

Malaysia: Key issues and challenges observed around IFRS 17 implementation in life insurance and Takaful

Introduction

The International Accounting Standards Board has decided to defer the effective date of IFRS 17 from 1 January 2021 to 1 January 2023. Effectively, this gives insurance companies a little over two years from now to implement and apply IFRS 17 to their business. In addition to insurance companies, it is likely that IFRS 17 will be applicable to Takaful companies as well, as there is significant insurance risk borne by the risk fund. In Malaysia, most insurance and Takaful companies have already started their implementation phase. Yet there continues to be ambiguity in interpreting several areas of the IFRS 17 standard, including:

- Mutualisation
- Fulfilment cash flows and contractual service margin for Takaful
- Treatment of surplus sharing
- Premium experience adjustments related to current or past service
- Discount rates
- Transition approaches
- Reinsurance and Retakaful

In this e-Alert we discuss each of these areas of concern.

Mutualisation

Under IFRS 17, some contracts affect cash flows of other contracts (i.e., cross-subsidisation), for example when sharing the same pool of ‘underlying items (e.g., sharing in the same surplus). For life insurance business, this will include participating products, whereas for Family Takaful business, this will include products with surplus sharing features. For these contracts, an adjustment is required to the fulfilment cash flows (FCF) to exclude the effects of mutualisation. In other words, for a contract which is cross-subsidising other contracts, its FCF would include the cross-subsidy payment made, and the FCF of a contract receiving a subsidy would exclude the amount of guarantee above its share of the pool. These exclusions include potential payment to or from future policies.

Paragraph B69 of the IFRS 17 standard states that “to the extent that payments to policyholders in one group are reduced from a share in the returns on underlying items of CU350 to CU250 because of payments of a guaranteed amount to policyholders in another group, the fulfilment cash flows of the first group would include the payments of CU100 (i.e. would be CU350) and the fulfilment cash flows of the second group would exclude CU100 of the guaranteed amount.”

The above paragraph can be explained with the following example shown in Figure 1.

FIGURE 1 : ILLUSTRATIVE EXAMPLE OF MUTUALISATION

POLICY HOLDER	GUARANTEED RETURN (USD)	RETURN WITHOUT GUARANTEES (USD)	ACTUAL RETURN (USD)	MUTUALISATION ADJUSTMENT (USD)
A	250	350	250	100
B	450	350	450	-100

In this illustrative simple example, two policyholders, A and B, share the same pool of underlying items. Policyholder A is guaranteed a return of USD 250 every year, while policyholder B is guaranteed a return of USD 450 every year. Let’s assume that the return on the pool of underlying items is USD 700. If there were no guarantees, policies A and B would each receive USD 350, if we assume both will receive an equal share of the return. However, due to the guarantees, policyholder B would receive USD 450, and policyholder A’s return would be reduced from USD 350 to USD 250. This is the effect of mutualisation, and would be removed under IFRS 17.

Based on paragraph B69 above, the fulfilment cash flows of policyholder A would have to include the USD 100 paid out, and the fulfilment cash flows of policyholder B would have to exclude the USD 100 received. The effect of this is that the cash flows of both policyholders A and B will recognise a return of USD 350.

The FCF and profitability of the group of contracts sharing in the pool of underlying items as a whole is not expected to change after the mutualisation adjustments, as they are merely moved within cohorts in the group (assuming there is no orphan surplus). The purpose of mutualisation is to allow for the allocation of profits to the cohort where they were 'generated'.

For example, if a contract which is cross-subsidising other contracts does not have the subsidy included in its FCF, it may be artificially profitable. Conversely, a contract receiving a subsidy may be artificially unprofitable. This has implications on the timing of recognition for IFRS 17 profits as they are spread out over the duration of a contract while losses are capitalised immediately.

