THE IFRS 17 IDENTITY

BY **SERVAAS HOUBEN**

Do not judge a book by its cover: although many actuaries might consider IFRS 17 yet 'another IFRS accounting standard', and hence a feast for accountants, this new insurance standard still provides lots of opportunities for actuaries. Servaas Houben provides in this article some examples of IFRS 17 challenges for which actuaries with their numerical skills can be effective, and where the creative skills actuaries possess can let this principle-based standard come alive.

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INTRO

IFRS 17 replaces the current IFRS 4 framework. The latter consisted of different reporting approaches (like US GAAP) making it challenging to compare results between countries or within a group based in different geographies. While the US GAAP approach was more towards the rule-based side of reporting frameworks, other IFRS 4 consistent frameworks provided more leeway for expert judgment or management's own perspective. IFRS 17 tries to overcome this spectrum of interpretations and tries to align differences in size and geographies to ensure more consistency between financial statements. >

However IFRS 17 is a market consistent framework and as a result its implementation is not all that straightforward across all geographies: for geographies used with market-based valuation, like Solvency II, risk-based capital and others, the switch from IFRS 4 to IFRS 17 might be intuitive as one can use the valuation metrics of other market based valuation frameworks. For other geographies which based their IFRS 4 reporting on historical/pricing assumptions, and not used to valuation of options and guarantees, the introduction of IFRS 17 might be an entirely different challenge.

Fortunately, the IFRS 17 framework is principle based and therefore provides leeway: the phrase '**without undue cost and effort**' is repeated multiple times in the legislation and thus the standard is aware of differences in size and resources between companies which result in various levels of finesse. However the drawback of a principle-based framework is that in can result in inconsistency between or within companies. Using quantitative assessments instead can result in a more robust and consistent application of the standard within companies and across time.

QUANTITATIVE IMPACT

IFRS 17 provides areas where a quantitative assessment can be applied:

- **Classification/measurement approach:** IFRS 17 Appendix A specifies three conditions which need to be fulfilled for groups of contracts to be VFA classified. Two of the three conditions refer to the word '**substantial**' which is not defined under IFRS. To avoid inconsistency between, one could consider applying a numerical threshold (e.g. based on historical profit sharing) when assessing if groups of contracts fulfill the VFA criteria.

- **Allocation underlying items to VFA portfolios:** IFRS 17.110 requires entities to describe the composition of underlying items (i.e. assets) for VFA contracts. IFRS 17 does not prescribe how an entity should allocate its assets to the IFRS 17 portfolios. The allocation choice therefore impacts the size of CSM and equity at transition and during subsequent measurement. Actuaries can apply different allocation methods like using ratios, assigning assets on an individual basis, or grouping assets considering both the asset and liability characteristics to limit volatility in CSM and equity figures going forward.

- **Reconciliation other reporting frameworks:** for benchmarking and explanation towards other stakeholders, it is common to compare IFRS 17 cash flows with SII equivalents. As creating these waterfalls usually requires an analysis of change involving performing multiple runs, actuaries can provide insights in the similarities and differences between reporting frameworks.

- **Risk adjustment:** while under SII standard formula, the risk margin is predefined, IFRS 17 allows for room of interpretation which the company can use to reflect their own perspective on the risks involved in cash flows (like SII ORSA). Changing in risk preference over time, changes in cost of capital over time, or different correlation assumptions are therefore allowed under IFRS 17.

- **Inflation:** although inflation has been a hot topic during 2022, IFRS 17 has been quiet on the topic except that, when possible, a market/current rate should be applied when possible. The standard therefore allows for different inflation perspectives, and inflation assumptions (wage, price, other)

- **Sensitivity testing:** IFRS 17.128 requires sensitivity testing of insurance and market risks, however, does not prescribe which sensitivities should be applied. Either the standard SII shocks could be considered, or other more company specific scenarios instead. >

- **Yield curves:** IFRS 17.B81 allows companies to derive the yield curve based on a reference portfolio (top down). As these reference portfolios can be company specific and the IFRS 17 group of contracts might not be a 1-1 match with the SII homogenous risk groups, quantitative derivation of sensible yield curves is an opportunity.

- **ALM matching/accounting mismatch:** the standard allows to reduce accounting mismatches between asset and liability classifications (e.g. IFRS 89(b), risk mitigation IFSR 17.B115). As reducing these mismatches requires alignment between assets and liabilities actuaries can provide insights in liability sensitivities and ALM matching.

- **Capital optimization:** as insurance companies have several metrics to steer their business (return on (SII) capital, (IFRS) earnings, ratings, internal capital models), optimization of capital might become a daunting task. As actuaries are familiar with optimization methods and familiar with different steering metrics, they can add value in providing insights how business strategy and ALM choices affect each of the reporting metrics and what tradeoffs to consider.

QUALITATIVE IMPACT

Besides using their quantitative skills actuaries are also well suited to use their qualitative creative skills to make an impact:

- **Interaction with accountants:** IFRS 17 is not a separate accounting standard which can be implemented in isolation. Especially the interaction with IFRS 9 when it comes to avoiding mismatching between OCI and P&L is prevalent within the IFRS 17 standard. Therefore cooperation with accountants, controllers, and asset managers is essential to avoid IFRS 17 to become the spanner in the works. As actuaries have a broad experience involving asset management, accounting, and balance sheet management they can cooperate and retain the overview of IFRS 17 and its interaction with other IFRS standards and departments.

- **Governance:** IFRS 17 disclosure and governance has similarities with Solvency II. The preference to use market-based assumptions before expert or company judgment, the valuation of options and guarantees, and the requirement of sensitivity testing are in line with Solvency II principles which are common to actuaries.

- **CSM concept:** the introduction of CSM as a representation of future profits, is remarkably like other valuation techniques like Embedded Value and hence feel much more intuitive to actuaries than past accounting frameworks which allowed for a day one gain or profit.

- **Capital and dividend management:** so far, most investor days published by insurance companies have indicated that IFRS 17 is considered as a change in accounting policy which will not impact capital and dividend management. Stakeholders still need to get used to the standard, or companies do not have around assessing the impact on capital and dividend policies. In the past, there was a clear link between income and dividends. Actuaries could help optimizing capital and balance sheet management across different reporting frameworks and capital and dividend management seems to still unexplored territory.

CONCLUSION

Although IFRS 17 is a principle-based framework which requires substantial judgement and interpretation, and therefore can be an ideal playground for (creative) actuaries. <

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