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FINANCIAL SERVICES

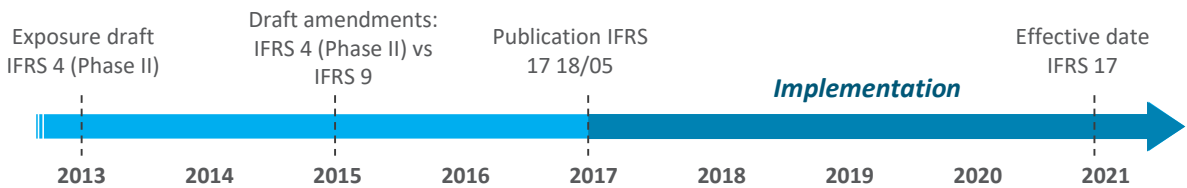
# IFRS 17: Impacts and Implementation Approach

May 2017

# Executive Summary

The International Accounting Standard Board (IASB) released on May 18th the long awaited IFRS 17 standard. This replaces the current IFRS 4 standard for insurance contracts accounting. Implementation due date is set for 2021 and implementation process is expected to last on average 3 years.

an operational and data perspective. Most insurers will face challenges obtaining and maintaining historical data of the right quality and granularity. This is further compounded by the use of legacy systems. It will be



The standard aims at enhancing the comparability of insurers performance across companies, geographies and business lines. There is currently no globally applied accounting standard and several accounting models are applied to each product type in different jurisdictions. A myriad of shortcomings exist nowadays, for instance, some of these practices do not take into account the value of time. Likewise, there's no update of valuation and estimates for insurance contracts post origination, where new market information is available.

necessary to improve data quality, and implement system changes and improvements which lead to more accurate consolidated financial reports.

The majority of contracts will be valued using the Building Block Approach (BBA), under which the reporting amount of the insurance liability is divided into four blocks: Future cash flows, Time value of money, Risk adjustment and Contractual service margin (CSM). In each reporting period, the insurer recalculates these values using up-to-date assumptions.

IFRS 17 will result in standardised processes that will lead to more efficient reporting, shorter turnaround times and potential cost reductions. These processes are the starting point for an overall enhancement of the company, which can further be enhanced via the use of new technologies such as RPA.

There are a number of implications that arise from the adoption of IFRS 17, especially from

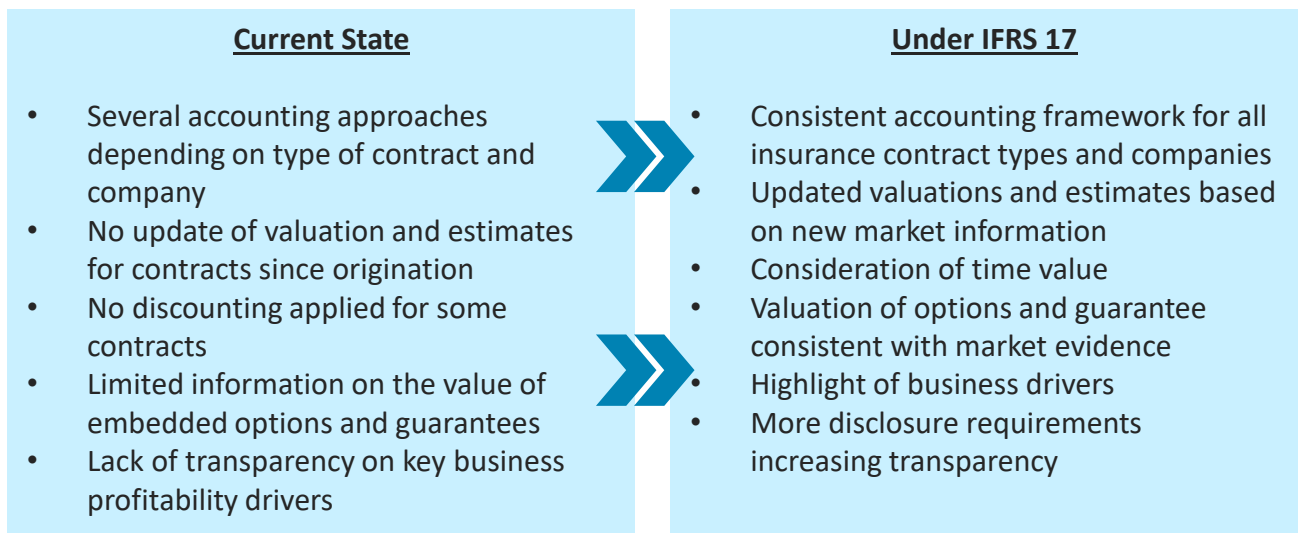
The implementation program will be both complex and challenging with costs similar to that of Solvency II. Some other similarities exist regarding systems, policies and processes, which might be leveraged for IFRS 17. Having the need of a parallel period in 2020, insurers have just under two and a half years to transition to the new standard. Moreover, they would also have to apply IFRS 9 (Financial Instruments) in that period.

