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Transition to IFRS 17 Challenge or opportunity?

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Introduction

Transition to IFRS 17 will fundamentally change the balance sheet and future profit emergence for insurance companies – but how? Where a fully retrospective calculation is impracticable, there are choices that can involve a trade-off between the level of future profit, the impact on equity, and operational considerations. There may also be different tax outcomes in cash, deferred tax and Solvency II.

Options are available, and decisions and judgements must be made – but which is the right path to take? The actions taken and investments made now will fundamentally dictate the impacts on transition and future profit emergence on the in-force business.

While many see transition as the biggest challenge in their implementation programme, it is an opportunity for companies to manage the financial and operational implications of moving to the new standard by taking informed decisions and making targeted investments.

Overview of permissible approaches

(To be assessed separately for each group of contracts)

1. Fully Retrospective Approach

- Calculation of CSM as if IFRS 17 had always applied – using day one data/assumptions and full history to date of transition, for each group.
- Have to apply unless impracticable.

If impracticable, free choice between 2 and 3

2. Modified Retrospective Approach

- Per fully retrospective, but with prescribed modifications permitted.
- Modifications differ between general model and variable fee business.

Or

3. Fair Value Approach

- CSM calculated as the fair value of the liabilities less IFRS 17 fulfilment cash flows at transition.

Financial implications

We are already seeing from initial impact assessments for companies writing long term insurance contracts that the transition approach followed can significantly affect the size of the Contractual Service Margin (CSM) on the future in-force business at the transition date, with a corresponding impact on shareholder equity and timing of the emergence of profit on this business. In some cases insurers are facing the challenge of explaining how significant profits currently being reported on blocks of business may be almost eliminated under the new standard – or considering whether a different approach to transition can help to avoid this. In addition, there are a number of further specific examples of financial consequences arising as a result of transition-related decisions to consider, including:

- **Changes in profit profile** – Products with profit profiles under current accounting that are particularly front-loaded (e.g. immediate annuities) or back-ended (e.g. with-profits) will see 'recycled' or 'lost' profits under IFRS 17 as profits are smoothed over the life of the policies. The impact of this will be dependent on the transition approach followed, to the extent that this drives the size of the CSM on transition.
- **Unit of account** – The modified retrospective and fair value approaches allow companies to group annual cohorts of business where necessary, which could result in a significantly higher level unit of account than under a fully retrospective approach. This has the potential to absorb volatility in the future results whereas the CSM for individual cohorts may have been extinguished.
- **Onerous contracts** – Contracts that would be considered onerous under a retrospective method may have a CSM under a fair value approach as an acquirer would expect to earn a profit margin.
- **Reinsurance** – Reinsurance contracts could follow a different transition approach to the underlying contracts, with financial mismatches arising from this.
- **New business** – The transition approach taken may result in differences between the future profitability of the in-force book compared to new business under the standard.
- **Tax** – If local tax rules do not adjust for the 'lost ' and 'recycled ' profits, the same profits could be taxed again. Many tax codes do contain adjustments for this but they may cause (for example) the entire transitional difference to be tax-effected at once, which can lead to adverse tax consequences. For example, some jurisdictions put a time bar on the use of losses. It is critical to articulate the outcomes to tax authorities at an early stage so that they can consider whether to amend tax legislation locally.

Challenges of a fully retrospective approach

Although the standard requires that every reasonable effort is made to apply IFRS 17 retrospectively, the IASB acknowledged that the assessments required meant this would often be impracticable (as defined in IAS 8).

We have seen companies start to encounter a number of issues as they assess the ability to perform retrospective calculations. These mainly relate to the availability of historic data, both actuarial and accounting, and valuation models that are able to use that data.

Completeness of data is a major issue. The retrospective calculation of a CSM under IFRS 17 requires data that companies have often not needed to retain in the past – such as initial premiums on single premium products, acquisition cash flows, and historic assumption sets – and some companies are finding this data now does not exist.

The granularity of data required poses another challenge under IFRS 17. The definition of a unit of account means that the data for a fully retrospective calculation is required not just at a portfolio level (i.e. for policies facing similar risks that are managed together), but specifically for groups of contracts issued within the same year and in the same group of profitability (as defined by paragraph 16 of the standard). In many cases data was never stored at this level of granularity – particularly in the case of actual (cash) movements – and new assessments of historic data may be required.

