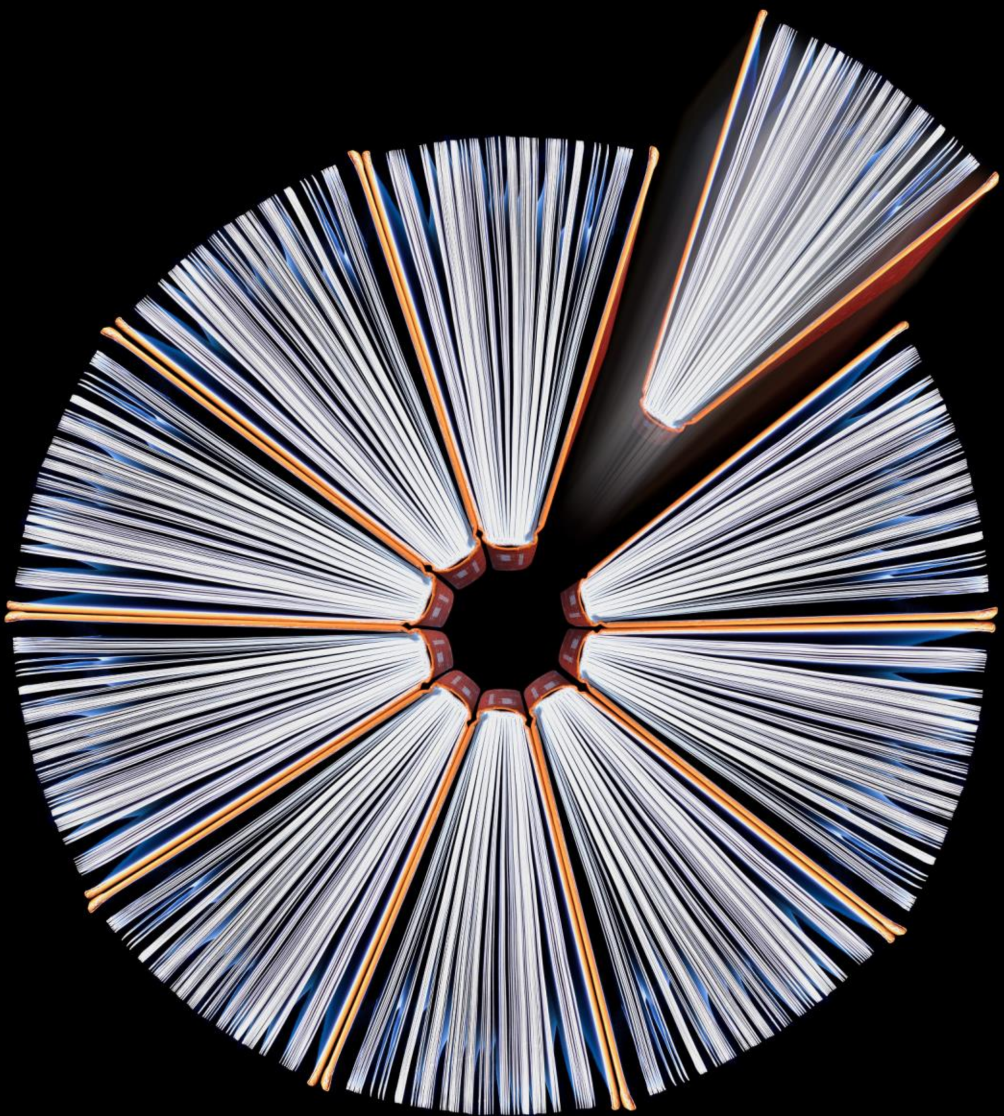

IFRS 17 in KSA

Observations and Implementation Insights

MAKING AN IMPACT THAT MATTERS since 1845

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Introduction to IFRS 17 and its implications for insurance entities

The transition to International Financial Reporting Standard 17 (IFRS 17), marks a new era in the insurance industry.

With a focus on improved transparency, comparability and consistency, insurance entities have undergone through a major transformation phase to meet these objectives. This transition has presented its fair share of challenges, with the regulatory authorities adopting a leading role in shaping the new financial reporting landscape, ensuring compliance and consistency amongst the insurance entities operating in the Kingdom.

