

VIEWPOINT

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IFRS 17: An Investor Perspective



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Introduction

The International Financial Reporting Standards (IFRS) 17 is a complex set of accounting principles that are expected to materially impact liability measurement and profit recognition for insurance companies. They are intended to help provide high-quality financial information that is globally comparable, consistent and transparent. This is welcome, as the current standard (IFRS 4) needs overhauling and results in highly divergent accounting practices that exist in the insurers' local jurisdictions. We therefore support the principles behind IFRS 17 as this standard can result in a significant increase in global comparability and enhance the quality of financial information. However, the intended objectives are unlikely to be met in full due to the crunched implementation timeframe. In this *ViewPoint*, we outline the history and scope of international standards, describe the potential benefits of IFRS 17, and highlight possible unintended consequences on insurers, analysts and investors. **Our key observations and recommendations are summarized on the following page.**

The IFRS Landscape

Historically, divergent views about the role of financial reporting made it difficult to encourage a commonality of accounting standards across the globe. However, over the course of the 20th century, efforts to create an international body to establish consistent international accounting standards gained widespread recognition, with a vision of a global set of accounting standards being supported by a variety of organizations within the international regulatory framework.

IFRS standards have been one of the main tools to drive that commonality and, over time, have replaced the myriad of national accounting standards, which had historically driven the production of company financial statements.

Initially, IFRS concentrated efforts in harmonizing accounting rules across the European Union (EU) and indeed, since 2005, all companies listed on a regulated European exchange are required to prepare their consolidated accounts in accordance with endorsed standards. Global acceptance has led to over 120 countries requiring IFRS for all or most listed companies and financial institutions, with a number of other jurisdictions also permitting IFRS submissions. Currently nine countries, including China and the US, use national or regional standards. The International Accounting Standards Board (IASB), the independent standard-setting body of the IFRS Foundation, has assessed the potential impact of IFRS 17 to insurance companies by analyzing information available from 626 listed insurance companies.

Based on this analysis, 72% of listed insurance companies use IFRS standards (see Exhibit 1 overleaf). Looking at the consolidated financial statements of the 25 largest insurance groups, 13 of them use IFRS as the basis of preparation, 6 use regional standards that are either identical or nearly-identical to the IFRS framework (Japan and Hong Kong), whilst 6 use US GAAP, where the Financial Accounting Standards Board has decided to take this particular project in a different direction and focus on making targeted improvements to US GAAP for insurers (see Exhibit 2).

The opinions expressed are as of October 2017 and may change as subsequent conditions vary.

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BlackRock Observations & Recommendations

1. Many investors support consistent and comparable accounting standards such as IFRS 17.

- 72% of listed insurance companies globally, and 13 out of the 25 largest insurers, report under IFRS, while 6 follow national / regional accounting standards that are relatively similar to IFRS.

2. The new IFRS 17 has the potential for greater transparency on insurers' profitability. But many insurers face the dual challenge of implementing IFRS 17 in a narrow timeframe and appropriately communicating its impact to information users.

- Many insurers will need to invest significant financial, actuarial and technological resources to evaluate the potential implications of different accounting approaches.
- Since IFRS 17 is a principles-based accounting standard, it will take time for analysts and other users of financial statements to familiarize themselves with the new concept of Contractual Service Margin, the components within each building block and their impact on profit recognition – as well as the multiple nuances between IFRS 17 and regulatory rules governing the measurement of insurance liabilities.

3. To achieve the best possible implementation of IFRS 17, we recommend a three-pronged, pragmatic approach:

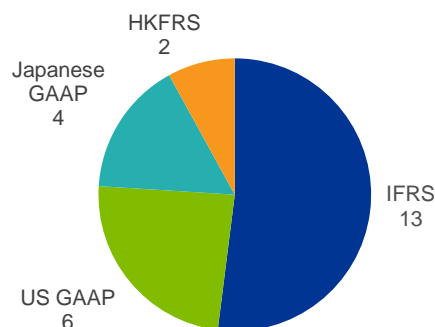
- The first recommendation relates to leveraging lessons learned through a recent and equally-complex set of rules impacting insurers, the EU Solvency II Directive.
 - We recommend a series of comprehensive field tests for IFRS 17 (such as Solvency II's Quantitative Impact Studies) to enable insurers to test and communicate the outcomes and implications to investors and other key stakeholders. Depending on the findings, this can provide stakeholders confidence and ensure that the objectives of IFRS 17 will ultimately be met.
- Secondly, we support the creation of the IASB Transition Resource Group (TRG) dedicated to IFRS 17 and make some recommendations for this Group to better support the implementation efforts of insurers.
 - Expand the remit of the TRG to address questions beyond the scope of implementation and to establish direct and interactive engagement between the TRG and the Interpretation Committee or the IASB.
 - Be flexible: being open to changes on the standard will enable a dynamic implementation of the standard without losing momentum.
- Thirdly, as companies move towards implementation, policy makers could review the implementation deadline to ensure a smooth transition to the new standards.
 - Based on the outcomes of the field tests, the experience of the TRG, and progress on having the infrastructure in place by 1 January 2021, an extension may be useful for the new standard to achieve the intended outcomes..
 - Extending the implementation timeframe could also improve insurers' evaluation of their asset liability management strategies and their selection of the most appropriate accounting approaches.