Even if data is found to be available, there are often problems faced in the ability to use that data to calculate a CSM. Significant level of actuarial model development across the industry means that companies are often finding that their existing valuation systems are now not able to process this data, unless they undertake extensive further development specifically for this purpose.

The issue of hindsight is another challenge of a fully retrospective approach. Retrospective application is impracticable if it is impossible to calculate estimates at historic dates without the use of hindsight. As companies develop accounting policies on areas of significant judgement, such as the calculation of the risk adjustment or liquidity premium in the discount rate, they must then consider the ability to apply these retrospectively, based only on the circumstances that existed at the point of recognition.

In addition, there are a number of issues that could give rise to differences between group accounts and those for subsidiaries preparing IFRS 17 accounts for local purposes, including:

- The requirement to build up the retrospective calculation of the CSM at each interim reporting date (where this takes place at a group level).
- Expenses may be different in the subsidiary and group accounts if there is a profit margin on intergroup transactions.
- The implications of internal reinsurance – potentially resulting in a different CSM at group level than the aggregation of individual entities.

Use of a fair value approach

The fair value approach has an immediate appeal in that it is undoubtedly the least burdensome from an operational perspective. Providing a fully retrospective approach is impracticable, it requires no historic data or retrospective tracking of the CSM. However, companies are finding that this method is not without its challenges.

It is a heavily judgement-based approach, and there is no consensus throughout industry on exactly how to calculate the fair value for insurance liabilities in line with IFRS 13 requirements. Although not a new concept, the implications of the calibration of fair value under IFRS 17 have brought it new focus. There are a range of approaches being considered, but the common challenge faced is how to calibrate the method used. With relatively limited market transaction data available to directly calibrate a fair value, many companies are looking to leverage existing information where possible – whether that is existing reporting metrics (such as Solvency II or Embedded Value), their own historic data on acquisitions or sales, or pricing information.

Additional challenges can arise here when it comes to reinsurance – since most existing valuation methods tend to focus on the net position, whereas IFRS 17 will require a fair value to be calculated separately for the gross and reinsured liabilities.

There are also risks around this approach. As the fair value will ultimately need to be calculated at the transition date, any estimate of the impact of using fair value is exposed to the risk of changes in market conditions – in particular large transactions occurring in the market between now and this date may change the view of fair value.

In addition to the challenge of calculating a fair value, the financial implications can be a major issue. Many companies are testing this approach through impact assessment exercises and questioning whether the level of CSM calculated gives a financially acceptable result – either compared to current accounting, or to new business under the new accounting standard.

Is a modified retrospective approach the answer?

For contracts under the general model, the modified retrospective approach can offer some relief through specific modifications where these are required. For example, where it is not possible to calculate the necessary adjustments to the CSM after initial recognition, the modified approach allows for a simpler method to be used to roll this forward to the transition date.

In addition, modifications enable companies to base the risk adjustment or discount rate calculation on data available at the transition date. This may help those currently tackling the issue of how to define these areas of methodology in a way that avoids hindsight in a retrospective calculation.

For contracts under the variable fee approach, the modified retrospective calculation is more prescribed, making use of historic actual data. We are seeing this approach being increasingly considered for UK with-profits business. This is an area of business where retrospective calculations of liabilities have been required for many years, and the data required for a modified retrospective calculation of the CSM is seen as less onerous than for other products under the VFA.

However, some companies are finding the prescribed approach for VFA contracts to be a constraint. For example, the option to follow a modified approach solely for the retrospective calculation of the risk adjustment is available under the general model, but not under the variable fee approach – with some feeling they are facing an 'all or nothing' decision.

Overall, the main issues we have seen from companies concern what is not available under the modified retrospective approach. The modifications permitted are limited to the specific methods set out in the standard, and do not allow companies to use other simplified approaches that they believe may best approximate the CSM.

In addition, a common challenge we have seen under the modified approach is the availability of actual historic data to calculate the CSM or subsequent adjustments (for example acquisition cash flows, or data on charges at the level of granularity required). This is an issue that the modified approach is unable to resolve, and is causing some to look towards a fair value approach.