The new standard introduces a restructured framework for the presentation of the Financial Statements, where the recognition of revenue and expenses arising from the provision of insurance coverage, is spread over the duration of the contracts. It also provides specific guidance for the reflection of timing and uncertainty of the cash flows. IFRS 17 introduces a measurement model that significantly differs from the preceding IFRS 4 standard, while also allowing the adoption of a simplified model under specific conditions. Finally, it mandates the application of a variation from the general model for contracts exhibiting certain investment like characteristics.

Maintaining extensive and detailed data records poses one of the primary challenges for insurance entities under the new standard. The extent, quality and availability of historical information highly influences the transition approach which in turn affects the transition impact, while for the post-transition phase, the enrichment of data tracking is imperative. Furthermore, the substantial changes in measurement and presentation of the financial results, compared to the previous accounting standard, necessitate the formulation of updated performance indicators to facilitate financial assessments and decision-making processes by the relevant stakeholders.

The implementation of IFRS 17 marks a significant milestone in the insurance industry. Regulatory authorities in the Kingdom have proactively established a comprehensive implementation plan, ensuring high degree of understanding of the principles outlined in the standard and promoting an effective and smooth transition. The timely adoption of IFRS 17 in the Kingdom is highly driven by these efforts. Shifting to IFRS 17 has also boosted regulatory efforts towards the transformation and advancement of the insurance industry, by triggering a wave of mergers and acquisitions and building strong foundations for the enhancement of the solvency supervision and financial planning.

Regulatory framework for IFRS 17 adoption in KSA

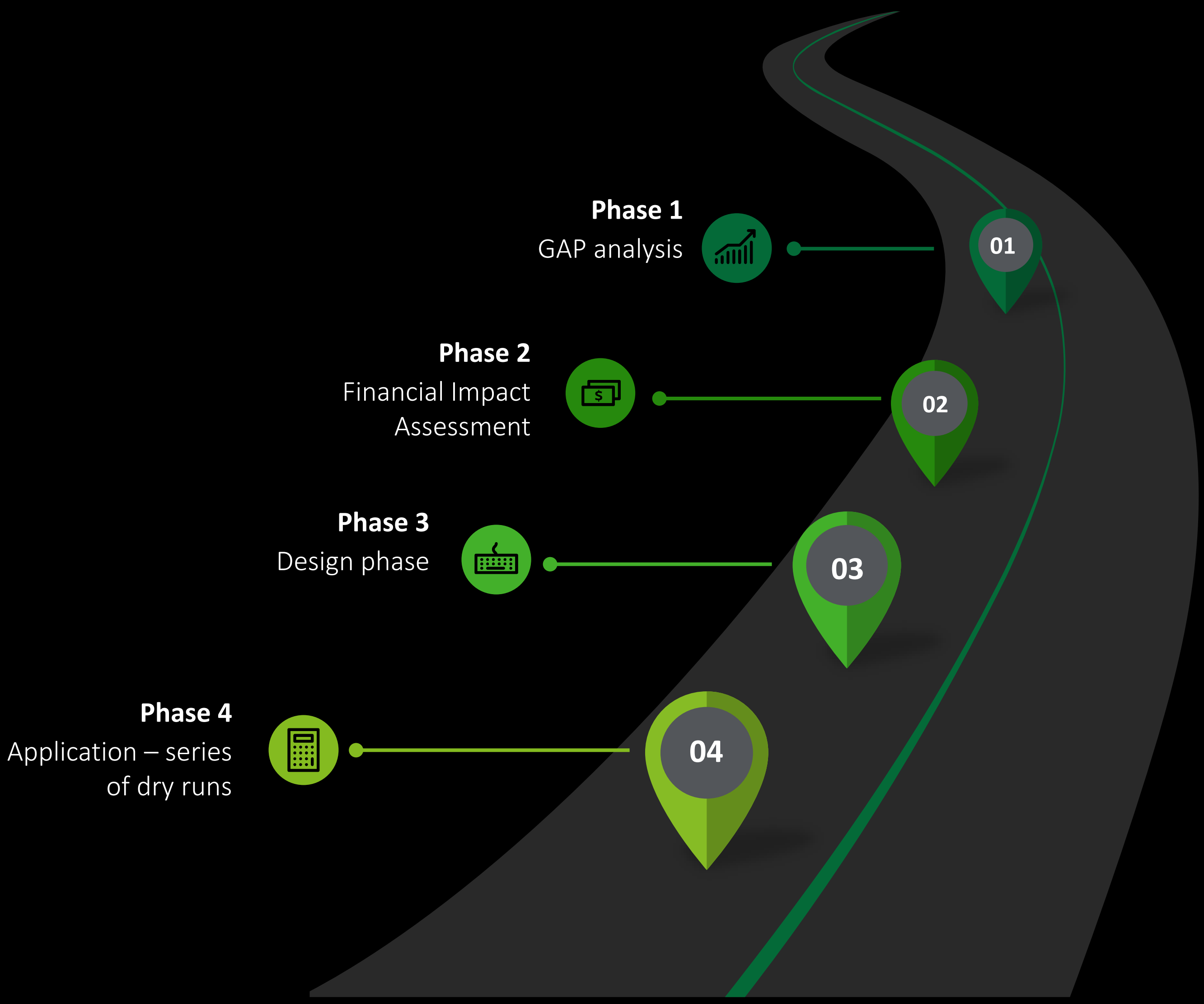
The lengthy and demanding project for the adoption of IFRS 17 has been under the supervision of Saudi Central Bank (SAMA).

