BY DAVID BRUNSVELD, BOUKE EVERS
AND SIMON WOODS

Strategic perspectives on IFRS 17

What insurers should be thinking about now (and maybe are not)

IFRS 17 is the long awaited new accounting standard that covers insurance contracts, expected to enter into force (at the earliest) at 2021. Insurance companies are currently struggling through the technical detail, identifying the impacts from this new standard on their data flows, actuarial models and systems, as well as the processes and controls in place. Yet, a critical consideration is to address the strategic consequences of IFRS 17.

This article will first discuss the strategic choices that have to be made with respect to the IFRS 17 implementation, taking into account the operational impact. Thereafter, this article will focus on the investor story and the perspective of insurance sector investors and analysts, through the dividend capacity linkage to IFRS earnings and the CSM at transition.

STRATEGIC CHOICES REGARDING THE IMPLEMENTATION OF IFRS 17

IFRS 17 results in a fundamental revisiting of the financial reporting processes of insurance companies that are reporting under IFRS, with impacts that go beyond the finance domain. IFRS 17 requires much more data at a more granular level, which is a big driver for operational impacts.

The first question that comes up can be: what is the ambition of the IFRS 17 implementation? Is the aim to have a minimum viable solution, having as few operational impacts as possible, or is IFRS 17 the driver of a fundamental Financial Transformation? The latter should lead to a more automated, robust and controlled end-to-end financial reporting process, deriving greater benefits from the greater insights that IFRS 17 is meant to enable. Some insurers are choosing to align different reporting frameworks for efficient and effective reconciliations as a way of getting more benefits from what can be seen as a sunk cost of compliance.

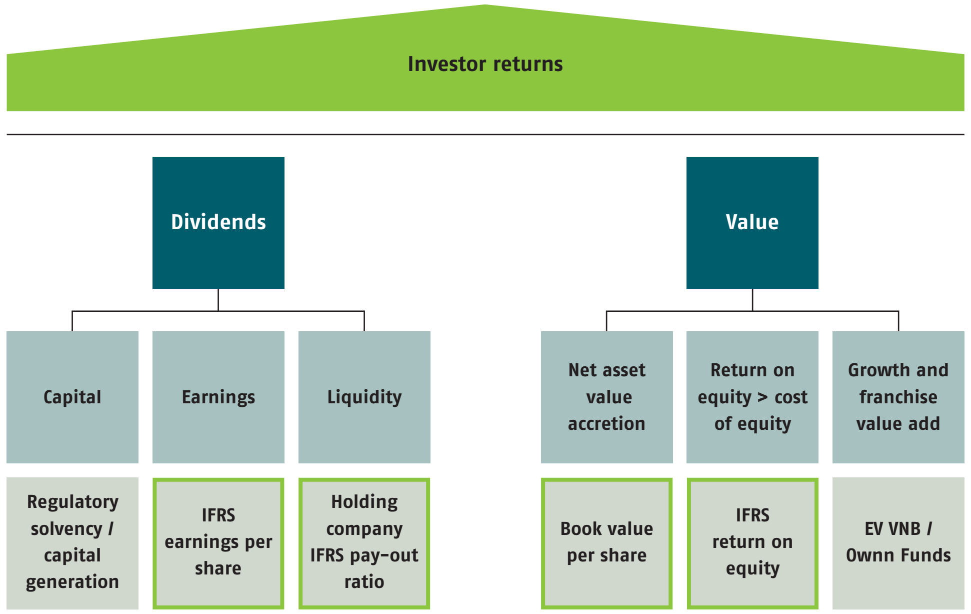
INVESTOR STORY AND DIVIDEND CAPACITY

The investor community does not yet seem to be very engaged with IFRS 17 (and IFRS 9) – not least because there has been limited quantitative guidance on how the financial statements will change. Most insurance companies are therefore performing financial impact assessments, to get a feel of the IFRS 17 based balance sheet and P&L.

An important question to ask is: how will IFRS 17 figures be used for external and internal purposes? Will analysts and investors pay a lot of attention to this new standard and use the financial statements in support of portfolio decisions, or is (for the European market) Solvency II the "right" answer[1]? Also, accounting changes do not change the economics, so a valid question is why insurance companies and investors would care at all?

Regardless of accounting, insurance sector investors are heavily focused on cash dividends. Investors expect dividends to be maintained post IFRS 17 implementation, and insurers have linked their dividend policy to a percentage of IFRS earnings. Therefore, IFRS earnings are an important metric for equity analysts. First of all, investors will want to understand if the relationship between dividend policy and the percentage of IFRS earnings is maintained. Also, investors want to know how IFRS 17 changes the earnings – are they bigger or smaller? Are they more predictable or more volatile? And are future dividends impacted?

