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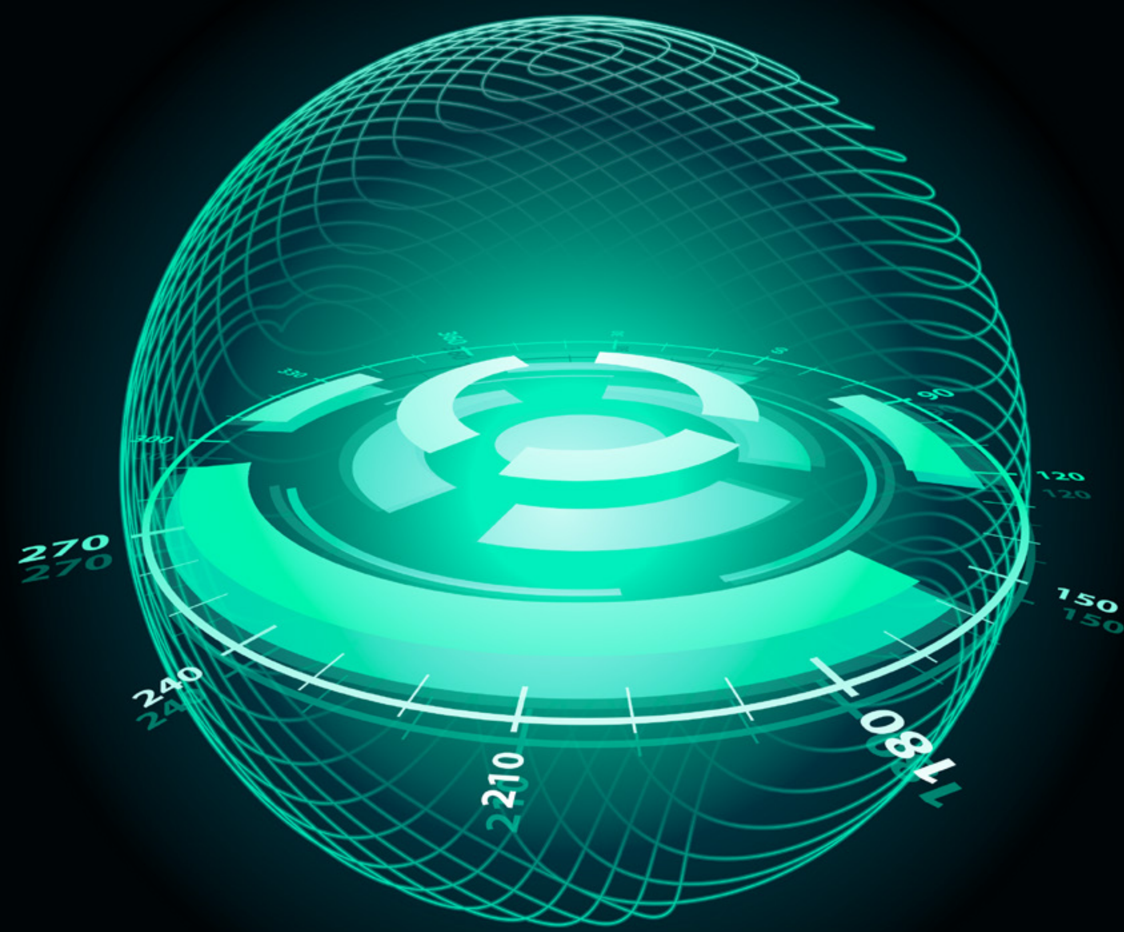
Understanding a more complete IFRS 17 picture