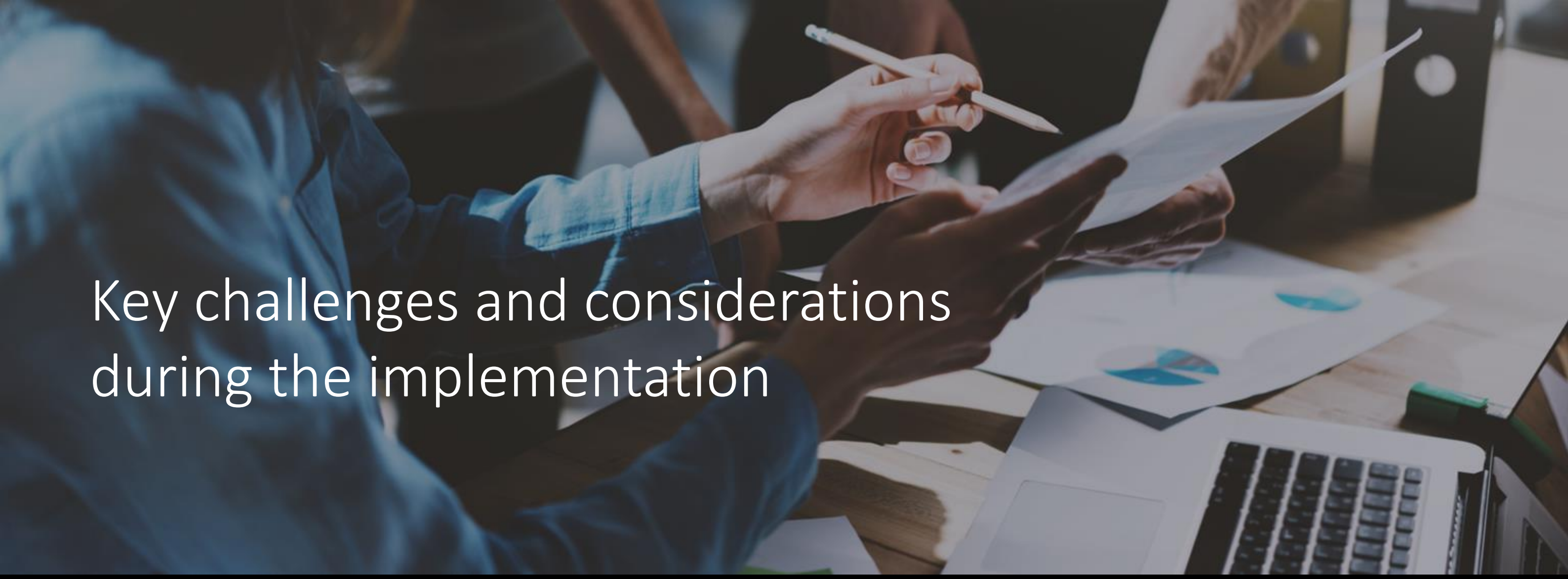
Regulatory authorities have launched an Implementation Road Map as early as in December 2018, with the four-year long journey reaching a conclusion in 2022 with the completion of the third and final dry-run exercise. As of January 2023, the new standard is effective, with the first quarter marking the first official preparation of the Financial Statements under IFRS 17.

