

IFRS17 Implementation

A new reporting framework comes with significant challenges

Kurt Lambrechts, IABE
 Henny Verheugen, AAG
 Takanori Hoshino, FIAJ, FSA, CERA, CMA
 William Hines, FSA, MAAA

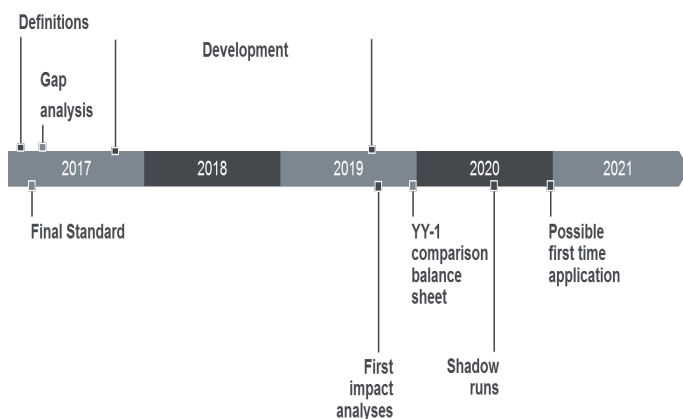


A successful implementation of IFRS17 for insurance contracts will depend on the successful use of actuarial systems, the application of good controls and careful consideration of accounting choices.

Introduction

After long preparation, a final IFRS standard on insurance contracts is now being drafted by the IASB and planned for publication in the first half of 2017. At this moment, the IASB foresees a 3.5-year implementation period, so that the first application of the new standard will be on January 1, 2021.

FIGURE 1: EXPECTED TIMELINE



This implies a very short period for implementation, especially considering the need for shadow runs well before 2021 in order to get control on the numbers produced. In this paper we discuss critical points of attention and suggest possible first steps towards implementation.

Implementation approach

HOW TO ADDRESS THE CRITICAL BUSINESS ISSUES?

There is a large overlap of content and implementation steps between IFRS Insurance Contracts and Solvency II. Therefore companies which have already established the Solvency II's three pillar approach could leverage the experience by applying a similar approach for IFRS17. For companies in jurisdictions that have not adopted Solvency II, the three pillar approach may serve as a useful framework for implementation as well:

- The requirements of Solvency II's second and third pillars are not directly applicable for IFRS17, but the concept of governance and discipline by public disclosure can enhance the quality of the calculations and processes in the same way. They can facilitate the implementation of sound organisational structures and processes.
- The three pillar approach will be easier to follow in the organisation and give an opportunity to re-use the experience and structures of Solvency II.

FIGURE 2: THREE PILLAR APPROACH

IFRS17		
Valuation Product classification Unit of account Contract boundaries Participating features Methodology Assumptions Discount rates Contractual Service Margin Risk Adjustment	Governance and processes Data quality Model governance Parameter setting Fast close Forecast process Asset & Liability mismatch Risk management	Presentation and analysis (revenue presentation) Classification of results Predictability and stability of results Comparability results over time Bridging with Solvency II First time application
IT and Data platforms		

Pillar 1: Valuation

During the long preparation stage of this new standard the primary focus is to set appropriate actuarial methods for the valuation and revenue recognition of insurance contracts.

Implementation will, however, require expert analysis on how the standard should be applied in the specific context of each individual insurance company.

Moreover, as the standard is to a large extent principle based, implementation will require a number of strategic choices to be made, which will determine how, among other things, an insurance company's revenue is presented to their stakeholders.

ACTUARIAL TOPICS

The principle-based rules in the new standard will require many technical issues to be worked out in detail. Some of these are likely to be evaluated at sector level (ensuring comparability) but others will be unavoidably entity-specific.

We discuss here some of these topics.

Unit of account and aggregation level

While the IASB acknowledges that the principle of a portfolio reflects the economics of insurance contracts, they also indicate that not all expected losses within a portfolio should be offset by expected gains. This means that for some contracts a negative contractual service margin cannot be offset, but should be reported in profit or loss immediately. The contractual service margin will also absorb the effect of changes in expected future profitability during the lifetime of the contract and can in the same way become depleted. This requires that contracts are at inception divided into onerous contracts, contracts without significant risk to become onerous and all other profitable contracts, with offsetting only allowed within each of these groups. As the release pattern of the contractual service margin must be linear over the expected insurance period, grouped contracts should also have similar expected durations.