Exhibit 1: Accounting Standards Used by Listed Insurance Companies

Reporting Framework	Number of Listed Insurance Companies	Total Assets (US\$ trillions)	% of Listed Companies Using IFRS Standards
IFRS Standards	449	13.3	72%
US GAAP	128	4.7	20%
Japanese GAAP	11	4	2%
Other National GAAP	38	0.1	6%
Total	626	22.1	100%

Source: IFRS Standards – “Effects Analysis | IFRS 17 Insurance Contracts”. As of May, 2017.

Exhibit 2: Application of IFRS among the 25 Largest Insurance Companies in the World



Sources: BlackRock, Forbes – “2017 Global 2000: The World's Largest Insurers”. As of May, 2017.

HKFRS: Hong Kong Financial Reporting Standards
GAAP: Generally Accepted Accounting Principles

Exhibit 3: IFRS 17 – Project History and Timeline



Sources: BlackRock, Grant Thornton – “IFRS 17: What you need to know”. As of Aug., 2017.

Current State of Play

The IASB established a two-phased approach for the development of a new accounting standard for insurance contracts. Phase 1 was completed by issuing IFRS 4 in 2004. IFRS 4 permits insurers to retain most aspects of their previous accounting policies, with no specific requirement for any assumption to be updated. IFRS 4, currently applied, does not properly reflect options and guarantees embedded in insurance contracts and there is no specific requirement to group contracts at a granular level. In addition, profits can be recognized when insurance services are deemed to be delivered and subsidiaries in different jurisdictions may apply different recognition measures. It has therefore been challenging for analysts and other users of financial statements to compare the profitability across insurers, or even between companies within the same group.

What IFRS 17 is

Following a lengthy development period, the IASB completed Phase 2 of their insurance contracts project, with the publication of IFRS 17 in May 2017, due to come into force on 1 January 2021 (see Exhibit 3).

The objectives of IFRS 17 are to establish a comprehensive set of principles around the recognition, measurement, presentation and disclosure of insurance contracts that reflect the effect of economic changes and improve comparability across insurers. It is a complex standard that will fundamentally change the accounting rules that govern the measurement of insurance contracts and profit recognition. Despite the anticipated complexity and heavy lifting to implement IFRS 17, we believe this change is welcome because it has the potential to provide more accurate and comparable insights into insurers’ Balance Sheet and profitability, thereby improving investor understanding of the sector.

Under IFRS 17, insurers will need to account for and disclose their business performance at a more granular level by aggregating contracts of similar risk profile.

We describe below the building blocks of the General Model and alternative approaches permitted for certain contracts under IFRS 17.

The General Model: The Building Blocks Approach

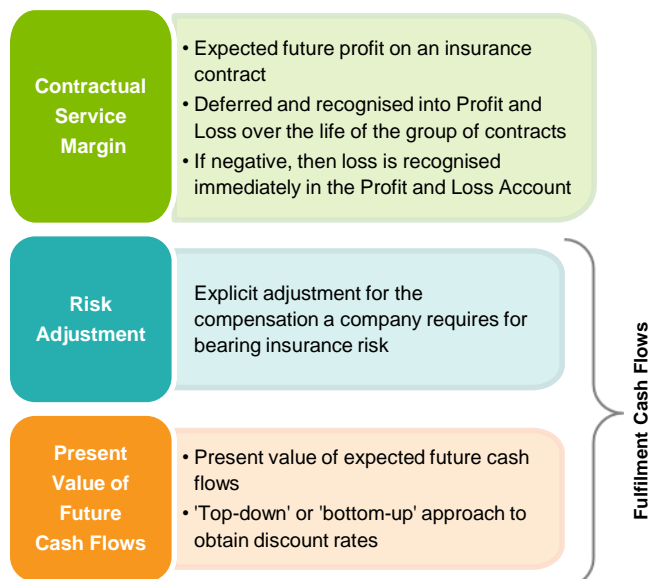
IFRS 17 introduces a comprehensive model based on the fulfilment cash flows of a contract, which are assessed using consistent current market assumptions. The basic components of the General Model requires insurance contracts to be measured and reported on the Balance Sheet based on three building blocks (see Exhibit 4). On initial recognition, expected profit is measured by calculating the Contractual Service Margin (CSM) and this is then spread over the life of the contract.