To ensure a gradual adoption, the plan was divided in four phases. The initial stage focused on identifying gaps and areas where significant changes will be required, while the second stage involved a quantitative element with the Financial Impact Assessment. With the target of building awareness about the standard and understanding potential complexities, these two phases enabled insurers to grasp the basic concepts of IFRS 17 and start thinking about the optimization of the implementation. Of crucial importance was the next phase of the plan as it would determine the whole direction of the implementation project for each entity. Technical papers analyzing the concepts introduced in IFRS 17, thorough investigations on alternative calculation methodologies and deep analysis on the available accounting choices constituted this phase. The completion of this stage allowed entities to establish a clear vision of the end-state, positioning them to guide the system implementations to align with their decisions. The fourth and final stage, involved a series of dry runs, where insurers were asked to prepare IFRS 17 Financial Statements and disclosures. Chief Financial Officers, Appointed Actuaries, audit committees and other stakeholders have been requested to examine the output of each dry run exercise, with the aim of achieving full compliance and consistency with the choices made during the previous phase.

For the supervision and support to insurance entities throughout this challenging project, SAMA had engaged with experts and other stakeholders from consultancies and insurance entities. The working group formed, had regular meetings discussing the complex aspects of the standard and specific characteristics relevant to the KSA market, offering guidance to achieve consensus and transparency. Leveraging the expertise of the working group, SAMA prepared roll forward templates and other forms to be completed by insurers at each valuation, facilitating supervision and enhancing comparisons. The involvement of the external auditors was also crucial in reviewing the results of the second dry run exercise serving two purposes: ensuring compliance and reducing the workload for the first official external audit, since the second dry run involved the preparation of the transition Balance Sheet which is disclosed for comparative purposes.

SAMA has been proactive in educating the market about the standard and creating a favorable environment for a seamless transition. As of January 2023, IFRS 17 has become effective, with the results of the first quarter marking the first official publication under the new standard.





Key challenges and considerations during the implementation

The implementation of IFRS 17 has introduced numerous challenges to the insurance market.

Insurance entities have worked intensively to overcome these challenges and achieve the optimal results for their organizations.

Level of aggregation

One of the major differences compared to the previous standard is the level of aggregation required under IFRS 17. The measurement of the liabilities of insurance contracts, must be performed at a much more granular level, involving three parameters: portfolio, cohort, and profitability. The industry was familiar with the split into portfolios which is based on the types of risks covered under the contracts, however the split into cohorts and profitability groups was something new. According to the standard, entities must split the contracts based on their underwriting date – cohort classification, and according to the expected profitability levels – profitability groups, with specific guidance and requirements on the splits. The increased volume of calculations required called for system updates as the existing processes had limited capacity.

Measurement models

The new standard suggests a default model – General Measurement Model (GMM), a simplified model – Premium Allocation Approach (PAA) and a modification for participating contracts – Variable Fee Approach (VFA). KSA insurance industry is dominated by the Medical and Motor sectors and while the measurement using the GMM involves many complexities, the short-term nature of these lines implies that most products are eligible for the simplified model. Even though the application of the PAA avoids some of the major complications embedded in the other two approaches, its application comes with several challenges as well. Entities must demonstrate that the liabilities are not materially different than those measured under the GMM, whereas in cases where the business is loss-making, an additional liability must be established, the measurement of which requires the application of the GMM.

Contractual Service Margin

A primary objective of IFRS 17 is to achieve more accurate revenue recognition with the expected profits being split throughout the duration of the contracts. The Contractual Service Margin (CSM) tracks the expected profitability of each group of contracts, and its determination requires advanced actuarial modelling techniques and data management capabilities. Insurers are also required to identify and quantify the impact from developments affecting future profitability and reflect their impact on the CSM. Accurately measuring the CSM also poses significant operational and technological challenges as the level of information needed increases exponentially.

Loss Component

Opposed to the profit recognition, which needs to be spread throughout the duration of the contracts, any losses expected to arise, must be reflected immediately in the profitability. This difference in the treatment of profits and losses, reduces the room for cross subsidies between the profitable and loss-making business, while at the same time creates several complications in cases where the profitability status changes in subsequent periods.