IASB consideration of industry concerns and challenges

A number of concerns have been raised by industry groups, including the Insurance CFO Forum and the European Financial Reporting Advisory Group (EFRAG). EFRAG communicated a list of issues to the IASB in September 2018, highlighting areas which 'merit further consideration'. This included *'the extent of relief offered by modified retrospective approach and the challenges in applying the fair value approach'*.

The IASB has been monitoring the concerns raised, and in their meeting on 24-25 October 2018, agreed the criteria for evaluating possible amendments to IFRS 17. The Board noted that the criteria set a high hurdle for change, and any amendments suggested would need to be narrow in scope and deliberated quickly to avoid significant delays in the effective date. In the coming months, the Board will discuss whether any amendments to IFRS 17 are justified. If the Board decides to amend the standard, any amendments would be subject to due process for amendments to IFRS standards, including developing an exposure draft and subsequent consultation period.

The staff brought to the Board's attention 25 topics identified as concerns and implementation challenges. The following related to transition:

- Some investors and analysts are concerned at the availability of options.
- The modified retrospective approach does not provide enough modifications.
- In applying the fair value approach on transition the amount taken to OCI on transition as nil should be extended to financial assets measured at fair value through OCI.

Companies will need to monitor these developments as the impact on IFRS 17 and its effective date are unclear.

Tax implications

As companies get to grips with the technical interpretation of the standard, while assessing which transition approaches are feasible or preferred, it is important to consider the tax implications. It is even more important to consider this aspect at an early stage because it will help companies to articulate the potential tax impacts to tax authorities in the UK and elsewhere, who may be considering legislative change to accompany the change in accounting policy. Even if numbers cannot be predicted accurately, direction of travel is likely to be helpful.

For example, some life companies may experience claw-back of historic profits on transition, which would under the UK's tax code give rise to a loss equal to the transitional adjustment in the tax return in the year in which the standard is implemented. If the loss is sizeable and cannot be fully carried back (12 months) or offset in year, the UK's loss restriction rules will apply and restrict its offset to 50% of profits each year. Companies in that position may wish to make a case for amendments to tax law to achieve a more neutral result.

This is just one example. In some countries there are restrictions on how long losses can be carried forward if unutilised; if the tax authority was unwilling or unable to change the rules, such companies might prefer to choose a transitional option which gives rise to a lower loss.

It should also be noted that normally tax is derived from the entity statutory accounts, and not the consolidated accounts. This means that looking at the overall transitional impact at consolidated level is unlikely to provide the tax impact at entity level. Individual entities will often have a mixture of business, and the impact on the entity as a whole must be considered for tax, not just one product group and not only the business subject to IFRS 17 (e.g. investment business will also be yielding tax results in the same entity).

Some groups may consider that it is too early to consider tax. We are however aware that discussions have commenced between industry representative bodies and the tax authorities in a number of jurisdictions, and HMRC in the UK announced the intention in the budget to commence an informal consultation on tax changes to be introduced into Finance Bill 2019/2020. Whilst it is possible that this timetable may flex if the standard is deferred, it shows that the lead time for legislative change (and competition for legislative Bill space) indicates that tax should be considered early if groups want to make their voice heard on this.

So what should you do?

When it comes to transition to IFRS 17, there are a number of one-off decisions, judgements and potential investments to be made – with significant financial implications for the future. Though the range of options and number of inter-dependencies can be daunting, there are a number of clear steps that can be taken to progress plans on transition.

1. **Define key accounting policies**
   Transition-specific policies will need to be defined – such as a methodology for defining fair value (assuming this approach is to be used for some portfolios). However, the feasibility and financial impact of different transition approaches will vary.
2. **Begin collecting data for new business written**
   The type and granular of data required may depend on the (non-transition specific) accounting policies set – e.g. the methodology defined for calculating the risk adjustment.
3. **Assess the availability and usability of data (without hindsight) to determine where a fully retrospective approach is impracticable**
   There is a significant data-driven element to the approach to take to transition, as well as considering the process in which this can be used – is the data compatible with the end-state system environment, or will a stand-alone solution be needed?
4. **Compare the expected financial impacts of different options**
   Whether it is through company-wide impact assessments or targeted testing of portfolios, indicative financial impacts are required in order to take informed decisions. Financial impacts are also required to inform lobbying in relation to tax.
5. **Engage auditors on key judgements to avoid wasted investment**
   Given the level of effort that will be invested, early engagement with auditors is essential to ensure successful implementation of a permissible approach.

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