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OPINION

IFRS 17: In search of better answers

SUITS THE C-SUITE
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(First of two parts)

According to Kurt Lewin's Change Management Model: Understanding the Three Stages of Change, the change process includes three steps: unfreezing, change, and freezing. Unfreezing is overcoming a current mindset or accepting that a current state cannot continue; change is when people begin to resolve their uncertainty and look for new ways to do things; and freezing means embracing the new ways of working.

Since International Financial Reporting Standards (IFRS) 17, the new standard on insurance contracts, was issued last May 2017, most, if not all, local insurance companies are understandably still in the process of trying to fully comprehend the significant change that is to come. A good number of insurance companies, though, have already taken steps to get used to the challenge of a totally different way of measuring and accounting for insurance contracts, and have started performing preliminary impact assessment exercises.

In June 2017, we published a *BusinessWorld* article (***https://goo.gl/gPvjyZ***) summarizing the requirements of IFRS 17 and the potential impact on local insurers when they adopt the standard. In this article, we will highlight the provisions in the standard that may bring about the biggest operational challenges that insurance companies may need to address on their implementation journey.

CLASSIFYING AND ACCOUNTING FOR INSURANCE CONTRACTS

Under Philippine Financial Reporting Standards (PFRS) 4, the current standard on insurance contracts, companies are required to assess whether the insurance contracts they issue meet the definition of an insurance contract, i.e. these contain significant insurance risk. Although there are certain guidelines, no specific accounting treatment is required under PFRS 4 and therefore the current accounting treatment used for statutory reporting purposes is allowed.

However, under IFRS 17, entities will have to follow one of the three measurement models (depending on the characteristics of the insurance contract) and the corresponding accounting treatment for each model as prescribed in the standard. In the Philippine setting, the valuation models are closer in principle to the newly implemented Gross Premium Valuation (GPV) method for life insurance companies and the previously applied 24th method for non-life insurance companies. However, the accounting treatment poses a significant difference with the current Financial Reporting Framework (FRF) for long-duration contracts.

Insurance companies should assess their current product classification process to determine whether this is robust enough to clearly define which contracts fall under IFRS 17 and which contracts will have to be accounted for under different standards, such as IFRS 9 or IFRS 15, and if the process is flexible enough to supplement the determination of the appropriate accounting treatment for each insurance contract the companies issue.

DEFINING THE UNIT OF ACCOUNT

Insurance companies currently manage their contracts on the basis of portfolios or lines of business. Grouping accounts on this basis will be a good starting point to meet the requirement of level of aggregation or unit of account under IFRS 17. The challenges come when companies start grouping their contracts by cohort and by profitability.

Insurance companies would need to evaluate their data quality and availability to enable them to group the contracts according to profitability. Companies will also have to establish a process to ensure a seamless flow in grouping the insurance contracts, considering there will always be new groups created at least annually. They may need to obtain additional information from policyholders in order to group the contracts to comply with the standard, possibly requiring modifications to existing application forms. They should also think about whether to align the grouping of insurance contracts with their reporting frequency or keep the group of insurance contracts open up to the maximum allowable period of one year. Companies should revisit their current cost allocation methods to align with the unit of account requirement, i.e. allocate costs to different groups of contracts and may have to undertake a cost analysis/study to determine a systematic and consistent way of allocating expenses.

DETERMINING THE MEASUREMENT MODEL

By default, insurance contracts are assumed to be valued using the Building Block Approach (BBA), also referred to as the general model. But for direct participating contracts, such as the variable or unit-linked insurance contracts which have been popular locally, these contracts will have to be measured under the Variable Fee Approach (VFA). For short-duration insurance contracts that meet the criteria under the Premium Allocation Approach (PAA), the insurance company may opt to use the PAA for valuing its contracts. However, for contracts with terms of over a year, the company will still be required to value the contract under BBA to show that the amounts under both measurement models are approximately the same.

IFRS 17 also introduces the concept of contract boundary, to distinguish the cash flows relating to existing insurance contracts from the cash flows relating to future insurance contracts.

Insurance companies may consider applying BBA to all of their insurance contracts, even if some of their contracts qualify for PAA, given that it will have to set up the process and system to value contracts under BBA. They should also start thinking about how to define the cash flows within and outside the contract boundary.

SETTING AND UPDATING ASSUMPTIONS

In setting discount rates for insurance contracts measured under the BBA, local insurance companies may use, as a starting point, the current rate provided by the Insurance Commission (IC) and add on an illiquidity premium to reflect the characteristics of the insurance contract.

In calculating the risk adjustment, local insurance companies may also initially use the confidence level technique that is currently being applied when they compute for the margin for adverse deviation, taking note, though, to apply the risk adjustment only to non-financial risks.

Insurance companies may have to consider setting one illiquidity premium to be applied across all contracts they issue. Companies should also look at whether a significant amount of judgment required in setting the discount rate and risk adjustment would lead to more variability in the valuation of insurance contracts. They may have to set up a governance committee specifically tasked to review and approve the judgments and estimates applied in setting and updating the assumptions. From the points of view of the IC, the companies' internal audit function, and their external auditors, there may be the question of what would be the basis for agreeing or disagreeing with the individual insurance company's judgment regarding the discount rate and risk adjustment when there is no prescriptive guidance provided in the standard. Given this, the IC may have to step in and provide some guidance.

In the second part of this article, we will continue the discussion on the specific provisions of IFRS 17, including its interaction with IFRS 9, Financial Instruments, amortizing and tracking contractual service margins, presenting and disclosing results, and transitioning to the new standard.

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