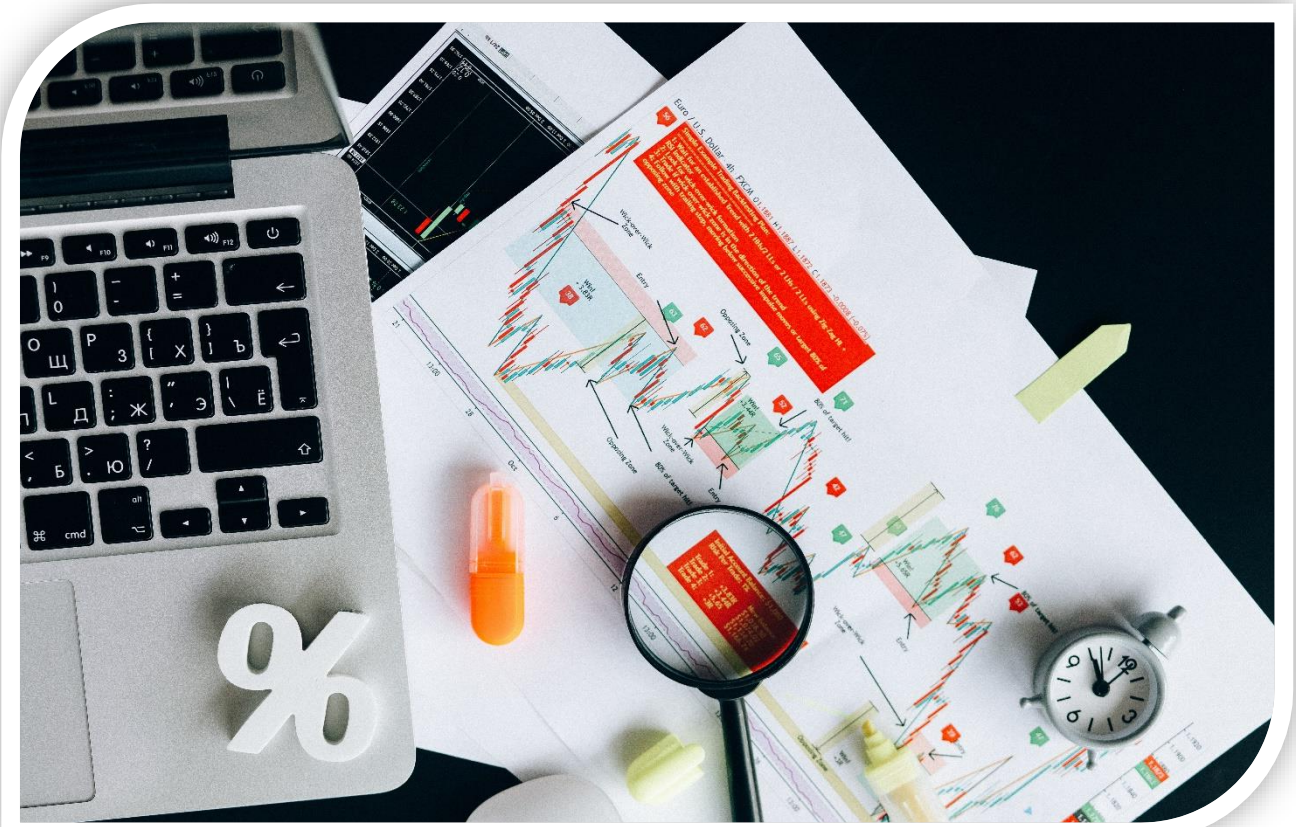


IFRS 17 – Revolutionizing the Insurance Industry



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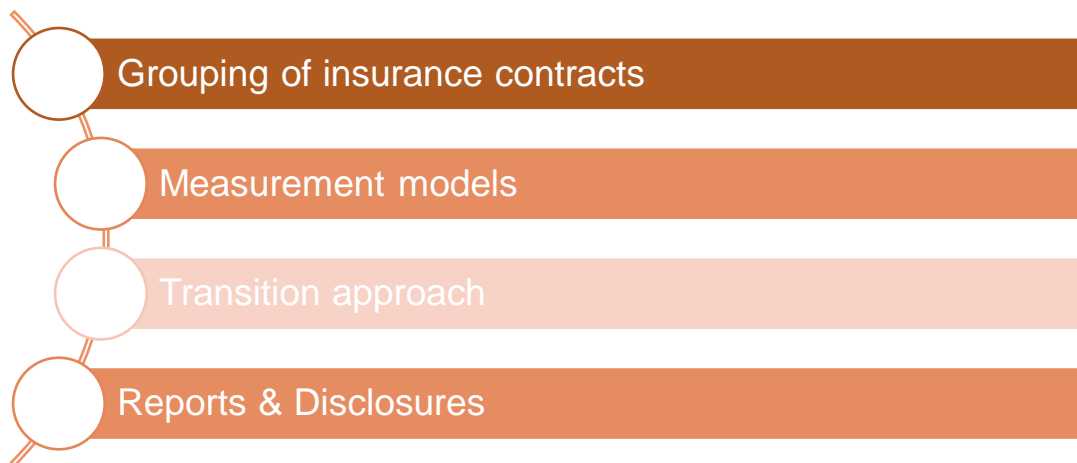
Overview

IFRS 17 is all set to get implemented from 1st January 2023 which will bring about a change in the financial reporting of insurance companies. It will not only be a leap forward but will also bring changes in accounting, actuarial and finance reporting processes, systems and data. With the deadline closing in, a well-planned strategy plan along with a well-defined governance structure is the need of the hour for the smooth transition to IFRS 17.

Prior to IFRS 17, IFRS 4 was an interim accounting standard that allowed insurance companies to use variety of accounting practices. Such differences in accounting made it difficult for stakeholders to understand and compare the books of accounts of insurance companies. Hence to ensure transparency and consistency across accounting for all insurance contracts and for better comparability, IFRS 17 has been introduced.

Under IFRS17, granular analysis of movement will be disclosed publicly for the first time. Reported profit in books of accounts will be directly impacted by the discount rates and risk adjustments. The transition to IFRS 17 involves significant changes in presentation as well as measurement of insurance contract liabilities. The same is required for insurance contracts with direct participation features and for reinsurance contracts held.

IFRS 17 can be worked out in below four steps which describe the complete requirements under IFRS 17.



