GLOBAL INSURANCE SERVICES

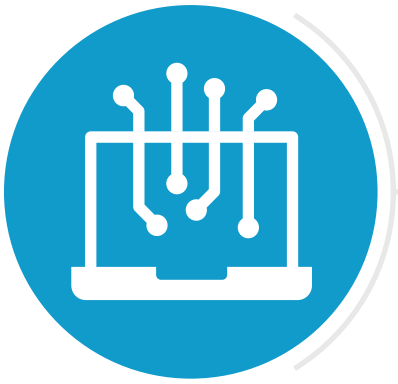
Heading towards the IFRS 17 quagmire?

FTI Consulting's research suggests that, although insurance companies are making good progress with implementing the new accounting standard, they may be overlooking some opportunities for proactivity, particularly in terms of managing risk, accelerating technological upgrades and embedding effective communication strategies.

FTI Consulting's in-depth research with C-level executives across the insurance sector suggests decent progress in implementing IFRS 17, with board members fully aware of the scale of the change and often directly involved in its implementation. However, in the following three areas it seems that best practice is not being universally followed. We advise insurers to address these shortcomings urgently in order to avoid errors seen in previous transformations, some of which had adverse effects on companies.

1. Risk management in the boardroom

We believe governance around risks of failure needs to be more ingrained in the implementation process. To address the risks inherent in an exercise of this size, firms should more deeply engage Chief Risk Officers (CROs) in their implementation programmes, alongside the other senior executives who are already involved.



2. Wider technology updates

Most insurers are using the implementation of the new standard as an opportunity to upgrade the finance function's system and processes, compensating for past under-investment. However, we believe they should consider at the same time implementing wider technology changes (such as those underpinning data analytics) to achieve additional benefits in a cost-effective way.

3. Communications

So far, there has been little engagement between insurers and the investor community about the new standard. The sooner insurers consider the implications of the new standard for their communications strategy, the better. Investor relations (IR) teams must be brought on board without delay to give them the necessary time and resources to formulate a communications strategy. Start to formulate a broad-based communications strategy at least 12 months before going live with disclosures under the new standard.

Navigating the transformation minefield

The new international financial reporting standard for insurance contracts, IFRS 17, is the latest of a series of change exercises that have been high on the industry's agenda over the past decade.

FTI Consulting recently conducted research to find out how well firms are positioned to avoid the mistakes of earlier transformations. Some of these mistakes, particularly around strategy and external communications, which have been the focus of our study, were apparent from the Solvency II implementation exercises across the European markets. