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Seven reasons to focus on IFRS 17

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Publishing IFRS 4 in March 2004 resulted from the need to implement any regulations prior to the date of listed insurers' adopting IFRS in 2005. Since the International Accounting Standards Board (IASB) knew that completing the works on a comprehensive standard (commenced in 1997) by that date would be impossible, it decided to apply a transitional solution, whose purpose was to provide guidelines to be used by the time the final standard is published. At the same time, IASB decided to recommence the work on the comprehensive standard within the second stage of the project.

After 13 years, the document has been published. In the meantime, draft new regulations were published (in 2007, 2010 and 2013, respectively) and gave rise to lively discussions. IASB has received over 600 formal letters with comments from potential users of the new standard. The length of the process and frequent changes in key project assumptions made many people believe that the standard would never be published. Therefore, the recent acceleration of works has been a surprise. Revolutionary changes nearing implementation with each new discussion materials published were often unwelcome, particularly by companies that still remembered organizational efforts and expenses necessitated by Solvency II implementation. Although prior to 18 May 2017 more modifications could have been expected to postpone the Standard's effective date, following the official publication of IFRS 17, there is no return from revolutionary changes in financial reporting of insurance companies.

IMPLEMENTATION CHALLENGES

Two questions arise in the face of the unavoidable changes:

What are the key practical challenges related to implementation of IFRS 17?

Is Hungarian insurance market different in this respect from other markets? In order to find the answer, let's review key issues considered controversial and requiring special focus by participants of recent discussions regarding the new standard. These issues include:

- selecting a measurement model and calculating contractual service margins (CSM);

- determining groups of contracts to be treated as a single unit of account;
- adapting accounting, actuarial and IT systems to allow calculation of CSM and its amortization for each unit of account;
- defining Risk Adjustment methodology;
- changes in reinsurance contract reporting; selecting the optimum methodology of recognizing the existing portfolio pursuant to the new reporting principles (transition);

a new form of reports, required disclosures and the necessity to adjust the existing executive reports and key accounting indicators.

SELECTING A LIABILITY MEASUREMENT MODEL

The General Model introduced in IFRS 17 assumes that insurance liabilities shall be measured as expected future cash flows (including discounts based on market return rate curves) increased by risk adjustment and CSM.

The first two components shall be calculated based on current assumptions regarding biometrics, costs and economic conditions. CSM shall be arrived at through amortization of the initial amount determined for a group of policies included in a single unit of account. The amortization scheme shall be based on insurance coverage expiration projections (for example: based on the number of policies projected over time). CSM is to be recognized to reflect expected future profit on a given group of policies. It shall provide a buffer to absorb possible adverse changes in assumptions underlying the measurement.

The above general model allows two modifications and one practical expedient. The modifications regard contracts that meet specific criteria of the policyholder's share in profit. In Hungarian conditions, such contracts may include contracts with unit funds and certain life and endowment policies. The benefits of using modified models include restricted variability of the liability amount resulting fluctuations in market related assumptions. The Premium Allocation Approach, or PAA, is close to the current model used in property insurance and based on the premium provision. No necessity to determine separate risk adjustment amounts and CSM materially simplifies measurement of liabilities. Application of the PAA approach is allowed mostly for short-term contracts (up to 12 months) and only for liabilities related to future insurance coverage. Apart from property insurance, the model may provide an interesting alternative, e.g. for group insurance contracts.

UNIT OF ACCOUNT

IFRS 17 requires reporting entities to determine and amortize the CSM by portfolio and unit of account. Portfolios are defined as sets of jointly managed policies, bearing similar risk. They are open and can be extended by newly acquired, subsequently grouped risks.

The standard requires reporting entities to determine at least the following groups within their portfolios for each 12-month sales period:

- onerous contracts;

- Policies with no significant risk to become onerous contracts as a result of not achieving assumed rates; • other policies.

An analysis whether a product should be classified as an onerous contract should be carried out on a single policy level. The use of practical expedients is allowed, provided, though, that an entity is able to ensure that as a result no onerous contracts are left outside the onerous contracts group.

The requirement to assess the level of risk that a given policy may become an onerous contract in during its term shall require an extended sensitivity analysis, in contrast to the current requirements.

NEED TO ADJUST IT SYSTEMS

The necessity to carry out calculations on the unit of account level results in a number of practical implications for IT systems. Separating several units of account for each year of sales and each portfolio makes reporting entities to adopt and store a large number of assumptions.

Moreover, due to interactions among changes in future projected cash flows generated by actuarial systems and the CSM margin, calculation tools will have to be closely integrated with accounting systems of reporting entities. The requirement to separate the socalled investment component may necessitate system modifications, to allow storing of current and complete information regarding the cash-in values (or amounts returned in the case of resigning) for all policies.

RISK ADJUSTMENT DETERMINATION METHODOLOGY

Risk adjustment, required to be presented separately from the expected value of future cash flows, is an important element of liability measurement under IFRS

17. The concept of the adjustment is close to the risk margin, being a component of technical provisions for solvency purposes. There are material differences between the two, though.

While the risk margin calculation method does not leave any space for material modifications and is forced by requirements of the delegated regulation, the approach adopted by IASB is based on own judgment and risk perception of reporting entities. Therefore, they will have significant freedom in defining their own risk adjustment calculation methodologies. The only thing required is to provide information on the confidence range corresponding to the amount arrived at using the methodology developed by a given entity. Using synergies with Solvency II calculations may be a cheap and fast-to-implement, although not always optimal solution.

REPORTING CHANGES REGARDING REINSURANCE CONTRACTS

Under the new standard, reinsurance contracts shall be treated as separate insurance contracts and measured on terms similar to 'classical' ones. For example, this will necessitate the determining of the contract scope, risk adjustment and (where practical), CSM. Consequently, reinsurance related reporting will become more demanding than today.

SELECTING THE OPTIMUM METHODOLOGY OF RECOGNIZING THE EXISTING PORTFOLIO

Recognition of the existing portfolio in accordance with the new standard requirements seems to be one of the key challenges for insurers. IASB has pointed out the importance of the issue announcing the plan to establish a task force to deal with its practical aspects.

IASB has indicated that reporting entities should measure all insurance contract in a portfolio as at 1 January 2020 (or as at the beginning of the year preceding adoption of IFRS 17, if adopted earlier) on a fully retrospective basis. This means that all contracts sold in the past and still held in portfolios must be remeasured as at the date of sale. Using hindsight during such measurement will not be allowed. Instead, historical assumptions must be adopted used in the past to rate the contracts. Initial values determined under this approach (e.g. the CSM margin) shall be adjusted by assumptions changed or fulfilled between the date of sale and the date of first recognition under new principles.

The above requirements are restrictive and seriously limit the practicality of the fully retrospective approach for contracts sold many years before the effective date of the new standard. This would require access to information about actual achievement of all assumptions for each contract, full information regarding policies, which may have been long ago lost by a reporting entity, data regarding actually incurred expenses (including acquisition costs), etc. Consequently, the use of the fully retrospective approach seems practical only for historical sales up to a few years before (depending on the quality of databases available in reporting entities).

Aware of difficulties related to the use of the fully retrospective approach, IASB has proposed two practical expedients: a modified retrospective approach and fair value based measurement. The use of practical expedients is allowed only when a reporting entity can prove that the application of the fully retrospective approach is not practical for a given group of policies. The necessity to collect the required data as fast as possible is the practical implication. When the standard has been already published and the scope of data required under the retrospective approach has been determined, reporting entities may find it difficult to argue that collecting such data (and applying the fully retrospective approach) for 2018-2019 sales has been impractical. Selecting a measurement method when adopting the new standard brings about a number of consequences. The initial CSM level for historically sold policies shall mostly determine their earnings profile after the effective date of IFRS 17.

Consequently, insurers who decide to apply the fair-value approach, may report lower profit in future. The selection of an appropriate measurement method when adopting the new standard is, therefore, of crucial importance, both in terms of future performance and capital management.

NEW REPORTING FORMS

Making financial statements prepared by insurers compliant with those of other industries is among key considerations underlying the development of the new standard. The necessity to redefine insurer's revenue and discontinue their recognition based on gross premium amount has been indicated. Shortcomings of gross premium based measurements are clearly visible in one-off premium insurance contracts. The solution proposed by IASB refers to the premium and performance equivalence principle. When measuring coverage, an insurer collects a premium sufficient to cover all expected costs and performances plus a risk charge and CSM margin.

The above components may be more easily distributed over the entire insurance period as the expected performances and costs naturally pertain to certain years, while risk charge and CSM may be released in accordance with certain amortization schemes (resulting from risk expiration and the protection performance, respectively). As a result, when presenting revenue, information regarding the premium may be replaced with information on performances expected in a given period and amortization charges for risk adjustment and CSM. Any investment components, though, shall be excluded from revenue, which may significantly change the perception of unit-linked contracts. The change of approach proposed by IASB may result in a number of implications, both regarding the market and internal procedures of each insurer. Improved comparability with other industries and enhanced disclosures will allow analysts obtaining more information on the financial standing of each insurer, which may translate in an increased number of potential investors. Management Boards should get prepared for a change in the perception of the insurance business and analyze their future standing compared to competitors.

Further, new aspects of IFRS 17 shall be discussed in more detail in our subsequent publications.