Willis Towers Watson

IFRS 17 – Managing the transition

The long-awaited standard on insurance contracts, IFRS 17, was published on May 18 2017, and the countdown is now on for companies to be ready for implementation. While the standard will have to be applied for reporting periods starting on or after 1 January 2021, this will require an opening balance sheet at 1 January 2020.

Given the scale of the standard's impact and its principles-based nature, insurers will need to make many technical decisions that will have significant consequences on both the financial and practical impacts of implementation. We are introducing a series of short papers to address these issues in turn, explaining the choices available and the factors and consequences to consider.

In this first paper, we look at the possible transition measures for each group of contracts that are available under IFRS 17. The decision made on the transition measures is one of the most significant choices for the standard's adoption, as it will impact the initial balance sheet, the level of future profit released and, as a result, affect future comparability between insurers over a long period of time, as well as the operational complexity of implementation.

Full retrospective approach

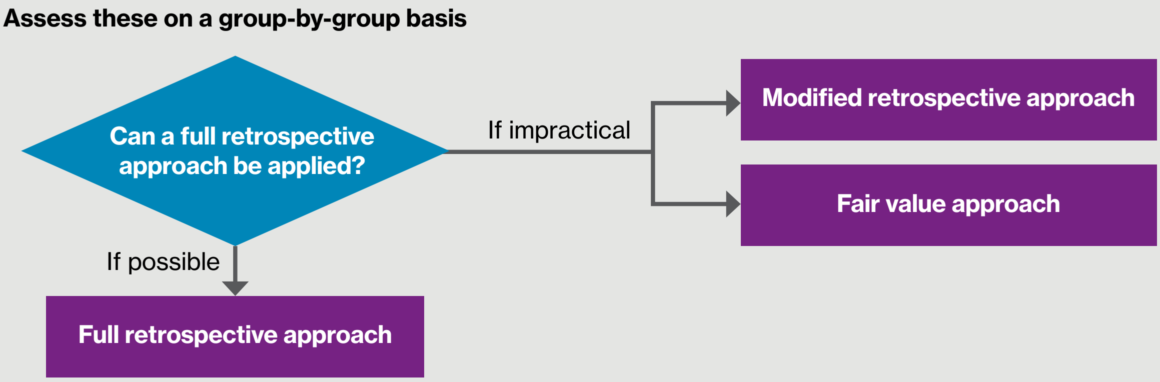
The first of three approaches available to insurers is the full retrospective approach, which has to be applied unless impracticable. What this means is that for each group and each cohort of contracts, an insurer must go right back to contract inception and project forward the contractual service margin from that date right up to the transition date.

This will involve a significant amount of historic data, assumptions at the point of sale and modelling complexity. Gathering information for contracts issued many years before transition could be either very costly or not possible.

Modified retrospective approach

Insurers able to demonstrate that the full retrospective approach is not a viable option will be permitted to choose between a modified retrospective approach and a fair value approach. The modified retrospective approach aims to achieve the outcome that most closely resembles the full retrospective approach, albeit with some approximations and simplifications along the way, using reasonable and supportable information available without undue cost or effort.

Figure 1. **Transition to IFRS 17 – Three approaches to transition**



A key feature of the modified retrospective approach is that there is no requirement to divide the groups of contracts into annual cohorts, unless the insurer has reasonable and supportable information to justify the divisions, which should help make the data requirements less complex. However, the disclosures will still be quite onerous and any approximations that are taken will need to be justified, not just at transition but every year thereafter.

Fair value approach

Under the fair value approach, the contractual service margin is determined as the difference between the fair value of a group of insurance contracts (measured in accordance with IFRS 13) and its fulfilment cash flows at the transition date (which are determined in accordance with IFRS 17). There is no requirement to divide the groups of contracts into annual cohorts.

Historically, many insurers issuing long-term contracts applied Market Consistent Embedded Value (MCEV) or European Embedded Value (EEV) Principles to measure insurance contracts for supplementary reporting purposes. Where still produced, insurers will be able to use these measurements or other economic-based regulatory measures (such as Solvency II in Europe) as a starting point for the fair value approach on transition to IFRS 17, with adjustments to reflect market valuations.

The IASB acknowledge that the optionality available on transition will result in less comparable financial statements until the contracts written before the transition date are derecognised. However, the IASB concluded that the costs associated with the full retrospective approach or modified retrospective approach might exceed the benefits if there is little information available on the transition date.

What next?

Figure 2. **What should insurers be doing now?**

Make an informed decision...

Financial impact

- Stakeholder message – back book and future book
- Estimation tool

Practical impact

- Disclosure requirements
- Data requirements
- Calculation engines and processes

Once selected, the transition approach will directly impact an insurer's financial results both in terms of their Day 1 balance sheet and future profit emergence. For this reason, it is important that the decision is made based on a full appreciation of the financial and practical considerations:

- What data is going to be required?
- What calculations, engine and aggregation will be needed to perform the transition and future valuations?

Being able to identify what disclosures need to be made will allow users of financial statements to then assess the effect that contracts within the scope of IFRS 17 have on the insurer's:

- Financial position
- Performance
- Cash flows

This will be a complex process, requiring quantitative and qualitative information about amounts recognised in the financial statements, significant judgements (and changes thereof), and the nature and extent of risks arising from contracts in the Standard's scope.

Insurers will also benefit from communicating at an early stage to key stakeholders, including market analysts and shareholders, providing clarity around the expected impacts to the financial statements and profit profiles. This will require firms to source data and build a tool capable of at least estimating what these financial impacts will look like both at Day 1 and for future profit emergence.

Further information

To learn more, please contact your Willis Towers Watson consultant, visit **willistowerswatson.com/ifrs17** or email **ifrs17@willistowerswatson.com**

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