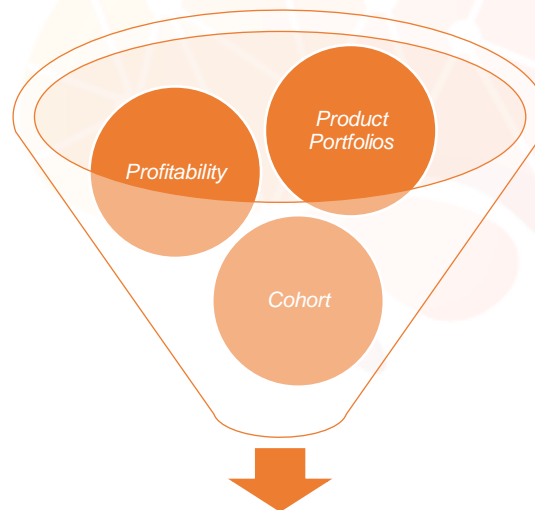
To make sure implementation process is completed without any difficulty, the insurers' will have to take key decisions immediately so that the strict timeline can be met. The ultimate goal is to generate reports and disclosure that comply with the requirements of IFRS 17. As the standard is very complex it brings along various data driven and technology driven challenges.

In this paper we will look into key decisions that insurers need to consider throughout this process along with challenges they might face in this implementation process.

Level of Aggregation

Insurance contracts are far more uncertain than other contract providing services. To overcome this uncertainty and to improve the usability of accounts, under IFRS 17, insurance contracts need to be aggregated into suitable groups. Grouping of policies allows the insurer to estimate fulfilment cash flows at the level of aggregation which is most appropriate for the insurers'. The unit of account currently ranges from individual contract level for some elements up to aggregation of contracts at entity levels for others, depending on what is the objective of evaluation.

The level of aggregation of insurance contracts required by IFRS 17 also differs from the level used by insurers for certain internal management purposes, e.g. when assessing risk, making pricing decisions and monitoring/reporting profitability. IFRS 17 requires insurers to recognize the insurance contracts according to three basic criteria's.