At the same time, it remains essential to keep the number of model points as small as possible when performing stochastic projections.

Discount rates

Discount rates need to reflect the characteristics of the insurance contracts and nothing more. The rates should be consistent with observable market rates and any regulatory adjustments (e.g., Ultimate Forward Rate and Volatility Adjustment) may need to be removed if irrelevant to the company's portfolio.

The IASB suggests two possible approaches:

1. Bottom-up approach: this approach involves a risk free rate as starting point to which extra characteristics of the insurance liabilities should be added (such as an illiquidity premium).
2. Top-down approach: in this approach, insurers can start from an actual or a reference portfolio of assets and then remove those characteristics that are not inherent to the insurance liabilities (such as credit risk premium).

Participation Features

Non-participating contracts will lock-in the discount rate used to determine the contractual service margin at inception of the contract. An amortized interest rate cost, using this locked-in discount rate, must be reported in the profit and loss. For participating contracts, it will be possible to unlock this discount rate to reflect the fact that higher (lower) future participation payments are related with a higher (lower) expected investment return. The way this is done depends heavily on the nature of the participation features and the IFRS measurement of the corresponding asset portfolio.

Confidence level equivalent

While every insurer can determine the risk adjustment from its own perspective, a uniform 'confidence level equivalent' must be additionally reported to make comparison among different insurers possible. For skewed risk distributions this will be challenging and probably require an actuarial consensus on the method to use.

CHOICES TO BE MADE

Discount rates

The top-down approach mentioned above can be linked with Asset Liability Management (ALM). ALM enables the reporting entity to base the discount rate for insurance cash flows on a reference portfolio that can actually be bought to back these liabilities. In this approach it would be possible to accurately reflect the actual economic ALM mismatch in the IFRS statements.

As the possible approaches for the discount rate do not necessarily lead to the same result, the choice between a bottom-up discount rate that is similar to certain existing valuation frameworks (MCEV, Solvency II) or a top-down discount rate that is more connected with the ALM policy should be examined not just from the technical aspects. The choice should be consciously taken by the management board after considering the impact of both possibilities on all aspects of the business.

Method for risk adjustment

Insurance companies are free to choose the method for determining the risk adjustment from their own perspective. This means that they can re-use the risk margin method from another framework (MCEV, Solvency II, USGAAP...) or apply

their own preferred method. For insurers that aim for a certain target return on risk capital, it is possible to align the risk adjustment to this strategy: in each reporting period the targeted return on risk will then fall into profit or loss and will in that way be visible as a part of the underwriting result.

The bigger the risk adjustment, the smaller the contractual service margin will be. The method for the risk adjustment has therefore an impact on whether contracts are considered onerous at inception and on the likelihood that they become onerous in the future in the event that assumptions for future cash flows deteriorate. For onerous contracts the current value of future losses must be taken up-front in profit or loss.

The risk adjustment and contractual service margin also have different release patterns. The risk adjustment follows the changing risk exposure of the insurer. The contractual service margin however is released in a linear pattern and reflects a more 'margin-style' type of profits. The chosen method for the risk adjustment therefore determines how the company will show future revenues to their stakeholders.

Again, it is recommended to measure the impact of different possible risk adjustment levels and methods so that management can make an informed decision on the best way forward.

Pillar 2: Governance and processes

It is important to realise that the results coming out of the IFRS17 process will have a predominant impact on the balance sheet and revenue statement of an insurance company and that many of the reported values will be a product of actuarial calculation systems.

It will be extremely important for insurers to have quality controls around the produced numbers and the processes generating them.

MODEL GOVERNANCE

Insurers may have pre-existing cash flow models that, with some adaptations, could be used for IFRS purposes as well. If these models are currently used for management or reporting purposes (like Solvency II) then the use for IFRS will lead to joint model use by the risk and the finance department.

Such use of risk models will further emphasise the need for robust model governance. The impact of model errors has potentially more significant consequences under IFRS than under other valuations as IAS8 requires an entity to correct all model errors retrospectively for all prior periods.