This approach eliminates any Day 1 gains but losses will be recognized immediately. Modifications to the General Model are allowed for certain contracts when specific criteria are met.

Alternative Approaches

- *Premium Allocation Approach (PAA)*: This can be used for short-term contracts and for longer-term contracts if it can be demonstrated that this simplified approach would give a similar approximate result to the Building Blocks Approach.
- *Variable Fee Approach (VFA)*: This must be used for participating contracts, provided the criteria in IFRS 17 are met.

Exhibit 4: Main Components of the Building Blocks Approach



Sources: BlackRock, IFRS Standards – “Effects Analysis | IFRS 17 Insurance Contracts”. As of Aug., 2017.

Exhibit 5: IASB's High-level IFRS 4 and IFRS 17 Comparison

IFRS 4	IFRS 17
Information about the Value of Insurance Obligations	
Some companies measure insurance contracts using out-of-date assumptions.	Companies will measure insurance contracts at current value.
Some companies do not consider the time value of money when measuring liabilities for incurred claims.	Companies will report estimated future payments to settle incurred claims on a discounted basis.
Some companies use the 'expected return on assets held' as the discount rate to measure insurance contracts.	Companies will use a discount rate that reflects the characteristics of the insurance cash flows.
Information about Profitability	
Some companies do not provide consistent or complete information about the sources of profit recognised from insurance contracts, especially when revenue is reported on a cash basis.	Companies will provide information about different components of current and future profitability arising from insurance contracts. Companies will recognise revenue as they deliver insurance coverage.
Many companies provide non-GAAP measures to supplement IFRS 4 information, such as embedded value information. This information, which has been defined independently of IFRS requirements, is not presented on a consistent basis or by all companies.	Companies and users of financial statements will need to use fewer non-GAAP measures. Information about expected insurance contract profits will be provided in a comparable manner by all companies.

Source: IFRS Standards – "Effects Analysis | IFRS 17 *Insurance Contracts*". As of May 2017.

The intended benefits of IFRS 17 are to address issues under the current IFRS 4, which we welcome. The table in Exhibit 5 above, summarizing the difference between the two standards, highlights the potential benefits of the upcoming standard compared to the existing one.

Potential Impact on Insurers

After the implementation of Solvency II in 2016, IFRS 17 is the next big challenge for European insurers – and it is probably an even greater challenge for insurers that do not apply Solvency II. Even though insurers can leverage part of the process established for the market-consistent Solvency II Balance Sheet, it will still require significant financial, actuarial and technological resources to implement IFRS 17. Aside from the technological and operational aspects, other challenges include establishing the newly-introduced 'Contractual Service Margin' concept, working out the appropriate discount rate and making decisions on the transition measures.

Time and Cost

Given the extent of changes to the Balance Sheet and Profit and Loss (P&L) account, as well as the retrospective evaluation required for all in-force business, some insurers believe that meeting the implementation date of 1 January 2021 (together with the comparative figures for 2020) will present a significant preparation burden. The window for preparation is just over two years from now. European insurers in particular will face very significant stretches to their resources, as they are also required to meet the Solvency II accelerated reporting deadline (requiring them to disclose, quarterly and annually, large numbers of Quantitative Reporting Templates attributed to the Solvency and Financial Condition Report and the Regular Supervisory

Report requirements – with the deadlines shortening by a week each year until 2020).

Further, some EU listed insurers have also learned from their Solvency II experience that considerable expertise is required in communicating any material changes of their Key Performance Indicators to the market in an effective and timely manner – to help ensure analysts and investors fully understand the impacts of the changes. An additional implementation challenge will be the concurring implementation of IFRS 17 and IFRS 9 'Financial Instruments' for those qualifying and opting for the deferral approach under IFRS 9.

The 'Contractual Service Margin' Concept

CSM represents the expected unearned contract profit of an insurance contract. It is a new concept introduced by IFRS 17. The IASB specifies that the CSM amortization pattern is to be based on the passage of time over the period the insurance coverage is provided. As said above, this is likely to have a significant impact to the Day 1 profit profile of some long-term contracts.

Discount Rates

The valuation of long-term insurance liabilities and the resulting profit recognition are highly sensitive to the selection of a discount rate. Under IFRS 17, the discount rate used is principles-based as contrasted with the prescriptive nature of the discount rate term structure under Solvency II. In addition to the impact on initial measurement, changes in current estimates including discount rate at each subsequent reporting date will potentially impact Accumulated Other Comprehensive Income in the Balance Sheet or in the P&L account as well as leading to adjustments in the value of CSM.