To determine this mutualisation adjustment, the contract's share of the pool of underlying items will need to be determined. For this purpose, some companies are considering the use of asset shares for participating business. The mutualisation adjustment can then be determined based on the surplus and the asset shares.

This might be particularly challenging for Takaful business, as most Takaful companies do not calculate asset shares for their contracts. In practice, the surplus distribution is determined at a portfolio level, whereas the mutualisation adjustment will need to be calculated at (or allocated to) a contract or cohort level. The surplus distribution will first need to be calculated at a portfolio level and then allocated down to the contract level, and this could be challenging for Takaful companies as most of their existing actuarial models only project cash flows and surplus at a contract level. Additional enhancements to the actuarial models will be required to calculate surplus distribution at an aggregate fund level, and allocate the surplus back down to more granular contract groups for IFRS 17 reporting purposes.

For both participating and Takaful products, some contracts might receive subsidies from orphaned surplus to meet guarantees or policyholder expectations. As this is also a form of mutualisation, an adjustment might need to be derived to eliminate this, but its calculation may not be clear. Even with the use of asset shares, it might still be difficult to determine this mutualisation adjustment as some of the orphaned surplus belongs to the contract holder. Thus, considering subsidies to and from orphan surplus might further add a layer of complexity to companies.

Fulfilment cash flows and CSM for Takaful

Referring to our previous e-alert on "Implementing IFRS 17 for Takaful companies" (click [here](#) to download), there is also uncertainty around whether companies should calculate fulfilment cash flows and contractual service margins (CSMs) separately for

each fund or at a total contract level (i.e., without considering interfund transactions).

This is applicable to contracts which involve cash flows between multiple funds. For example, a Takaful contract may include cash flows from the risk fund and the Takaful operator fund.

As of early 2020, it is observed that the market is divided between both approaches. While some companies are performing their calculations at a fund level, others are calculating at a total contract level.

Currently, no formal guidance has been issued by the local accounting standards board in Malaysia. However, the local accounting standards board may decide that the financial statements have to be prepared on a columnar basis, which requires results to be reported for each fund, and this is particularly relevant for Takaful companies. Companies performing calculations at a total contract level will need to enhance their models to calculate cash flows separately for each fund.

Treatment of surplus sharing

With reference to our previous [e-alert](#), it remains unclear whether treatment of surplus sharing under IFRS 17 should reflect statutory reserving and capital requirements or accounting requirements. In Malaysia, currently surplus distributions need to be in line with the company's surplus management policy and take into account statutory reserves.

In addition, surplus distributions are determined net of reinsurance cash flows under current practice. As IFRS 17 states that reinsurance contracts held should be measured separately from underlying contracts held, it is unclear whether surplus distributions will need to be determined separately for underlying and reinsurance contracts.

Premium experience adjustments related to current or past service

The standard does not clearly explain how to account for the differences between expected premiums and actual premiums (premium experience adjustments). Based on the discussion in the Transition Resource Group (TRG) for IFRS 17 in September 2018, the premiums experience adjustments related to future service should adjust the CSM, whereas the premium experience adjustments related to current or past service should be recognised immediately as part of the insurance revenue.

However, the premium experience adjustments may often involve a mix between future service and current or past service (e.g., annual premium in the 10th year of a 25-year contract). Judgement may be required to determine whether this should adjust the CSM or be recognised in the insurance revenue.

Discount rates

To determine the discount rates used for IFRS 17, a company may use a bottom-up approach or a top-down approach.

- Using a bottom-up approach, the company may adjust a liquid risk-free yield curve to reflect the differences between the liquidity characteristics of the financial instruments that underlie the rates observed in the market and the liquidity characteristics of the insurance contracts. However, it can be challenging to determine this illiquidity premium.
- Using a top-down approach, the company may adjust a yield curve that reflects the current market rates of return implicit in a fair value measurement of a reference portfolio of assets, by eliminating any factors that are not relevant to the insurance contracts. However, it might be difficult to find a suitable reference portfolio, or such eliminating factors.

