Jessica Chew Cheng Lian: IFRS 17 Insurance Contracts

Welcome address by Ms Jessica Chew Cheng Lian, Deputy Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Joint IFRS Foundation & MASB Regional Workshop “IFRS 17 Insurance Contracts”, Kuala Lumpur, 17 May 2018.

* * *

Good morning ladies and gentlemen and welcome to today’s Regional Workshop on IFRS 17 Standards for Insurance Contracts, jointly organised by the IFRS Foundation and the Malaysian Accounting Standards Board (MASB).

Allow me first of all to congratulate the IFRS Foundation and MASB for putting this workshop together, with an impressive line-up of experts and practitioners to share their knowledge and insights on IFRS 17. We are especially privileged to have with us today two senior members of the IASB Board Mr. Darrel Scott and Mr. Amaro Gomez, both of whom have been with the IASB for more than 10 years. The strong interest in IFRS 17 and its importance both to financial systems and businesses are clear from the turnout today, with more than 250 participants from over 15 countries, representing industry players, accounting firms, national standard setting bodies and financial regulators.

It is an honour for me to offer some brief remarks this morning to kick off today’s workshop. On my way here, I recalled a joke in which a lady was once told by her doctor that she would only have six months to live. Understandably very distraught, she asks the doctor for advice on what she should do. The doctor suggested that she should marry a CPA. “Will that make me live longer?” the lady asks hopefully. “No,” the doctor replies. “But it will *seem* longer”.

Well, I promise to keep my remarks short, although since this is an accounting workshop, you will forgive me if they might *seem* long.

As you know, IFRS **17** was finalised and issued in 20**17**. Today, the **17**th of May, also marks **17** years since the International Accounting Standards Board took on the job to develop a globally accepted accounting standard for insurance contracts. What a remarkable coincidence indeed!

The final IFRS 17 standards represent a historic milestone – for the first time, insurers in over 120 countries, with assets worth at least USD13 trillion, will be reporting financial statements based on a common set of standards when IFRS 17 comes into effect in January 2021.

Almost two decades ago, standard setters embarked on a Herculean mission to develop a globally accepted accounting standard for the measurement of insurance contracts which did not exist before. In the time that it took to finalise IFRS 17, we have witnessed significant developments in the accounting world, including the transformation of the International Accounting Standards Committee (IASC) into today’s IASB, the formation of the Monitoring Board to enhance public accountability of the IFRS Foundation, and sweeping reforms to key accounting standards to address the deficiencies which were believed to have amplified the 2008 global financial crisis.

The development of IFRS 17 itself saw the issuance of IFRS 4 as an interim standard, one discussion paper and two exposure drafts. Its finalisation was achieved after more than 900 meetings, 600 comment letters and 4 rounds of fieldwork and testing! I am told it is among the longest in duration, largest in scale and most complex project ever undertaken by an international standard setter – making it a tremendous feat and a testament to the intellectual capacity and perseverance exemplified by the IASB.

Even then, this 17 year journey remains incomplete as the final stretch begins with the passing of the baton from the standard setter to those involved in preparations for implementation – that is the industry. As the clock counts down to the global implementation date in January 2021, the most important implications of IFRS 17 lie *ahead* of us.

1. First, it will have an important impact in strengthening market discipline.
2. Second, it will improve alignment between business units and financial management and reporting. This in turn will provide more robust foundations for the growth and development of the insurance sector in this region.
3. And third, it will raise important issues around governance to ensure the integrity of financial reporting by insurers and other market participants.

Strengthening market discipline

For a long period, the absence of a common uniting standard to account for the measurement of insurance contracts has resulted in a wide range of approaches being applied by insurers across the world. Take for example the measurement of present value of future cashflows from insurance contracts. While some insurers update the discount rates to reflect current economic conditions, others opt to retain the use of historical discount rates when these contracts were originally underwritten, ignoring recent and future developments that could affect the value of the contracts. This means that similar contracts are being measured very differently, resulting in contrasting representations of the true performance and strength of an insurer. Such variations in measurement approaches significantly complicate comparability between insurers. This in turn weakens market discipline.

The harmonisation of insurance contract measurement approaches across the globe brought about by IFRS 17 is therefore timely, if not long overdue.

The measurement of insurance liabilities using current market prices will bring about a closer alignment between the assets and liabilities on an insurer’s balance sheet. And with a clearer demarcation between underwriting and investment profits and the recognition of profits over the lifetime of a contract rather than at a single point in time, IFRS 17 will also paint a more accurate picture of an insurer’s performance.

These improvements will increase the relevance and utility of financial information provided to investors, financial advisers, insurance risk managers, businesses and individuals to inform investment and purchasing decisions. As a result, markets should work better to reward prudent and profitable performance, and appropriately penalise risky and poor performance. This is positive both for financial stability and the efficient allocation of economic resources.

Improving alignment between business units and financial management

Bank Negara Malaysia also expects IFRS 17 to be a key catalyst for insurers to review, if not overhaul, business processes across the organisation. This will be driven by at least three factors.

First, the need for business units to capture broader and more granular information required for financial reporting. Second, changes in the way performance is measured under the new standard. And third, increased opportunities for institutions to differentiate themselves from the competition, helped by a more integrated view of performance. These considerations will have wide implications for insurers’ organisation structures, data capture, infrastructure and systems, risk management, and product design and development.