South African Insurance Outlook 2021 | Navigating the insurance landscape

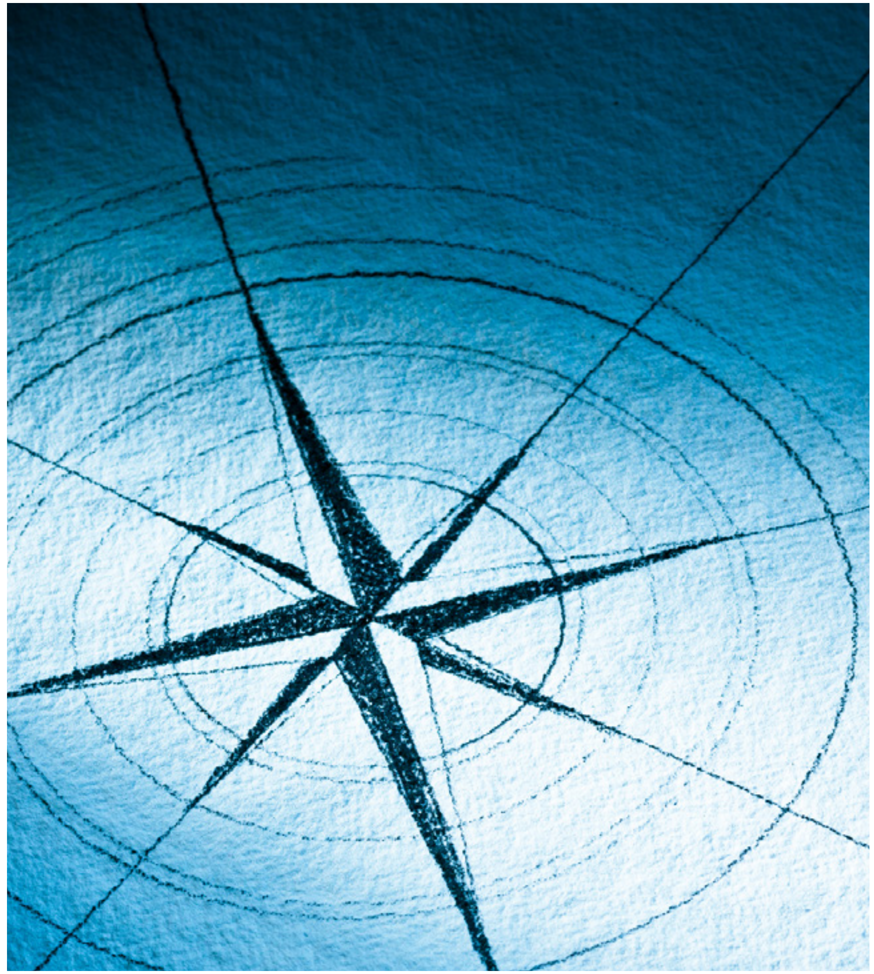
Understanding a more complete IFRS 17 picture

This introductory article is the first edition in a series of articles exploring the implications of IFRS 17 on the business functions and capabilities of an insurer outside of financial reporting. Each subsequent article will focus on specific topics contemplated in this article, so that the relevant stakeholders can consider the implications of IFRS 17 within their domain. This edition introduces the key functions and capabilities that are likely to be impacted and outlines the crucial steps to accelerating the IFRS 17 transition across the insurer.

The new international financial reporting standard for insurance contracts, IFRS 17, was published in May 2017. At that time the effective date of the standard was set to be 1 January 2021. Had the original timelines been maintained, the standard would already have been in effect for a number of months as at the date of this article. Insurers with 31 December year ends would be running their financial processes and operations under the requirements of the new standard.

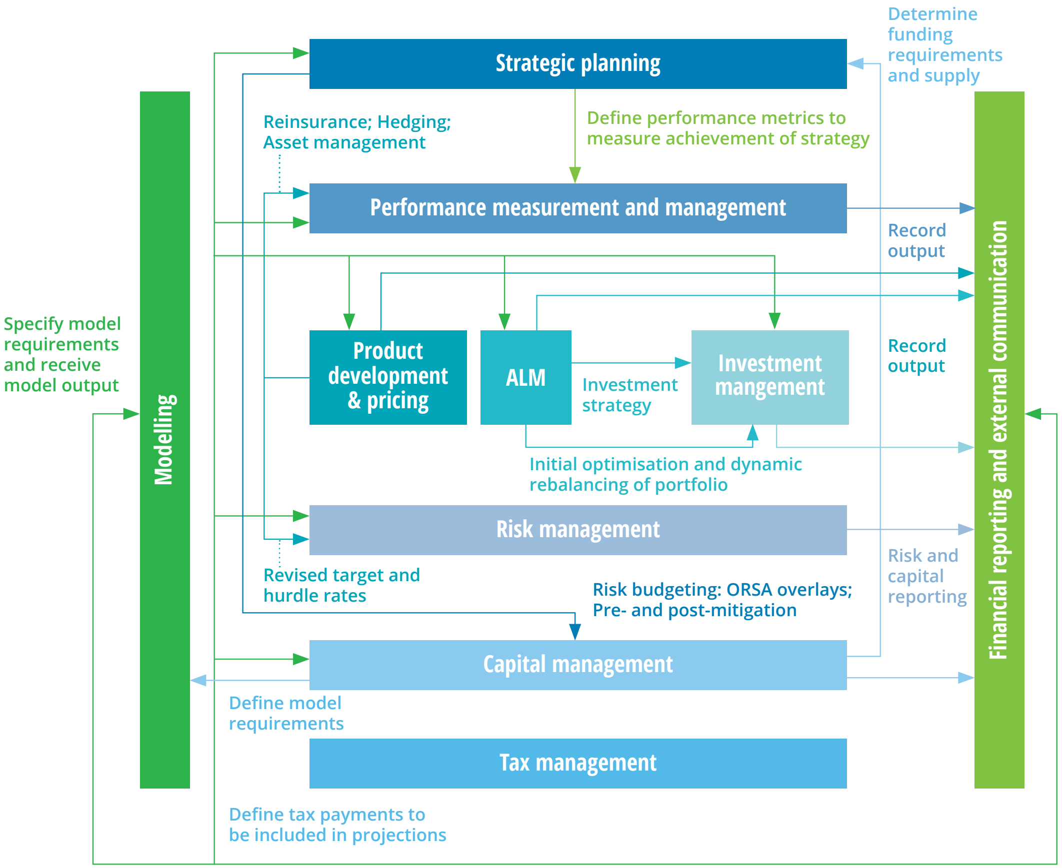
This original timeline was ambitious, given that most insurers are still busy with their implementation. Even with the two years of additional implementation time, the industry, locally and globally, is still struggling to ensure that their programmes will meet the revised timelines. As such, the key focus of most programmes has been to ensure that they achieve the primary objective of the standard, namely the production of financial statements that are consistent with the requirements of the standard.