Based on our observations, most companies in Malaysia seem to have leaned towards the bottom-up approach, as they can leverage the risk-free rate used for current statutory reporting.

For Takaful companies, it is also unclear whether a single discount rate would be adopted for the single contract, or whether multiple discount rates would be adopted varying by the underlying funds, i.e., Operator's Fund, Participant Investment Fund and Participants Risk Fund.

From a modelling implementation standpoint, adopting a single discount rate appears to be the most practical approach. There are significant modelling challenges in adopting multiple discount rates varying by different funds, thus companies need to be aware of such challenges if such an approach is selected.

Transition approaches

IFRS 17 states that the full retrospective approach should be applied unless impracticable. In Malaysia, we observe that most companies are not able to apply the full retrospective approach. The common issues faced by companies when applying the full retrospective approach are splitting of past cash flows by cohorts and splitting of the insurance and investment components for past claims.

If the full retrospective approach is impracticable, then companies may apply the modified retrospective approach or the fair value approach. The objective of a modified retrospective approach is to achieve the closest outcome to a full retrospective approach using reasonable and supportable information.

The fair value approach is the difference between the fair value of a group of contracts and the fulfilment cash flows measured at that date. Companies may use the accounting standard IFRS 13 on Fair Value Measurement to determine the fair value.

The CSM and insurance revenues might differ significantly under both approaches. Typically, we see that the fair value approach produces a lower CSM compared to the modified

retrospective approach. A higher CSM would produce a greater profit for the company in the future, but companies would have to set aside a greater portion of their retained earnings on the transition date to support a higher CSM. This can be investigated further through a financial impact assessment to evaluate the impact of various approaches.

Reinsurance and Retakaful

IFRS 17 requires reinsurance contracts held to be reported separately from insurance contracts issued. Contract boundaries for reinsurance contracts held are determined separately from contract boundaries for the underlying insurance contracts and in many cases are not expected to be aligned. As a consequence, the FCF for reinsurance contracts held may include reinsurance cash flows arising from underlying insurance contracts which have not yet been sold, which poses a challenge as insurers may have to explicitly quantify cash flows arising from future new business.

The measurement of CSM for reinsurance contracts held is also affected by the CSM for underlying contracts issued. This occurs, for example, in the case of either of the following:

- The reinsurance contracts' CSM is adjusted for losses on initial recognition of an onerous group of underlying contracts.
- Changes in FCF of underlying contracts do not adjust the CSM for those underlying contracts because the group of underlying contracts is in loss recognition, correspondingly FCF changes of reinsurance contracts held in relation to this group of underlying contracts do not adjust the reinsurance contracts' CSM.

To do this, companies will have to map changes in FCF of reinsurance contracts held to changes in FCF of the corresponding underlying contracts, which is not a straightforward task, as a group of reinsurance contracts held may correspond to multiple groups of underlying contracts, and conversely a group of underlying contracts may be reinsured under multiple groups of reinsurance contracts held.

In Malaysia, most companies have not yet modelled reinsurance and Retakaful cashflows accurately and extensively, with many companies adopting simplified approaches. The majority still rely on legacy systems to conduct reinsurance and Retakaful calculations. Hence enhancing their legacy systems and actuarial models to comply with IFRS 17 requirements for reinsurance and Retakaful is an ongoing challenge for many companies.

Conclusions

Overall, the nuances of implementing IFRS 17 have been challenging for many companies in Malaysia, although most companies have made good progress with their implementation efforts relative to the new deadline of 1 January 2023. The Takaful industry remains slightly behind conventional

companies in terms of implementation progress, given the additional challenges of interpreting the new guidelines for Takaful. Milliman has worked extensively in the implementation of IFRS 17 for life insurers and Takaful companies in Malaysia and across Asia, and is well-positioned to advise and support companies with their planning and implementation, particularly around actuarial modelling.



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