At present, many insurers are operating on multiple, fragmented legacy systems – including largely separate systems supporting the finance, investment and actuarial functions. Systems for regulatory reporting and compliance are also often separate in a number of institutions. As insurers begin to prepare for the reporting of insurance liabilities under the new regime, IFRS 17 will create both a need and the opportunity for insurers to strategically re-think information flows across the organisation – not only to improve efficiencies in financial reporting and mitigate operational risks, but also to capture synergies that will improve business and compliance outcomes. This includes leveraging on data analytics to support more refined pricing, elevate investment and treasury operations, and achieve greater capital efficiency.

Risks will also shift into sharper focus. As IASB chairman Hans Hoogervorst puts it, "*proper accounting shines light on risks that might otherwise go unnoticed*". The financial reporting changes brought about by IFRS 17 will support profitability analyses at the level of individual business units and products, thereby increasing the visibility of risks and performance associated with specific business strategies and operational models.

Governance considerations

IFRS 17 will also have important implications for governance.

One of the most problematic issues with the adoption of IFRS has been around the more extensive use of management judgement and discretion in financial reporting. For example, in the context of IFRS 17, calculating the contractual service margin component, an insurer's choice of assumptions can have a significant impact on its forecast of future profits. While this is consistent with the view that financial reporting should reflect management decisions, the scope for abuse is also higher. This has also been a particular concern for regulators, resulting in dual reporting standards for general purpose and regulatory compliance which continue to be maintained in some jurisdictions today.

Such concerns are not entirely unfounded. Past studies have suggested that strong associations exist between accounting discretion and opportunistic behaviour by firm managers where governance is weak. In other words, in the absence of strong governance, managers have strong incentives to exploit accounting latitude in order to achieve certain short-run performance goals that are linked to rewards.

This raises a number of important issues for governance. For one, insurers will need to consider the adequacy of existing internal controls and accountability frameworks to ensure the integrity of financial reporting. For example, where actuarial models are used, to what extent are these models and the assumptions underpinning them subject to sufficiently robust validations? Insurers will also need to consider the depth of knowledge and expertise required at the audit committee level to enable the effective oversight and monitoring of management discretion. Part of this oversight includes the rigor applied by boards and audit committees in the appointment of external auditors to ensure their ability to act as an independent check on management discretion.

It is also essential for insurers to develop strategies for improving communications with users of financial statements. A key risk will be that users fail to make sense of reported results which can lead to irrational behavior and unintended consequences. Equipping board members and senior management to communicate results effectively will be particularly important.

These are also the issues that supervisors will be concerned with. Given the potential for heightened risks and uncertainty, the Bank will examine the need for regulatory prescriptions or guidance – particularly in the early phases of implementation. Over time, we expect stronger governance within insurers to reinforce associations between financial reporting and fundamental economic factors, as intended by IFRS.

In Malaysia, the finalisation of IFRS 17 is indeed timely in the light of current reforms being undertaken by Bank Negara Malaysia to further develop the domestic insurance market. This will see greater competition and complexity in the insurance sector, alongside a renewed impetus for growth through channel diversification and digitalisation. In this environment, the implementation of IFRS 17 will have an important role in improving the quality of information provided to the market on how these developments impact the performance of insurers, and in strengthening foundations for sound governance and risk management. This in turn will promote the effective functioning of insurance markets to serve the economy.

Early preparation is key

So then, where do we stand today? With less than two and a half years before the implementation date sets in, how prepared are insurers to implement IFRS 17?

The answer is not encouraging. A recent survey published in January this year by a software firm covering some 240 insurance companies spread around the world, found that a startling 92% of insurers had yet to start putting solutions in place. Among those that have started, a vast majority are still only in the initial stages of planning.

While there is still some time before the first reporting period under IFRS 17, it would be a grave mistake to leave things too late given the scope and enormity of the issues that that need to be addressed. This is compounded by the prospect that insurers that are late to the game are likely to face an acute skills shortage as first movers draw down a limited pool of qualified actuaries, IT specialists, software and systems vendors and technical consultants.

In Malaysia, early steps have been taken by Bank Negara to engage the industry on the development of broad implementation plans. That said, the granularity of the plans and implementation progress remains uneven across insurers and takaful operators.

Recognising the complexity and wide-ranging implications of the new standards, several industry technical working groups have been established in coordination with the Actuarial Society of Malaysia to examine key issues and provide recommendations on the implementation of IFRS 17. We have also conducted a first preliminary round of quantitative testing, which was intended to help insurance companies gauge the potential impact of the new standards on their resources, systems and reported performance. A second, more comprehensive quantitative testing exercise has also been planned for the third quarter of this year. Going forward, the Bank will be intensifying our monitoring and engagements with insurers and takaful operators on their preparations in the run up to 2021.

Conclusion

Looking ahead, a more optimistic outlook for the global economy will support favourable conditions for a smooth transition to IFRS 17. But the work must start now, and it must start right by taking a broader and integrated approach to implementation. Today's workshop aims to bring some of the most important issues in implementation to light, and provide you with valuable insights from our distinguished speakers and subject matter experts. With greater clarity and knowledge to inform careful preparations, insurers can be confident of not just achieving a smooth transition to IFRS 17, but of laying strong foundations for long term growth and success.

That is the ultimate goal.