Risk Adjustment

Another new concept introduced by IFRS 17 is the Risk Adjustment (RA), which replaces the prudency included in the actuarial reserves as calculated under IFRS 4. Under the new standard, the liabilities must be estimated using realistic assumptions, free from any margins. The additional buffer which would increase the confidence that the insurance obligations will be met, should be explicitly estimated, and reported. As a principle-based accounting standard, IFRS 17 does not prescribe the methodology for the quantification of the risk adjustment, but it rather provides guidance of the properties that the selected approach should satisfy. Given this flexibility, insurers have established numerous methodologies involving a wide spectrum of sophistication, imposing an additional challenge on the consistency and comparability across the industry.

Yield Curves

Under IFRS 17, insurance entities need to use interest rates for valuing insurance liabilities. The process of setting up the required yield curves can be complex as the pattern of interest rates may vary depending on factors like time, currency, and credit risk. To comply with the requirements of the standard, insurers must establish the curves in alignment with the characteristics of the insurance contracts. This exercise requires expertise in financial modelling, understanding of the interest rate dynamics, and access to reliable data sources.

Transition impact

The quantification of the transition impact is arguably one of the biggest challenges insurers had to face during the transition period. The direction of this exercise was heavily influenced by the availability and quality of historical data and assumptions. Insurers are required to establish the IFRS 17 Balance Sheet as at the transition date – 1st of January 2022, assuming that IFRS 17 has always been in place. This implies running the calculations since the inception of the earliest contracts, which in some cases was not possible due to the limited information kept historically. In those instances, the standard allows the use of two alternative approaches for the transition, which although simpler and less data intensive, involve several difficulties.

KSA specific parameters

The KSA insurance industry contains some specific characteristics which are not common in other countries. The application of IFRS 17 on those components imposes additional challenges, since there are limited resources addressing those factors, and thus SAMA has played a vital role in shaping the framework for their treatment. Some of these components are the surplus distribution to the policyholders, the Takaful business model, and the operation of certain types of insurance pools. Furthermore, SAMA has encouraged several mergers and acquisitions with the ambition of establishing a stronger insurance market. The measurement of insurance liabilities under IFRS 17 following a transfer of contracts or a business combination, requires specific treatment.

Other considerations

Implementing IFRS 17 led to the revision of several studies and the reassessment of methodologies employed. A more detailed expense exercise and allocation mechanism is required as the new standard sets new expense classes. The actuarial reserves which were traditionally calculated with reference to the accident date of each claim, will now have to be quoted in relation to the underwriting date of each contract. The new disclosures mandated by the standard require a more granular split of the service provided between past, current, and future service, making the exercise data intensive. The parallel adoption of IFRS9 by the insurance industry has also increased the pressure to the insurance finance departments and managers. Finally, the transition to IFRS 17 triggered a demanding reconciliation exercise against the previous standard, which was hindered by the inconsistencies in the reporting requirements.

The transition to IFRS 17 poses significant challenges and requires careful consideration for insurance entities. The guidance and supervision from SAMA throughout this transition period, along with the development of advanced data management systems and effective collaboration between accounting and actuarial teams was crucial for navigating the complexities and achieving compliance.

Lessons learned from IFRS 17 implementations

Successfully implementing IFRS 17 and optimizing the accounting policy choices is critical for the financial stability of insurance entities.

Considering the complications involved, this task is far from being straightforward. Careful planning, commitment, robust data management and effective collaboration between various stakeholders are some of the key parameters required for achieving the best results.

A main characteristic of successful implementations is the religious adherence to the implementation plans. This requires the identification of the key milestones and the assessment of the effort anticipated for each step. Since many implementations have commenced quite early, it was difficult to estimate with accuracy the effort required at each stage. As the level of awareness matured and the complexities overlooked came into the surface, there were cases where the timelines initially set started to look very tight. Insurers who managed to keep track of the implementation plans and proceeded with corrective adjustments when deemed necessary, were able to ensure a smoother transition.

A fundamental aspect consistently observed in all successful implementations is the significant improvements made in the data management systems. The standard introduces complex measurement and disclosure requirements, necessitating the availability of accurate and reliable data. Successful implementations have emphasized the need for a strong data infrastructure, accompanied with robust validation mechanisms and thus invested in enhancing technology and automation. On the other hand, insurers who chose to apply limited improvements in their data management systems, have to deal with several manual interventions and approximations.