# The need for a change

There is currently no globally applied accounting standard for the valuation of insurance contracts. Hence there is a myriad of accounting models according to each product type and in each particular jurisdiction, which results in differences in reporting and disclosure. For example, some insurers identify all their premiums received as revenue, while others exclude any customer investment element. This leads to a lack of comparability among insurers, business units and products.

and reinsurance contracts, developing a comprehensible and principles-based framework. Thus making the insurance industry more comparable across entities, countries and potentially other industries.

Moreover, it will increase transparency by providing information on how much risk and uncertainty there is. IFRS 17 will expose the hidden value of embedded



Some existing insurance contracts accounting approaches do not provide a holistic view of the effect on the financial results of the insurer. For example, some valuation methods utilise expectations that were established when the contract was signed, and these are very rarely updated in the light of new events. Similarly, a discount rate is normally based on estimates of investment returns determined at the inception of the contract.

The new standard aims at applying uniform accounting standards for all types of insurance

options and guarantees and will make visible the impact of current low interest rates across the insurance industry. Disclosure requirements will be more stringent and require insurers to provide information regarding estimation judgements, nature, extent and quantitative data of risks and mitigation actions.

This way, the real drivers of performance will be highlighted and managed, as well as the different risks that affect both liabilities and investments.

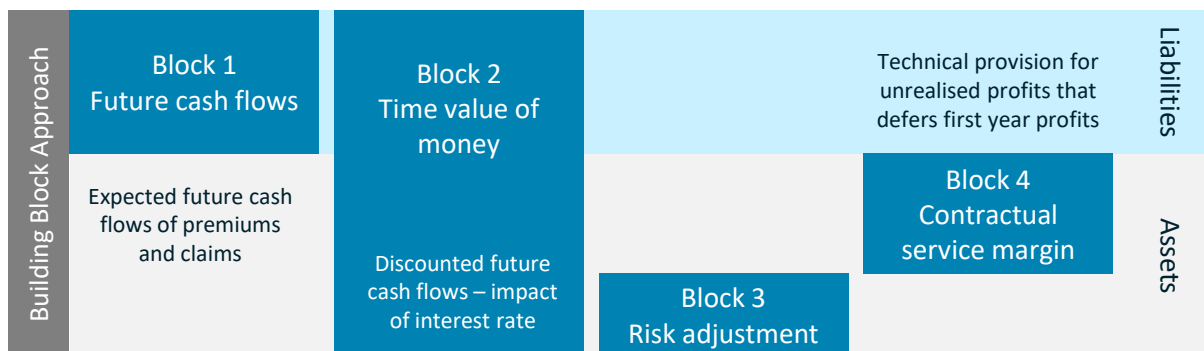
# The new standard in a nutshell

There are three different approaches to value insurance contracts: The Building Block Approach (BBA), the Premium Allocation Approach (PAA) and the Variable Fee Approach (VFA). The majority of contracts will be valued using BBA, under which the reporting/carrying amount of the insurance liability is divided into four blocks: Future cash flows, Time value of money, Risk adjustment and Contractual service margin (CSM).

The first block is calculated as the sum of undiscounted probability weighted cash inflows and outflows from premiums and claims estimated at moment of reporting. It does not take into account the time value of money and therefore it will usually result in a liability.

Finally, the new concept of CSM represents the unearned profit as the insurer provides services related to the contract, estimated at contract origination. It can be recognised on portfolio level for contracts with similar initiation date and cannot have a negative value. In each reporting period, the insurer recalculates the fulfilment cash flows using up-to-date assumptions and, thus, CSM is adjusted and recognised in P & L statement.

Some contracts will be allowed to use PAA, a more simplified model, for short-term insurance contracts. A liability for the remaining coverage is calculated as well as a liability for incurred claims. This approach is similar to the one currently used for non-life insurance products.