Level of Aggregation

Product portfolio means similar risks that are grouped together. Contracts within a product line would be expected to have similar risks and hence are expected to be in the same portfolio when being managed together. Profitability would either be onerous, non-onerous or others. Cohort is defined as the year of sale of the product. As per IFRS 17, contracts issued one year apart cannot be part of the same group. The size of the cohort will indirectly determine the amount of contractual service margin (CSM) that will be released into revenue over time.

Multiple sets or individual contract can form a group. Groups are recognized at initial recognition and are not reassessed or altered subsequently during the coverage period. Hence the level of aggregation is very important and will form basis for any calculations that are required as per IFRS 17. The grouping is particularly relevant for the determination of CSM. This will also help in creating more consistency in profit recognition not only across the insurance industry but also across other industries globally.

Level of aggregation also raises concerns as applying the annual cohorts' requirement would require significant changes to systems and increase costs. It will also impact how onerous contracts are identified compared to the current practices and hence may affect the pricing of certain products.

Measurement Model

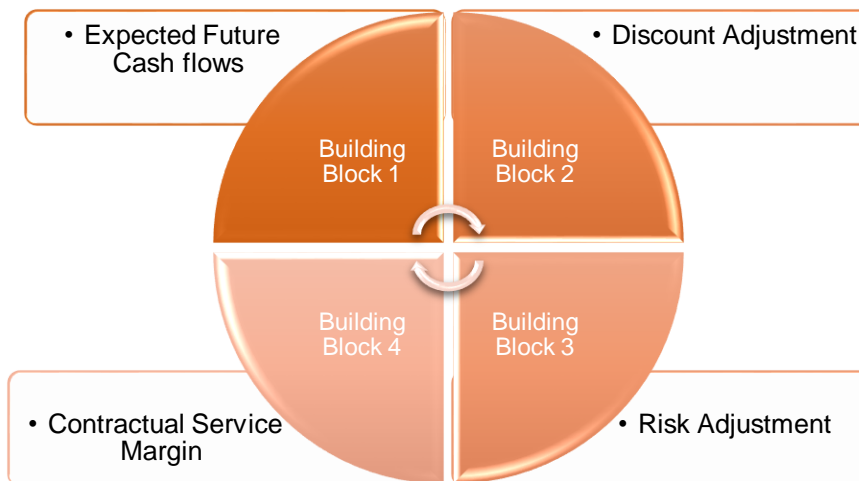
The three measurement approaches acceptable by IFRS 17 describe how a life insurer accounts for the fact that they have received premiums, but the policy coverage extends into the future. Each of the three approaches are used for different types of products. The contracts can follow any of the three measurement models as specified in the standard.



Policy data will need to be analysed carefully to allow the company to make reasonable judgement calls on which model to use.

General Measurement Model

GMM is the default measurement model for insurers' unless the company chooses to use some other approach which has to be justified. GMM is appropriate for longer term contracts which cover a specified risk over a certain period. It is also called the building block approach.



The liability of remaining coverage includes all above blocks. The future cash flows are discounted to reflect the time value of value and subsequently adjusted for risk adjustment. The CSM represents the future profits expected to arise on these contracts. Holding the CSM as a liability on the balance sheet and running it off over the lifetime of the contract has the effect of recognising profits over the term of the contract - a key aim of IFRS 17. The main challenge in this model is the calculation of time value of money of all cash flows and then applying risk adjustments.

Premium Allocation Approach

PAA is the most simplified approach among the measurement models available and is applicable to insurance contracts with short durations (less than one year). PAA is a more straightforward approach that can be considered for calculating remaining coverage liability. The adaption of this measurement model is optional for each group of insurance contracts that meet the eligibility criteria. Contracts with more than one year duration can also be considered under PAA if the difference in liability for remaining coverage for PAA and GMM is immaterial i.e. PAA eligibility tests will be required in case insurance company follows PAA for long term contracts.

The liability of remaining coverage is based on premium received rather than the CSM approach. Premium is recognised overtime as revenue unless release of risk follows a different pattern. While the PAA doesn't involve CSM component, contracts valued under this method are still required to be grouped at the same level of granularity as for the GMM. Proving that the liability of remaining coverage under both PAA and GMM are similar is the main challenge under this approach if the company wants to measure long term contracts under PAA.