Despite IFRS 17 being primarily an accounting standard, the significance of effective collaboration extends beyond the finance function. The data-intensive calculations necessitate the active involvement of IT departments, whereas the sophistication of the calculations amplifies the actuarial needs. Finance managers are also expected to coordinate with key stakeholders including external auditors and regulators, alongside the imperative task of effectively communicating the new concepts to shareholders. Successful implementations have been achieved by entities exhibiting strong sense of ownership and commitment on the project. This dedication has leveraged on the collective expertise of each stakeholder, leading to a cohesive and integral end result.

Enhancing actuarial models and revisiting techniques employed, is also crucial for the optimization of the financial results under the new standard. The detailed level of granularity suggested by the standard, increases materially the volume of calculations required, while the sophistication of the calculations, particularly for the contracts which do not qualify for the simplified PAA measurement model, necessitates enhancements. Insurers are faced with decisions for the length of their cohorts, the methodologies for calculating risk adjustment, the classification of expenses and many more. Each decision presents numerous alternative approaches involving varying levels of complexity and offering distinct benefits. The financial landscape shaped by the standard is dynamic and involves many interdependencies among these choices. Successful implementations have carefully evaluated these considerations and proceeded with the options that are more aligned to their specific requirements. The correlation between increased sophistication and enhanced outcomes is not always as straight forward as one might assume. It becomes evident that successful implementations often endorse simpler methodologies and consciously opt for the simplifications offered by the standard.

Effectively navigating the challenges of IFRS 17 and ensuring ongoing compliance is an enduring endeavor. Insurers must stay abreast of updates and continuously educate themselves as the standard progresses towards a more mature phase.

Key Performance Indicators from published results

The transition to IFRS 17 has profoundly transformed the financial reporting of insurance entities, demanding the establishment of new metrics for assessing performance and performing comparisons.

Upon the closure of the first quarter of 2023, insurance entities in KSA have officially prepared their financial statements under the new standard for the very first time. The published accounts contain comparatives against the restated financial results of 2022, along with details on the transition impact and the accounting choices made.

Some of the key metrics that may be used from stakeholders when assessing financial performance and strength of the insurance entities are:

KPI	Description	Formula
Insurance profit margin	Net insurance profit as a ratio on the revenue	Net insurance service result / Insurance revenue
Insurance service margin	Gross insurance profit as a ratio on the revenue	Insurance service result before reinsurance contracts held / Insurance revenue
Reinsurance recovery ratio	Ratio of the claims recoveries over the reinsurance premium	Amounts recoverable from reinsurers for incurred claims/ Allocation of reinsurance premiums paid
Loss Component ratio	Loss Component as the ratio on the total Liability for Remaining Coverage	Loss Component / Total LRC
R/I share of loss component	Share of reinsurer on the loss component	Loss recovery component / Loss component
Acquisition costs ratio	Ratio of the acquisition costs amortised in the period on the revenue	Acquisition expenses amortisation / Insurance revenue
Combined ratio	Total claims and expenses incurred as a ratio on the revenue	(Incurred claims + Insurance service expenses) / Insurance revenue
RA proportion	Risk adjustment as a ratio on the Liability of Incurred Claims	RA / LIC
R/I RA proportion	Reinsurance risk adjustment as a ratio on the Asset of Incurred Claims	Reinsurance RA / AIC
R/I to Gross BEL	Share of the reinsurer on the claims outstanding	Reinsurance total BEL / Gross total BEL
R/I to Gross RA	Share of the reinsurer on the risk adjustment	Reinsurance RA / Gross RA
R/I to Gross LIC	Share of the reinsurer on the LIC	AIC / LIC

The return on equity (ROE) is a conventional indicator employed to assess a company's profitability and efficiency as perceived by its shareholders. Upon transitioning to IFRS 17, insurers may need to reformulate this ratio. The definition proposed, accounts for the inclusion of risk adjustment and CSM in equity, as these components relate to embedded profits and risk premium that would flow into the equity over time. Variations in the ratio can be analyzed by excluding the impacts of movements in the Other Comprehensive Income (OCI).

$$ROE = \frac{Underwriting\ Profit +\ \Delta RA +\ \Delta CSM}{Equity + RA + CSM}$$

The analysis provided below, relies on the unaudited results of the two leading insurers in KSA insurance market, namely Bupa and Tawuniya, as per the publicly disclosed results in Saudi exchange. The objective of this analysis is to illustrate some of the key metrics that stakeholders may employ to evaluate the performance of insurance companies. Investors and other stakeholders should not rely on this analysis for any specific purpose and should contact their own comprehensive assessments.

