key areas of current debate within the industry.

IFRS 17 requires firms to measure the CSM at least at an annual cohort level. Obtaining sufficient data to meet the requirements of IFRS 17 is one of the most significant concerns in the industry at the moment, and our experience is that insurers, particularly those with large amounts of legacy business, are struggling to obtain data at sufficiently granular levels. It is therefore perhaps unsurprising that 57% of Turkey respondents and over 60% of EU respondents expect to use annual cohorts (the least granular level currently allowed) as opposed to semiannual or quarterly cohorts, when determining onerous contracts.

The confidence level at which the IFRS 17 risk adjustment is set can have implications on the determination of onerous contracts at recognition and the timing of profit recognition, making it a key technical decision for firms. IFRS 4 was considered to have limited visibility of the margins allowed for within the reported liabilities; under IFRS 17, firms are able to choose the confidence level at which they calculate the risk adjustment but disclosures are increased, with firms required to disclose the selected methodology and confidence level, as well as provide a reconciliation of the risk adjustment between reporting periods.

Q7: DO YOU EXPECT TO USE QUARTERLY, SEMI-ANNUAL OR ANNUAL COHORTS?
We also asked firms to estimate the percentage of new business sold in the first year after adopting IFRS 17 that they expect to be onerous, potentially onerous or unlikely to become onerous. Only four firms in Turkey responded to this question, suggesting that a large number of companies are not yet at the stage where they are able to determine this. Of those that did respond, whilst there was a lot of variation in their responses, some trends did seem to appear.

Firms 1 to 4 in the graph for Q8 indicated they expect the majority of new businesses to fall into the ‘could become onerous’ category. The expectation for ‘unlikely to become onerous’ category is lowest for the first three firms.
Method used

CHOICES LIMITED BY PRODUCT TYPE
We asked firms to estimate portion of their business they expect to apply to each of the three methods: General Model, Premium Allocation Approach (PAA) and Variable Fee Approach (VFA). Only three of them gave responses. Two stated that they expect to apply the General Model to 100% of their business, while the other one expect to implement the Premium Allocation Approach to 75% of its business and the General Model to 25%. None of them was in favour of the Variable Fee Approach. In general, the choice of methodology is largely dependent on the type of business sold. As a general rule:

- Contracts with direct participation features (such as with-profits or unit-linked business) are measured using the VFA
- Short-term contracts (such as general insurance contracts) are measured using the PAA
- All other contracts are measured using the General Model

TRANSITION METHOD
We asked firms to tell us what proportion of their business they expected to apply to the following transition methods (based on number of contracts): the full retrospective approach (FRA), the modified retrospective approach (MRA) and the fair value approach (FVA). Only three Turkish firms responded these questions. Two of them expected to apply the FRA to 100% of their business, while the other expected to apply the FVA to 100% of its business.

The main difficulty firms face in relation to the full retrospective approach is the extensive data requirements. The feasibility of applying this approach is therefore likely to vary among firms depending on aspects such as the extent of legacy business covered and the administration systems used.
Wider impact of IFRS 17

IMPACTS EXPECTED TO GO BEYOND THE BALANCE SHEET

The extent to which IFRS 17 has an impact on the wider business (for example on risk management or on business decisions such as dividend payouts) will depend on the metrics used in each part of the business, as firms that use Solvency II instead of IFRS or GAAP accounting as the key driver for decision-making are likely to experience less of an impact. Our experience is that shareholder-owned insurers tend to make business decisions with an eye on IFRS profits stability, and so are likely to have to amend processes to suit IFRS 17. On the other hand, firms owned by for example private equity firms are likely to focus more on Solvency II capital optimisation and so may experience a narrower range of impacts.

We asked firms to consider the wider impacts (if any) that IFRS 17 might have on their business and 60% of Turkish firms anticipated some form of change outside of the direct impact on the IFRS balance sheet. Firms were able to select more than one option and those selected varied among firms, including several respondents that had not yet determined where those impacts might be, suggesting that there is still a great deal of uncertainty about the effect of IFRS 17 from a business perspective. According to some of the responses, firms expected that pricing and risk management would be affected.

In addition, in separate questions, 80% of Turkey respondents indicated that they anticipate continuing to present financial results in the current format (premiums, investment return, claims, expenses, changes in reserves), as additional information once IFRS 17 is adopted.
Conclusion

The results of the survey largely confirm expectations based on what we’ve seen in the market: firms are still a material distance away from being IFRS 17-ready, and the extension of the implementation date to 1 January 2022 is likely to have come as a welcome relief to the vast majority of firms. Despite the extra year being much needed, there are already signs that some firms might be decelerating implementation projects as a result of the extension, which has the potential to be a risky move given the amount of work most firms have left to do. We would encourage firms to maintain the momentum of existing progress and instead use the extra time to optimise their final IFRS solutions, looking at areas such as information technology (IT) systems where perhaps shortcuts were initially taken but are no longer necessary.

It is also worthwhile at this point to encourage firms to think about the lessons they learnt from the implementation of Solvency II and to consider whether they are applying these lessons or heading towards the same mistakes. Given the budget and resourcing challenges inevitably faced by firms at this stage in the implementation process, it is particularly important to have learnt and formed action plans from previous implementations, enabling them to focus on the new, additional challenges that IFRS 17 introduces. For example, one of the key issues we are seeing our clients face is the requirement for a streamlined end-to-end process which covers a wide range of departments and requires strong and continuous communication between actuaries, accountants, underwriters, management and many others. Whilst breaking the implementation requirements down into silos might make the task seem more approachable, if there is no one taking the high-level view to ensure all the pieces are consistent and fit together, then firms are likely to experience further challenges in the latter stages of implementation.

Finally, we would like to thank the 118 firms who responded to our survey, noting that in this paper we have only outlined a portion of the 75 questions covered in our survey. Therefore, we do encourage readers to get in touch if they are interested in benchmarking a particular aspect not covered in this paper.

How Milliman can help

Milliman has a wide range of experience in global insurance markets and, in particular, in Solvency II and IFRS 17. Milliman’s experts have closely followed and continue to closely follow the development and implementation of both regimes.

Milliman can provide a range of services to assist with all aspects of IFRS 17, including:

- Methodology development and implementation
- Independent review
- Training
- Gap analysis and impact assessment
- Financial modelling

If you would like to discuss any of the above with us, or anything else, or if you have any questions or comments on this paper, please contact one of the named consultants below or your usual Milliman consultant.

Notes on recent IASB amendments

April 2019:

March 2019:

February 2019:

January 2019:

Premium Allocation Approach

Discount Rates

Risk Adjustment

CSM Amortisation