D. Brunsveld MSc AAG (left) is a Senior Manager at EY Netherlands. David is the actuarial lead on IFRS 17 for EY Netherlands, and helps insurance entities with implementing IFRS 17. He has industry experiences in the area of modelling, model governance, ALM/hedging, risk/regulatory reporting.
B. Evers MSc AAG (middle) is a Senior Manager at EY Netherlands. Bouke is responsible for the Dutch Finance, Risk and Actuarial Change taskforce, covering a wide spectrum of change for the insurance sector, such as Solvency II, Accounting Change (IFRS 9/17) and Recovery and Resolution Planning.
S. Woods MA, PPE is a Partner at EY Switzerland. A former investment banker, Simon leads a number of EY's Insurance strategic offerings globally, including advising insurance clients on investor communications and financial metrics. Simon has worked extensively in the Dutch market with many of the listed insurers in the Netherlands.



The transition from IFRS 4 to IFRS 17 will mean a more market consistent value of insurance liabilities and a new approach to account for the performance of insurance contracts, potentially affecting reported IFRS earnings. Timing of profit recognition will be an important driver of IFRS earnings change as we move to IFRS 17, and investors will be concerned about deferral of profit recognition and lower headline earnings year on year. Currently initial day 1 profits and / or reserve releases flow directly into the P&L, which is useful for managing profitability against consensus expectations. This will change significantly with IFRS 17, with a distribution of earnings over time as insurance services are provided.

Furthermore, the asymmetry of accrual of profits and immediate recognition of losses on onerous contracts, along with a market consistent balance sheet, may lead to increased earnings volatility and make it harder for investors to forecast future earnings. These forecasts are a key driver of valuation models.

As IFRS 17 financials become a reality, there will be a need to do substantial education to the investor community. What are the earnings levers, and how do these work? If earnings are different, will valuation multiples (e.g. P/E), or company valuations themselves change?

Pro-active communication about the investor story to investors is key to avoid surprises. The timing of these disclosures will also be of interest. Changing KPIs is always challenging, as both investors and management compensation schemes need to adapt to the new numbers. Nonetheless, the run up to Solvency II has some similarities. It could be a matter of time and education to get familiar with IFRS 17 results in making decisions to invest in the insurance sector.

TRANSITION CSM

A critical decision in the IFRS 17 implementation is the approach to transition. There are different methods - full retrospective, and if impracticable, modified retrospective or fair value. How these are implemented can have a significant impact on the transition balance sheet, and most critically, the split between CSM and shareholders' equity.

Although IFRS 17 aims to provide more transparency and comparability between insurance companies and sectors, the degrees of freedom with respect to transition (e.g. the calibration of the fair value approach) will potentially provide very different results between insurance companies.

The future profits of life insurance companies will be heavily influenced by the transition CSM (amortized over time). Companies are asking themselves whether they aim for a higher transition CSM (and therefore a lower shareholder equity), or for a higher shareholder equity (accepting a lower transition CSM). While, in theory, this only affects the timing of profit realisation[2], it will have a major impact on reported IFRS metrics, with associated impacts on valuation and management compensation incentives.

INTERNAL MANAGEMENT INFORMATION ON PRODUCT PROFITABILITY

Management information on product profitability is expected to focus on the actual cash flows. For the meantime, we expect regulatory metrics will drive business decisions more than accounting standards.

However, with IFRS profitability being an important measure for external stakeholders, we expect this measure will continue to be closely scrutinised internally. The impacts of grouping products together into cohorts under IFRS 17, coupled with the asymmetric recognition of profitability, will lead to far greater focus on individual product vintages (especially for those that are or become onerous) than has historically been the case. This is likely to be further exacerbated by the decoupling of the reinsurance element, which in certain cases could result in material day 1 losses.

Looking ahead, it is not difficult to foresee significant challenge around the profitability of certain core insurance products, leading to hard decisions between economics and accounting.

CONCLUSION

IFRS 17 has significant strategic as well as operational and technical challenges.

The industry risks missing the bigger picture as it grapples with the enormity of the delivery programme, the technical interpretations of the standard, and competing pressures on management time and corporate resources.

Insurers will need to spend time educating investors on the changes arising from IFRS 17. More fundamentally, the choices made now will have a significant impact on future strategic choices available to company management. ■

1 – whereby the Solvency II ratio and the net capital generation figures are leading

2 – Assuming no onerous contracts are created at transition.