However, while this objective is critical, there are other areas where insurers' IFRS 17 programmes need to start focusing their efforts. These are predominantly in the realms of the business operations where IFRS metrics are used in decision-making. It is therefore critical that an insurer has a clear view of where IFRS 4 metrics are currently used across the business, to monitor, measure and report on financial position and performance, and how the latter will evolve under IFRS 17.



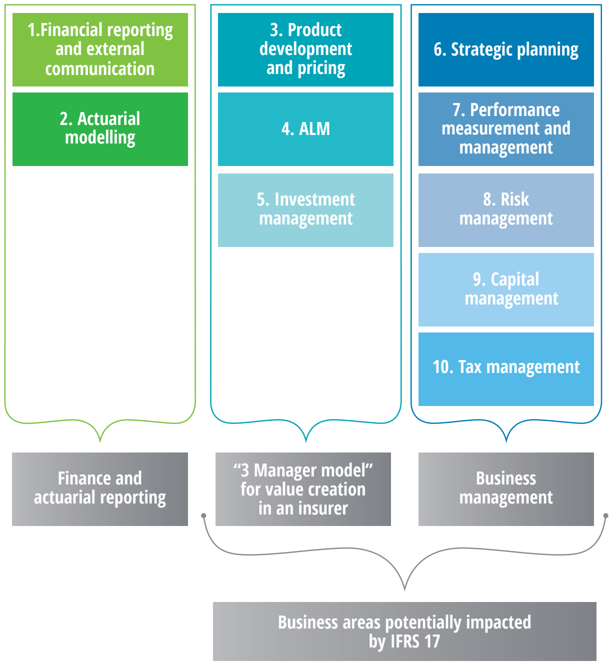
A simplified operating model for an insurer

To assess the areas where changes to IFRS reporting metrics might have an impact on an insurer, we outline a simplified operational model that illustrates core functions of an insurance company. This diagram below shows the core areas of this operating model.



1. Financial reporting and external communication	Govern and run the financial reporting processes to produce IFRS compliant financial statements and required performance metrics for the business.
2. Modelling	Govern and run projection and other mathematical models required to project and discount contract and business cashflows and provide other calculations needed for financial and regulatory reporting, and performance and risk management and reporting.
3. Product development and pricing	Design, development and administration (including recording of sufficient information for financial reporting) of insurance products which create liabilities on the insurance balance sheet. Management of non-investment risk.
4. ALM	Identification and management of asset/liability risk. Hedged or manage this risk in line with, primarily, the investment risk appetite.
5. Investment management	Responsible for the implementation of the investment mandates for both shareholder and policyholder portfolios. Investment management must allow for the investment mandates imposed by the various bases. Govern and run the administration of information necessary to support investment management.
6. Strategic planning	Respond to internal and external opportunities and risks to make and implement strategic choices available to the organisation in line with shareholder value creation, informed to some extent by IFRS earnings expectations.
7. Performance measurement and management	Define and manage metrics that the insurer will use to ensure targeting of an appropriate return/profit requirement. Determine and manage the performance of the business units across required dimensions.
8. Risk management	Support businesses in identifying key drivers that underpin volatility of the balance sheet and income statement. Identify implication earning metrics on risk management techniques. Implement appropriate non-financial risk management strategies (incl. reinsurance) to manage earning volatility within appropriate levels. Manage and administer reinsurance agreements.
9. Capital management	Manage capital position of insurer for both regulatory and economic purposes.
10. Tax management	Manage the determination and payment, as well as ensure appropriate reporting of the various tax obligations of the insurance company.