Even if models are already validated as fit for use in solvency reporting, it can be expected that a separate validation of the model for IFRS use is additionally required.

PROCESSES

As far as cash flow projection models already exist in the company, IFRS17 will put extra demands on efficiency and effectiveness.

Fast close

Most publicly listed companies inform their stakeholders of their financial results within 6 to 10 weeks after closing. The disclosure includes the consolidation and analysis of the results and risks. Consequently, the IFRS17 calculations and analysis need to be completed very quickly. Other reporting processes like MCEV or Solvency II may have less tight time scales.

Forecasting

Both internal and external stakeholders will require a view by the management on the expected results for the next reporting periods. Some companies may also want to forecast IFRS statements for making day-to-day strategic / business decisions. These forecast processes are generally based on aggregated models that additionally need to be developed and may require a significant improvement or industrialization of the current actuarial models.

BUSINESS GOVERNANCE

Asset and liability management

The earlier implementation of IFRS9 can lead to a significant valuation mismatch between insurance liabilities and assets. The IASB recognised the issue for the insurance industry and published an interim solution in September 2016. The presented deferral method will create the least volatility and immediate burden for insurance companies.

Once IFRS17 is active, it will be important to align the classification of assets at fair value through profit or loss and/or fair value through other comprehensive income with the classification of the insurance liabilities so that an accounting mismatch caused by interest rate fluctuations is minimized. The choice will need to be evaluated on a block-by-block basis and be informed by how the underlying assets are managed.

Risk management

Commonly, risk management is focused on protection of available capital and the solvency ratio. Where risk models are also used for IFRS reporting, additional focus must be put on stabilising income as well, combining the concerns of the risk and finance departments.

On certain aspects, the valuation of insurance liabilities under Solvency II and IFRS will be different. The challenge will be to define measures that consider both regimes simultaneously.

Besides differences in valuation, also the materiality thresholds and accepted volatility of income will be different under IFRS (generally expected to be lower) than the current risk appetite in capital matters.

Pillar 3: Presentation and analysis

CLASSIFICATION OF RESULTS

IFRS17 does not provide a prescribed detailed template for the presentation of results. Analysts have a strong preference however for transparent, detailed and comparable information. Templates must be developed that are applicable for all lines of business (i.e., lines covered by the ‘Building Block Approach’ as well as short-term business covered by the ‘Premium Allocation Approach’).

Also there is a need to define all components of the income presentation:

- Calculation of the interest expense (i.e., 1-year capitalisation of the fulfilment cash flows): which rate to be used?
- Distinction of experience variance, change in assumptions and change in financial environment: a clear separation between the items that will adjust the contractual service margin and other items is required.
- Separation of the other comprehensive income components.

PREDICTABILITY AND STABILITY OF RESULTS

Stability and predictability of results is of key importance to assure confidence by analysts and shareholders. Unexpected movements and effects may lead to a negative impact on the share price.

ANALYSIS OF CHANGE

In order to come to a meaningful analysis it will be necessary to identify the causes and drivers of the performance. An analysis of change as traditionally used in MCEV reporting for life insurers will provide important information about the performance. However, in its current format, it is considered too high level for IFRS17 purposes and generally does not capture nonlife business.

RECONCILIATION WITH SOLVENCY II

Insurance liabilities are also valued as part of the economic balance sheet under Solvency II. Differences from IFRS are unavoidable. Therefore, this will additionally require that:

- All differences in methodology and parameters are identified and explained.
- A bridge between IFRS Equity and Solvency II eligible Own Funds is built.

FIGURE 3: RECONCILIATION WITH SOLVENCY II

Item	Solvency II	IFRS 17
Value of future profits	<ul style="list-style-type: none"> • Immediately recognized in the Reconciliation Reserve included in the Eligible Own Funds 	<ul style="list-style-type: none"> • Recognized over the life time of the contracts via the release of the CSM
Risk Adjustment	<ul style="list-style-type: none"> • Risk Margin calculation is very strict: 6% * NPV(Future SCRs) 	<ul style="list-style-type: none"> • Flexibility on the level of the Risk Adjustment as well as in the method used to derive it
Expenses	<ul style="list-style-type: none"> • All expenses included in the Best Estimate 	<ul style="list-style-type: none"> • Only expenses directly attributable to the contract included in the Fulfilment cash-flows
Discount rates	<ul style="list-style-type: none"> • Use of the UFR • Same adjustment to the swap rate for all contracts (volatility adjustment) 	<ul style="list-style-type: none"> • Will the use of the UFR be relevant in the IFRS framework? • Different levels of “liquidity premium” regarding the underlying liabilities?