Bupa

Bupa is the one of the leaders in KSA insurance market. It is a mono-line insurer, focused on providing health insurance solutions to individuals, families, and businesses.

Key accounting choices

- Measurement model: PAA for all contracts
- Insurance Acquisition cashflows: Deferred and amortized
- Yield curve: N/A – no discounting is applied
- Risk Adjustment Confidence level: 75th percentile
- Length of cohorts: Annual
- Revenue recognition: Passage of time

Transition Impact

Driver	SAR '000
Risk adjustment	-29,187
Loss component on onerous contracts	-5,830
Reinsurance risk adjustment	682
Total Impact on equity on transition to IFRS 17 on 1 January 2022	-34,335

Key Performance Indicators

The indicators below refer to the position as of 31st March 2023 for the Medical portfolio. Amounts are reported in SAR '000.

KPI	Medical
Insurance revenue	3,750,413
Gross insurance service result (Insurance service result before reinsurance contracts held)	172,014
Net insurance service result	168,483
Insurance profit margin	4.49%
Insurance service margin	4.59%
Insurance overall result (gross)	172,014
Reinsurance recovery ratio	88.27%
Reinsurance overall cost	-3,531
Insurance overall result (net)	168,483
Loss Component value	61,734
Loss Component ratio	1.41%
R/I share of loss component	N/A
Acquisition costs ratio	4.48%
Combined ratio	95.41%
RA proportion	3.85%
R/I RA proportion	3.73%
R/I to Gross BEL	1.08%
R/I to Gross RA	1.04%
R/I to Gross LIC	1.07%

Tawuniya

Tawuniya is the one of the leaders in KSA insurance market. Tawuniya operates across several insurance lines, with the biggest portion of revenue coming from the Medical portfolio (more than 75% according to the unaudited published accounts of March 2023).

Key accounting choices

- Measurement model: PAA for all contracts
- Insurance Acquisition cashflows: Deferred and amortized
- Yield curve: USD EIOPA risk-free rates plus volatility adjustment
- Risk Adjustment Confidence level: 75th percentile
- Length of cohorts: Quarterly
- Revenue recognition: Passage of time

Transition Impact

Driver	SAR '000
Explicit risk adjustment, net of reinsurance	-161,827
Increase in deferred part of insurance acquisition cash flows	125,471
Expected premium receipts adjustment	114,261
ENID, net of reinsurance	-27,327
Loss components, net of PDR and loss recovery	-69,588
Discounting of liability for incurred claims (LIC), net of reinsurance	13,885
Impact of non-performance risk provision	-16,799
Other impacts	970
Total Impact on equity on transition to IFRS 17 on 1 January 2022	-20,954

Key Performance Indicators

The indicators below refer to the position as of 31st March 2023 for the Medical portfolio only. Amounts are reported in SAR ‘000.

KPI	Medical
Insurance revenue	2,586,863
Gross insurance service result (Insurance service result before reinsurance contracts held)	119,864
Net insurance service result	126,966
Insurance profit margin	4.97%
Insurance service margin	4.63%
Insurance overall result (gross)	87,555
Reinsurance recovery ratio	123.63%
Reinsurance overall cost	-8,509
Insurance overall result (net)	96,064
Loss Component value	1,374
Loss Component ratio	0.06%
R/I share of loss component	N/A
Acquisition costs ratio	6.06%
Combined ratio	96.24%
RA proportion	6.06%
R/I RA proportion	1.91%
R/I to Gross BEL	5.45%
R/I to Gross RA	1.64%
R/I to Gross LIC	5.22%

Contact us

Want to engage?

In light of the challenges posed by IFRS 17, Deloitte has established a dedicated team comprising seasoned experts, deeply knowledgeable about the intricacies of the standard, capable of providing specialized guidance and experience-driven solutions for navigating the complexities of IFRS 17 with confidence and proficiency.

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