The **modelling** and the **financial reporting and external communication** capabilities on either side of the diagram are core to the production of performance metrics, both internal and external. It is in these areas that insurers' IFRS 17 programmes are currently focusing their efforts.



The diagram above is a more simplified version of this framework. The right two columns of this show the core business functions of an insurance business, where we see insurers could (or should) be using elements of the new IFRS 17 reporting standard to inform and enhance decision-making.

Starting in the middle, we have used a "three manager model" to separate out the core areas of value creation in insurers. These are :

1. **Liability origination/generation:** product production and distribution and pricing of non-financial risk
2. **Asset Liability Management (ALM):** pricing of financial risk and asset/liability management; and
3. **Investment management:** generation of investment returns

In certain companies these functions are combined.

In these functions we see the following potential impact of the change to IFRS 17:

- Product pricing and underwriting functions may need to allow for the new IFRS 17 metrics and product classification if IFRS is, or becomes, a core performance metric for the company
- Insurance financing results in the income statement, IFRS 17 gives users of financial statements more insight on asset/liability management. Insurers will need to explain these results. This is much more relevant for life insurers than short-term insurers, given the nature of the products and balance sheets.

Looking at the **strategic planning** and **performance management** capabilities, in particular for listed insurance companies, the key impact will be on the IFRS investor story. Many insurers are still waiting to see the first estimates of their transitional balance sheets and the forecast IFRS 17 revenue and profits of their existing business. There are choices available to insurers, in determining initial CSM and subsequent amortisation pattern of the CSM. We see that there will be a balancing act to achieve a targeted Return on IFRS Equity (RoE), by maximising the CSM at transition, and more sustainable IFRS earning growth, where we expect new business with lower margins replacing the older generations of products. Insurers will also need to look at refining their strategic planning models to forecast and stress-test their IFRS earning results under the new standard.

Insurers are also starting to look at IFRS performance metrics currently used in their performance management frameworks. For some there will be no significant changes in the metrics between IFRS 4 and IFRS 17. However the IFRS 17 system changes may impact the production of management information. This is an area where some insurers are yet to consider the implications on their IFRS 17 programme.

For others we expect changes to the revenue and profitability metrics under IFSR 17. We see the needs for a rethink of the IFRS metrics that might be contained in, for example, long- and short-term incentive plans, and a transition to new IFRS 17 metrics and targets.

Where IFRS volatility is considered in an insurer's **risk management** framework, and where IFRS earnings informs an insurer's dividend policy, and subsequent **capital management** framework, the impact of IFRS 17 will need to be considered. This will require both a better understanding of how IFRS 17 earnings are expected to emerge under different scenarios in the future, and also how the data sources of IFRS metrics into these functions will change once the new IFRS 17 data platforms and systems have been implemented.

And finally, while still uncertain, the implications of IFRS 17 on determining and reporting of **tax** need to be considered

Next steps for an insurer

Moving the focus of an IFRS 17 programmes from "the production of IFRS 17 financial reports" to "IFRS 17 enhanced Management Information (MI) for decision-making", means that insurers will need to be more deliberate when it comes to ensuring that the impact of IFRS 17 across their business is appreciated and addressed.

We see 5 key steps for an insurer to prioritise in their IFRS 17 programmes:

1. Build an IFRS 4 Inventory

Insurers need to obtain an inventory of where IFRS, in particular IFRS 4, is currently used in any business decision-making processes. This will provide a starting point for insurers to gain an appreciation of current applications, data sources, processes and relevant impacted stakeholders are. The IFRS 4 inventory would likely include elements such as:

Strategic planning

- Pricing environment relationship to IFRS 4 outcomes

Performance measurement and management

- KPIs targeting current IFRS earnings, insurance result/ change in actuarial liability, etc

Risk management

- Areas which drive volatility in their IFRS income statement and balance sheet.
- The relationship and reconciliation between the IFRS and SAM metrics.

Capital management

- IFRS-driven capital allocation decisions

2. Identify supporting data and systems

Insurers should prepare a current state view of the data and systems environments that support the use of the IFRS 4 metrics. These may be ledgers and/or sub-ledgers from which information is extracted, but also proxy or forecast models where estimated IFRS 4 metrics are projected or used in calculating a subsequent measure (for example performance triggers). This step also involves an understanding of the sequencing of data feeds and surrounding data governance.