Variable Fee Approach

VFA needs to be followed always, in case of direct participating insurance contracts. The approach considers the variable fee associated with direct participating contracts. The underlying items can be held or referenced.

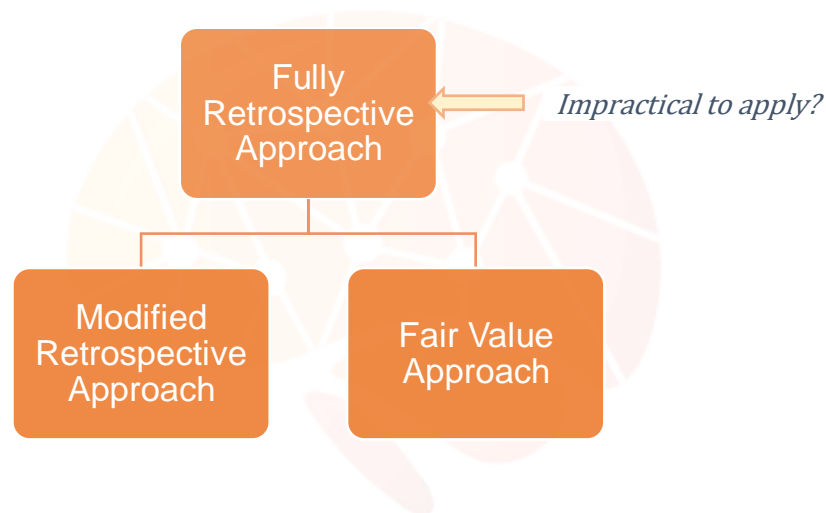


Basically, VFA differs from GMM only in the way that the CSM changes over time. This difference arises from an appreciation that contracts with direct participation features generally have profitability that is heavily dependent on market movements. Hence for such contracts, economic movements in value of the entity's share of underlying items are incorporated into the CSM. The contract includes both investment and insurance related services the coverage units and release of the CSM needs to reflect both.

Whichever model the insurers' chooses, it will involve a lot of work both at the initial implementation and on ongoing basis. The precision of the calculations in the measurement approaches is dependent on the accuracy and reliability of the underlying data i.e. on grouping of insurance contracts. But overall, IFRS 17 provides flexibility in choosing the approach to measure policy liabilities.

Transition Approach

Going forward in the implementation process, the insurance company needs to decide on the transition approach that needs to be adopted. As per IFRS 17 only fully retrospective approach needs to be adopted, unless impracticable to get historical data in which case a modified retrospective approach or fair value approach can also be considered.



In case of fully retrospective approach, the discount rate effect and CSM require a complicated retrospective analysis that can be burdensome to implement. Also this requires discount rate at initial recognition date and all assumptions changes between initial recognition date and transition date. Further under this approach, historical data is required from the year of sale of policy which seems to be impractical for many insurers'.

The modified retrospective approach will achieve the closest outcome of a full retrospective approach using reasonable and supportable information without undue cost or effort. Under this approach insurers use the modifications as prescribed in the standard only to the extent that they do not have reasonable and supportable information to apply the full retrospective approach. So even though this approach offers a certain degree of simplification, it is not as modified as expected.