Transition Measures

Another critical decision for insurers implementing IFRS 17 is to evaluate the applicable transition measure for each group of contracts. Three approaches are available under IFRS 17. The full retrospective approach is to be applied unless impracticable. If impracticable, the entity is permitted to choose between a modified retrospective approach and a fair value approach. The decision made on the transition measures is likely to impact the level of future profit to be released, thus affecting future comparability between insurers over a long period of time.

The **Transition Resource Group (TRG)** set up by the IASB will provide a forum for stakeholders to follow the discussion of questions raised on implementing IFRS 17. However, we view the remit of the TRG as being relatively restrictive, with a focus on implementation issues only. Questions have to meet a set criteria before they will be discussed by the TRG.

We would suggest the IASB to expand the remit of the TRG to address questions beyond the scope of implementation and to establish direct and interactive engagement between the TRG and the Interpretation Committee or the IASB.

We would also recommend a flexible stance where the IASB remains open to changes on the standard after taken due consideration of the outcomes from the TRG discussions and the comprehensive field test, which we support. This will enable a dynamic implementation of the standard without losing momentum.

The Perspective of Investors and Analysts

BlackRock supports the principles behind IFRS 17.

Theoretically, the model will be a step forward for users of insurance companies' financial statements, particularly for assessing their profitability by product line. The implementation of IFRS 17 will seek to improve some of the weaknesses present in IFRS 4 and will seek to enhance comparability across companies and contracts.

Given the inherent complexity of IFRS 17, however, it will take some time for general users and analysts, to get used to the new disclosures and rules. **Over time and with education, analysts should be able to better identify sources of earnings** and, therefore, to evaluate profit trends with more accuracy across product lines.

Overall, we do not see IFRS 17 triggering an adjustment in the creditworthiness of the industry, assuming the new standard has no meaningful impact on corporate strategy or capital policy. It is possible, however, that for certain types of business, a meaningful change in the profit recognition pattern could influence the timing of dividend payments,

particularly for specialist insurers focused on one product line. In addition, growth priorities and management attention may well be diverted at a time the industry is grappling with a series of other challenging issues.

Analysts will need to dig deeper to fully understand the impact of the changes to financial risk assumptions because the effect can either be recognized in the P&L or Other Comprehensive Income, bringing further complication when comparing the P&L among insurers. Many insurers are likely to plan to take the deferral option available under IFRS 9 'Financial Instruments' to delay adoption until the IFRS 17 implementation date, so as to mitigate the market movement impact on their financial statements. Subject to the effectiveness of asset liability management, insurers' Balance Sheet and P&L may be more volatile going forward.

From a valuation perspective, insurers' dividend payment capacity is typically governed by their regulatory capital level. IFRS 17 will have no impact on the face of this accounting change. However, facing a potentially more volatile P&L and Balance Sheet, insurers may choose to build up further buffers in their equity reserve, therefore indirectly affecting dividend distribution during the transitional period of time. We believe that EU insurers are still digesting and optimizing their business profiles following Solvency II, which has proved to be significantly more complex than many had anticipated. One of the lessons from Solvency II was the importance of the Quantitative Impact Studies, **we believe similar 'field tests' would be of value for IFRS 17 too.** Given that there has yet to be a truly comprehensive industry study published on IFRS 17, we believe that **more time for a testing period would be beneficial to help ensure a smooth transition and potentially improve the process of selecting the accounting options.** This additional time would also allow insurers to educate users of their financial statements of the multiple nuances to the reporting requirements under different rules (such as IFRS 4 and Solvency II). We would be supportive of such a study, as opposed to the more commonly presented recommendation from commentators to 'start preparing for a big effort now'.

Finally, we recognize that Solvency II and IFRS 17 set out to serve different purposes. Understandably, the two sets of rules have different approaches in fundamental areas such as the valuation of insurance liabilities and treatment of illiquidity premium. However, for investors, in an ideal world, **there would be a far closer convergence between the Solvency II and IFRS 17 methodologies,** providing a consistent view of both capital adequacy and profitability.

Conclusion

BlackRock appreciates the intent and welcomes the principles behind IFRS 17. We note, however, that despite the prolonged development that IFRS 17 has been under the potential financial and operational implications have not been fully communicated to, and digested by, the market. For example, information available for investors on the impact of the changes such as the CSM concept to specific insurers is very limited. We, therefore, recommend a three-pronged, pragmatic approach to provide stakeholders confidence and ensure the objective of IFRS 17 will ultimately be met.

Until some of the impacts of IFRS 17 are better understood, we see a risk that the burdens associated with implementing the new rules under existing stretched timetables could outweigh the benefits. Such concern comes at a time when insurers are already grappling with a challenging monetary backdrop and unprecedented ongoing regulatory change, which should not be under-estimated. As insurance companies move towards implementation, policy makers could review the implementation deadline to ensure a smooth transition to the new standards.

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