FIRST TIME APPLICATION

IFRS17 will require a first-time application at the introduction of the new regulations. Several approaches will be allowed to derive the IFRS17 opening balance sheet: a full retrospective application or, if this is impracticable, the choice between a simplified retrospective application or the fair value approach. Between the latter two a significant difference in contractual service margin could result.

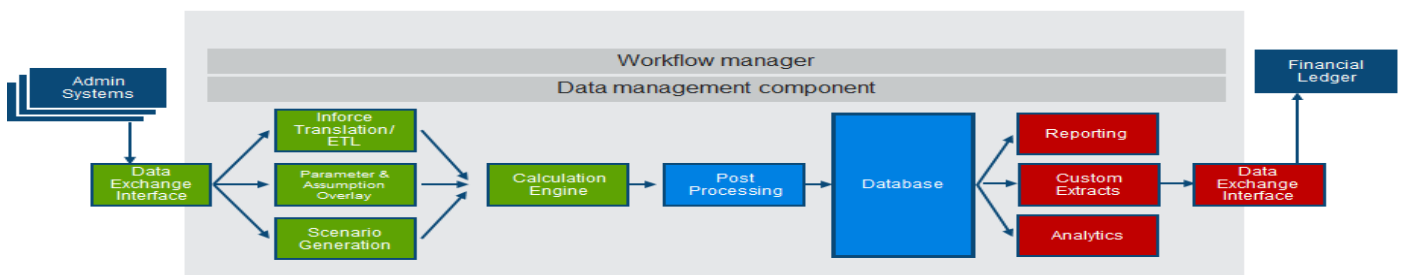
IT and data platforms

The movement from an existing Solvency II, GAAP or MCEV basis to a full operational IFRS model involves many challenges and complicated issues:

- A seriatim ALM calculation
- Staged transition between reporting periods
- Cost of embedded options at granular level
- Movements between onerous / profit making contracts
- Risk adjustment calculated at seriatim / cohort level;
- Unlocking of the contractual service margin
- Computer speed as an integration of cloud computing and efficient implementation
- Interaction and dependencies with Solvency II calculations

From a data management perspective, a very robust system design is required that combines vast data storage requirements with a high degree of computational complexity.

FIGURE 4: IT AND DATA PLATFORM REQUIREMENTS



GENERAL LEDGER

To comply with IFRS17 the accounts in the general ledger have to be changed significantly. The reconciliation between the traditional structure of the income statement and the new presentation format is important and challenging.

DATA MANAGEMENT ISSUES

Serial calculations coupled with the need for ongoing unlocking of the contractual service margin and the need to maintain a full prior history will create significant data management issues. The same holds for the analysis of change and forecasting information.

This all calls for a thoroughly designed and robust data warehouse that bridges the distance between the actuarial models and the accounting ledgers.

How can Milliman help?

In order to assist clients in setting up their implementation project for IFRS17, Milliman has developed a framework to perform a gap analysis that gives valuable insight and can help insurers with:

- Defining work streams that need to be considered, related to the three pillar view on implementation
- Supporting the discussions on expected workload and budgets in several disciplines, including actuarial, accounting and IT
- Supporting a better decision on possible approaches, analyzing implications and conducting an impact study for particular choices on: use of building block approach / premium allocation approach / variable fee approach, contract grouping and CSM amortization pattern, reinsurance effects, use of other comprehensive income, choice of discount rates, hedging effects, etc.
- Assisting in the functional analysis of the required data warehouse architecture
- Assisting in sorting out computational issues due to the demanding requirements of IFRS17 and providing semi-industrialised solutions to keep models performant.



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CONTACT

Kurt Lambrechts
kurt.lambrechts@milliman.com

Henny Verheugen
henny.verheugen@milliman.com

Takanori Hoshino
takanori.hoshino@milliman.com

William Hines
william.hines@milliman.com

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