Then block 2 is calculated using discounted future cash flows with the appropriate discount rates, reflecting the contract currency and liquidity and the timing of cash flows. Subsequently, the third block reflects the compensation that the insurer requires for uncertainty about the amount and timing of cash flows. IFRS 17 does not prescribe any particular technique to adopt. The sum of all these three blocks is called “fulfilment cash flows.”

When the policyholder liability is linked to underlying items, the contract will be measured under the VFA. In them, the policyholder is paid a substantial share of the returns and the cash flows vary with the cash flows from the underlying items. The VFA assumes that the insurers must pay the policyholder an amount equal to the value of the underlying items net of a variable fee for the services of managing these items.

# What would be the impact?

There are a number of implications and changes that arise from IFRS 17, especially from an operational and data perspective. There will be a necessity for a more backward-looking and granular set of data. System changes will need to facilitate a new way of collecting, storing and analysing data and producing consolidated financial reports.

IFRS 17 will impact across business functions, not only finance, actuarial and IT departments, but also product design and development, distribution, risk, sales and even HR departments. For example, a review of sales incentives and remuneration policies will be required.

There will be significant changes in the income statement, balance sheet and actuarial models. Insurers will need to maintain two sets of balance sheet data: one calculated with the current discount curve and one with the discount curve at contract origination. In addition, the trajectory of revenues and profits will dramatically change and the volatility of accounting results will most likely increase. Insurance companies will have to revise their forecasting methodologies and assess their ALM strategy under different

accounting standards.

IFRS 17 will allow for standardised processes that combine actuarial, finance and risk functions. Thus leading to more rapidly delivery times and cost reductions. These standardised processes are the starting point for an overall enhancement exercise inside the company, optimising them through the use of new technologies such as RPA.

Moreover, under IFRS 17, accounting policies will need to be standardised and the compliance processes must be auditable. With this standardisation of processes and policies better insights from business performance are possible and it is also possible to organise certain functions and processes in centres of excellence.

Transitioning to this new standard will require a high degree of internal coordination between finance, actuarial and risk management. Especially to leverage the investments made concerning SII programs while still working on embedding SII processes into the organisation. Acquiring the right skills and know-how will be key to successfully meet the deadlines.

## IFRS 17 vs. Solvency II

Some similarities exist with SII programs, especially the already enhanced systems and defined policies, roles and processes, which were designed, tested and documented and might be leveraged for IFRS 17. Similarly, both programs are intensive in data quality, control and management, and any required data quality remediation that has been already performed can be exploited.

Clearly, there are still some differences regarding data, thus the key challenge is to ensure that the diverse types of data will be available and that systems have the flexibility to adjust to different inputs.

# What should you do now

One of the lessons learned from Solvency II programs is that these transformation challenges are complex, costly and time-consuming. Some insurers have started to plan and size the project, planning for the resources given the shortage of skills, while others have already performed impact analysis.

A number of companies are even now estimating that they will need more than 3

years, especially considering the time spent on SII programmes.

Enhancing the operating model to meet IFRS 17 requirements is key to successfully implement this new standard and gain a competitive advantage in the meantime. Key questions must be addressed early to develop an effective programme:

## Key Questions

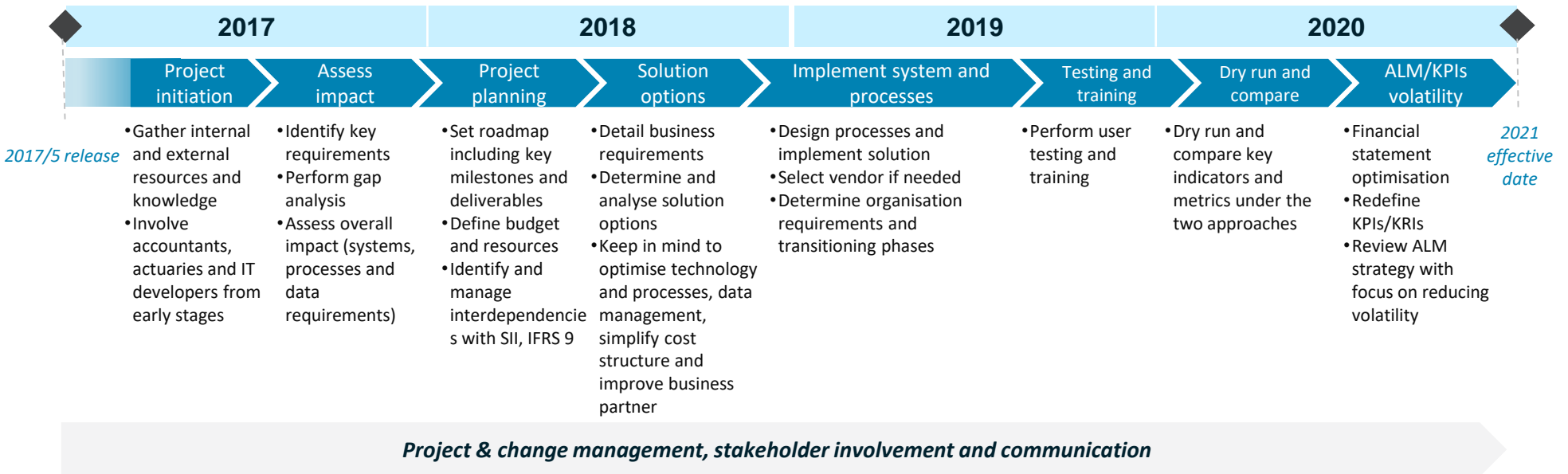
- ❖ What does an IFRS 17 implementation programme look like? How long will it take and cost?
- ❖ Which business lines need to apply BBA and which ones is it possible to use an alternative, simplified approach? How will the balance sheet and income statement change for each of these major business lines?
- ❖ How is the IT target infrastructure? How will the technical integration between actuarial and accounting systems provide sufficient level of granularity?
- ❖ What new software is required and what would be the software selection criteria?
- ❖ What are the overlaps with SII and IFRS 9 programs? What can be reused? What is the target reporting structure to accommodate IFRS 17 and SII metrics?
- ❖ What new processes and roles need to be defined? What will the organisation look like in each transitioning stage?
- ❖ How are current business decisions affected by IFRS 17?
- ❖ Should new KRI and KPIs be developed? Will the Economic Capital as per SII or IFRS 17 pilot the company?



## Our proposed approach

So, how can an insurer successfully tackle this undertaking? We propose a proven approach to effectively implement this transformation project, starting early by identifying the key implications and allocating crucial resources:

### Our Approach



An as-is and to-be analysis should be undertaken to assess the overall impact in the organisation and appropriately define budget, roadmap and key deliverables. Current SII, IFRS 9 and any other financial enhancement project must be taken into consideration.

It is crucial to appropriately integrate actuarial processes into the financial reporting chain with emphasis on eliminating bottlenecks to delivery times. In

addition, data management should be enhanced updating manual procedures allowing for an efficient audit trail.

Finally, improvements to forecasting methodologies should be carried out to reduce income statement and financial reporting volatility

# Our services

FiSer Consulting can assist in this transformation process with different services, from strategy to implementation, with a business and technology perspective:

## ❖ Business Case Advisory

With major systems, modelling and business processes changes, our consultants can formulate a solid Business Case which will cover an assessment of the potential costs and benefits, project risk evaluation a high-level delivery approach.

## ❖ Project & Program Management

IFRS 17 implementation involves changes that affect many stakeholders. Our Project & Program Management capability can structure and manage a variety of stakeholders across the business. Our managers and consultants combine multiple years of experience with in-

depth knowledge of the Financial Services and regulatory space.