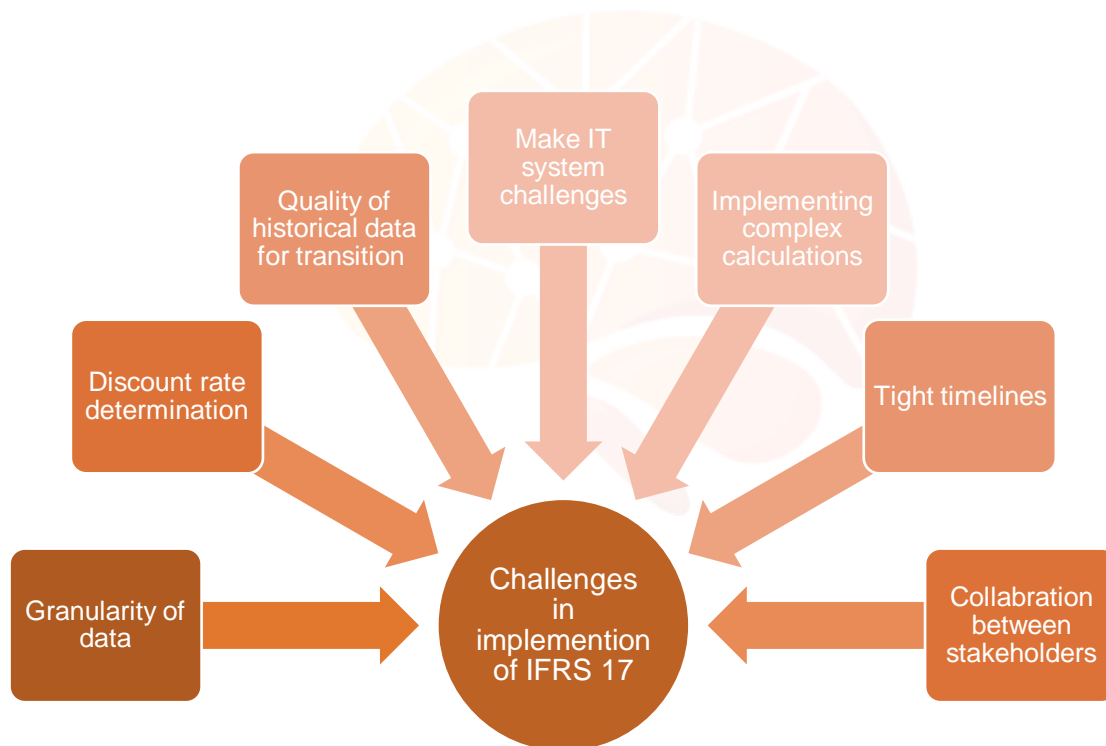
The fair value approach requires an insurer to determine the CSM or loss component at transition date for a group of contracts as the difference between the fair value of a group of insurance contracts and the fulfilment cash flows of the group measured at that date. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Regardless of the approach taken, new data will need to be gathered and calculations performed. Further specific data issues might arise on transition for the insurers'. Complications may arise in relation to previously acquired claim liabilities where CSM has to be recognised on transition. The insurer might have to explore the availability of data to determine the transition approach.

Challenges

The worldwide implementation of IFRS 17 will result in massive changes in the insurance industry. Apart from taking key decisions discussed, the insurers' will have to take crucial accounting policy decisions and adapt suitable digital tools to make this implementation process hassle free.

IFRS17 creates a complex end-to-end change for insurers, with multiple functions from across the business needing to work in coordination to make sure that the IFRS 17 implementation is achieved on time.



Most of the challenges mentioned above can be achieved by appropriate and timely decisions. An IFRS 17 integrated operating model across operations, actuarial, finance, technology and data will need to be defined to adapt to the new IFRS 17 requirements, technology, capabilities and competencies.

With challenges come great opportunities and insurers' that will exploit these opportunities through active, timely and complete preparedness of IFRS 17 would emerge as successful examples for all across the industry.

The Way Forward

Insurers need to start with interpreting the standard, defining accounting positions, developing and enhancing actuarial models, and implementing new technologies and systems to enable the timely production of significantly more onerous financial reporting requirements. Once the data challenges are solved standing in the way of choosing the right measurement approaches, the final step in the IFRS 17 journey is to generate compliance reports.

It needs to be understood that IFRS 17 will enhance the quality and comparability of financial information. Implementing IFRS 17 in itself will have a significant influence on financial reporting, which will primarily help in overcoming the current challenge of different accounting treatments. In order to ensure successful roll out of the standard, it is crucial that sufficient time, resource and consideration is provided to the transition.

Going forward, insurers need to...

- Review contracts
- Document key decisions and policies
- Integrate an IFRS 17 solution
- Start dry runs to understand the impact of the change on the financial reporting

Now is the best time for insurance companies to initialise their IFRS 17 implementation starting from planning and taking important decisions to processing dry runs for understanding impact on financial reporting. A thorough fit-gap analysis will be extremely beneficial for insurance companies to assess the impact and extent of effort that will be required to implement the new IFRS requirement.

With the change that IFRS 17 will bring in, insurance companies should look at this new implementation not as a burden and additional cost but instead as a one-time opportunity for the insurance companies to align the actuarial, risk, accounting and reporting areas that will provide more transparent and meaningful financial information results to stakeholders across the globe.

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