3. Identify and engage with impacted stakeholders

In addition to the systems and data view, the IFRS 17 programme will need to identify and engage with stakeholders who currently use IFRS 4 in their functions. They will need to understand how the information contained in the IFRS 4 metrics is used by the relevant stakeholders. This is key in ensuring that all relevant stakeholders are identified for the IFRS 17 change management programme and an equivalent IFRS 17 metric is identified that addresses the needs of those stakeholders. Both internal and external stakeholders should be considered.

4. Create IFRS 17 awareness and or education of IFRS metrics

Key users of IFRS 4 information will need to educate stakeholders on the implications of IFRS 17 for their function. These sessions also need to explore the following aspects:

- How the IFRS 17 metrics are expected to behave relative to existing IFRS 4 and other metrics
- Areas where there is no suitable replacement for the IFRS 4 metric, and a parallel reporting capability will need to be retained, and
- Whether IFRS 17 provides new/additional information that the stakeholders can use to address their needs.

These aspects will need to be addressed in the IFRS 17 change management plan.

5. Build appropriate actions into the IFRS 17 Programme

Insurers should then use the outcome of the above steps to design the future business and operating model, in order to address the requirements of all the users of IFRS 17 metrics in the core business functions/ capabilities, to ensure that:

a) Systems and data; and

b) People and processes are aligned with the changes in the overall financial reporting/record to report and modelling capabilities of the insurer.

Conclusion

IFRS 17 was always going to have a significant impact on the actuarial modelling and financial reporting functions in an insurer. The data, systems, processes and people implications are now much better understood, and most insurers are well underway to be ready to produce their first sets of IFRS 17 financial statements in 2023.

However, we believe that now is the time for the IFRS 17 programmes to look beyond external reporting and to the business operations of the insurer that rely on IFRS 4 metrics to make appropriate business decisions, and bring these elements of change required into their programme.

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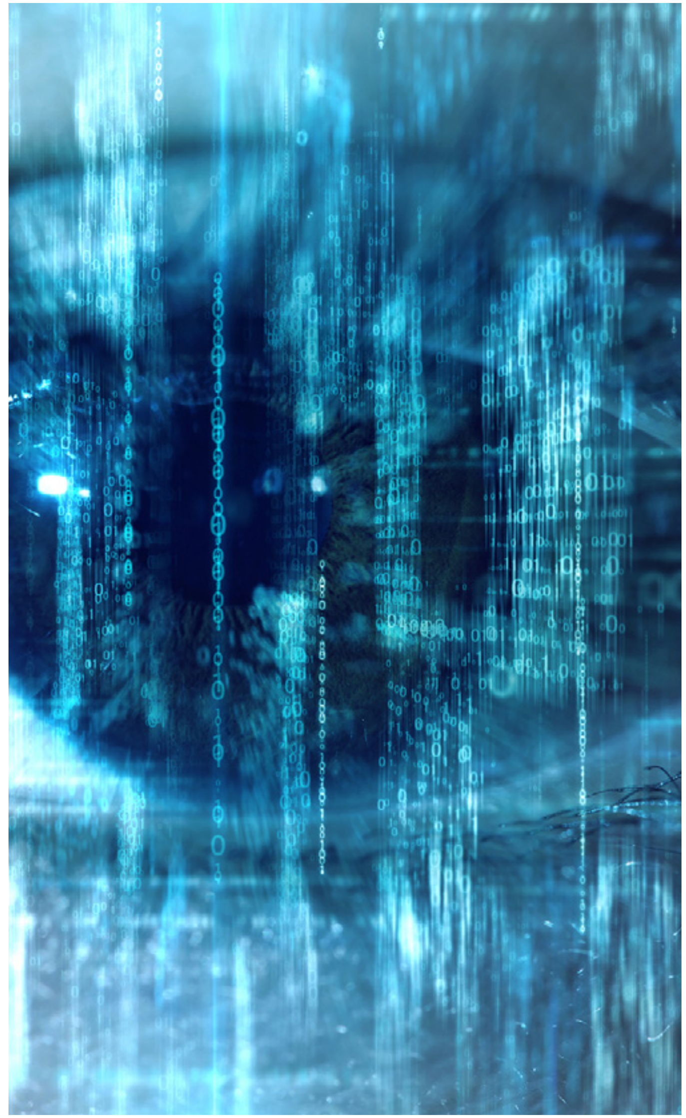

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