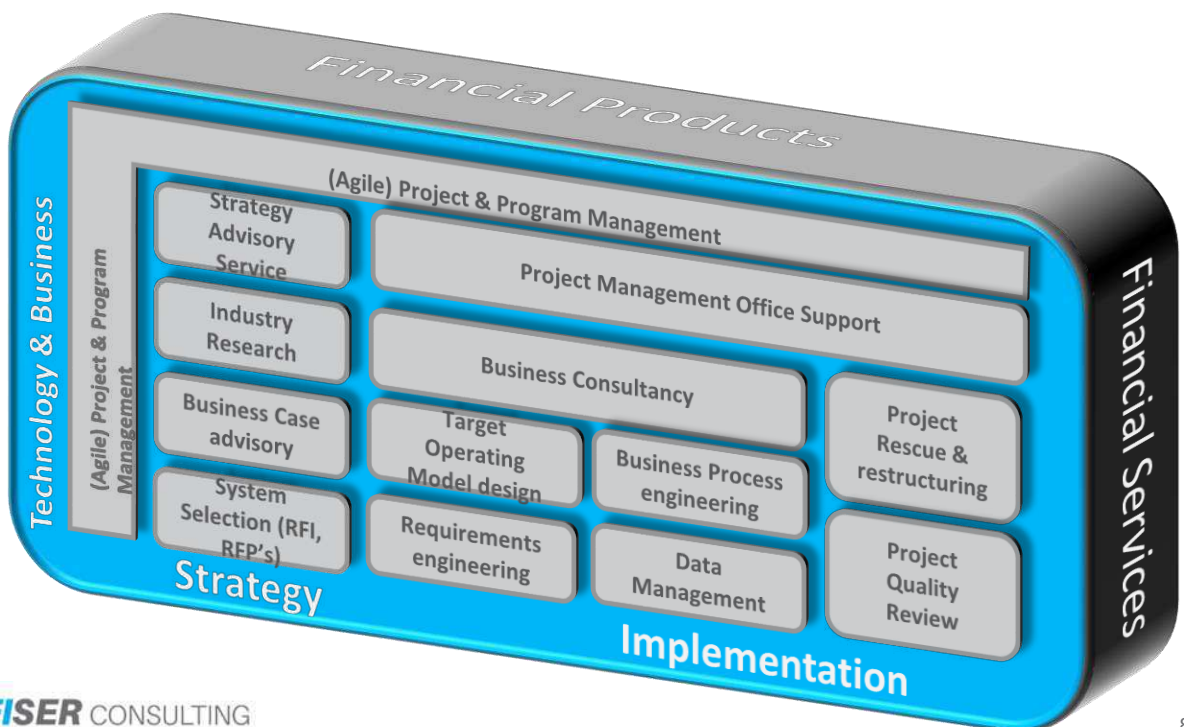
## ❖ Requirements Management

Our consultants will assist the organisation in translating and identifying key requirements of the regulation keeping in mind the interaction with other regulatory constraints and existing processes, systems and organisational structure

## ❖ Target Operating Model

Our consultants have a strong content background will assist you in interpreting the new IFRS 17 requirements and design a target operating model. We will define the infrastructure, processes, controls and organisational implications with a focus on efficiency.

## FiSer Consulting Services





# Next Steps

For further information on IFRS17 and where FiSer Consulting can assist you, please contact:



**Mischa Wesdorp - Managing Partner**

Mischa is the founder of FiSer Consulting and brings over 14 years experience in the Global Financial Services and Banking Industry. Mischa has acquired an all round understanding of Risk, Lending and Payments and he is specialised in Operational Risk and Payments related projects.

Finally, acting as program manager, Misha has experienced ensuring the correct implementation several regulations, such us Solvency II.



**Constanza Díaz - Junior Consultant**

Constanza has over 2 years experience in Management Consulting. She has gained extensive experience working in a wide range of industries such as Financial Services, Retail, Utilities, Pulp & Paper, and Insurance.

She works accurately, she knows how to map problems and how to search for solutions actively.

Recently, Constanza supported the transformation and implementation of Solvency II framework in a major Insurance company in the Netherlands.



**Roberto Nieves- Consultant**

Roberto is a skilful consultant with 5 years experience implementing risk management and cost reduction initiatives for global financial institutions. During his career, Roberto has developed not only a solid banking and insurance base knowledge but also keen interpersonal skills that motivate corporate change. He actively participated in developing the strategic framework and an execution roadmap for the efficient implementation of Solvency II framework for one major insurance company at EMEA.



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# Glossary of Terms

Term	Definition
<b>ALM</b>	Asset & Liability Management
<b>BBA</b>	Building Block Approach
<b>CSM</b>	Contractual Service Margin
<b>EMEA</b>	Europe, the Middle East and Africa
<b>EMIR</b>	European Markets Infrastructure Regulation
<b>IASB</b>	International Accounting Standards Board
<b>IFRS</b>	International Financial Reporting Standard
<b>IT</b>	Infrastructure Technology
<b>KPI</b>	Key Performance Indicator
<b>KRI</b>	Key Risk Indicator
<b>MiFID</b>	Markets in Financial Instruments Directive
<b>PPA</b>	Premium Allocation Approach
<b>POC</b>	Proof of Concept
<b>RFI</b>	Request for information
<b>RFP</b>	Request for proposal
<b>RPA</b>	Robotics Process Automation
<b>SEPA</b>	Single Euro Payments Area
<b>SII</b>	Solvency II
<b>VFA</b>	Variable Fee Approach

