

The wait is nearly over?

IFRS 17 is coming, are you prepared for it?



We are close to a new IFRS insurance contracts accounting standard. IFRS 17 (previously referred to as IFRS 4 Phase II) is expected to be issued in early 2017 with an effective date of 2021

Assessing the expected impact now will make for a more effective planning process. Many large insurers have reached this stage

A structured approach to IFRS 17 project planning will help overcome challenges and maximise opportunities

IFRS 17 is coming, are you prepared for it?

Summary



Background

- The new IFRS standard for insurance contract accounting (previously referred to as IFRS 4 Phase II, now expected to be IFRS 17) has been under development for many years. However, the IASB are now finalising the drafting of the final standard and we appear to be closer than ever to the final chapter in this particular saga.
- A robust standard is clearly needed as current IFRS 4 allows a myriad of different accounting policies resulting in a lack of comparability, even within insurance groups.
- The standard is expected in early 2017 with an effective date of 2020 or more likely 2021. The long lead time is a reflection of the complexities anticipated around implementation.
- IFRS 17 will be a complex standard that will include some fundamental differences to current accounting in both liability measurement and profit recognition. See [page 3](#).
- There are parallels with Solvency II in Europe, for which insurers 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 but important differences between the frameworks exist, notably the contractual service margin concept under IFRS 17.

- Insurers have been granted some relief from applying IFRS 9 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 remain related disclosure requirements to consider before then, in addition to building the interaction between the two standards into IFRS 17 planning.
- The IASB is currently conducting topic-based field testing using a questionnaire that incorporates draft wording from the standard. This exercise is to identify issues around interpretation of the requirements and potential operational difficulties that might arise when applying those requirements.



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. Areas already identified by early IFRS 17 movers include the following and are covered in more detail on [page 4](#) of this publication:

- 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 looking at areas such as:

- 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. [Page 5](#) of this publication provides an indication as to what you might do depending on your current status.

An overview of the standard

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 to address particular features, subject to eligibility criteria as illustrated.

| | Why is it needed? | Key features | Types of contract |
|-----------------------|--|--|--|
| BBA | Default model for all insurance contracts | <ul style="list-style-type: none"> • 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 option² for changes in discount rates to reduce P&L volatility • Transition approach allows significant simplifications and judgement • More transparent disclosures | <ul style="list-style-type: none"> • Long-term and whole life insurance, protection business • Inflation-linked annuity contracts • Immediate annuities • US style universal life, certain fixed annuities (BBA with some adjustments) • Reinsurance written (BBA with some adjustments) • Certain general insurance contracts |
| PAA ¹ | 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. | <ul style="list-style-type: none"> • 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 | <p>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.</p> <p>As per BBA with additional features, notably:</p> <ul style="list-style-type: none"> • 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) | <ul style="list-style-type: none"> • Unit-linked contracts, US variable annuities and equity index-linked contracts • Continental European 90/10 contract • UK with profits contracts |

¹ Premium Allocation Approach – See our publication: *General insurers should not ignore IFRS 4 Phase II*

² Other Comprehensive Income (OCI) comprises items of income and expenditure that are not recognised in P&L

Areas of challenge and lessons learnt so far

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 profit and equity
- Greater transparency through disclosure
- OCI option provides linkage to asset accounting (IFRS 9)

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 through to Group-wide technical or systems and data impact assessments. Some have even begun to consider systems design.

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 3 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 use of OCI to manage profit and loss volatility and the use of the PAA for short duration business. In choosing the preferred policy or option, it will be important to take account of 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.
- **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

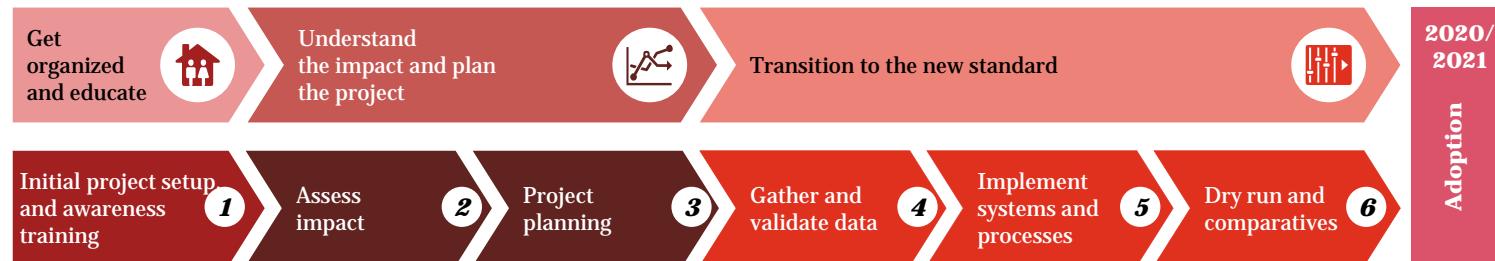
complex with more optionality than they had originally hoped for. If the insurance industry is to reduce its cost of capital compared to other industries then insurers will need to carefully consider their 'IFRS 17 story' in the run up to adoption as well as the key metrics they will apply in the new 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. There could also be an impact on the cash tax position, both on transition and ongoing tax profile. As a result, groups may wish to lobby for special tax rules to deal with the new standard.
- **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

So how can you address potential pitfalls and ready yourself for the changes IFRS 17 will bring? Consider an illustration of the steps an insurer might go through up to expected IFRS 17 adoption date:



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

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

The key questions at this stage are: Where you are now? How long you think the transition process (steps 4, 5 and 6) might take? and What is the level of effort (resources, budget, systems development time) required to complete the process? It is impossible to accurately answer the second and third questions without carrying out some form of impact assessment and project planning. The nature of this work and steps to take now will depend on the 'where you are now' question. We are aware of several large insurance groups, the IFRS 17 market leaders, that would consider themselves well set in terms of having assessed financial and operational impact and begun to plan their implementation projects. Others have carried out high level gap analyses and project sizing exercises but have not yet 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.

We suggest that there are several component parts to any 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 above.



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 group-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.

The wait is nearly over?

PwC

September 2016

Where to go for further information



Alex Bertolotti

Global IFRS insurance leader

T: +44 (0)20 7213 1253

E: alex.bertolotti@uk.pwc.com



Kirsty Ward

Partner - Accounting

T: +44 (0)20 7804 2999

E: kirsty.a.ward@uk.pwc.com



Graham Oswald

Director - Actuarial

T: +44 (0)20 7804 7373

E: graham.oswald@uk.pwc.com



Gail Tucker

Partner - Accounting

T: +44 (0)20 7212 3867

E: gail.l.tucker@uk.pwc.com



Dominic Veney

Partner - Actuarial

T: +44 (0)20 7804 3573

E: dominic.veney@uk.pwc.com



Tom Brown

Partner - Finance and technology

T: +44 (0)20 7804 0722

E: tom.r.brown@uk.pwc.com

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PwC does not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2016 PwC. All rights reserved. "PwC" refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.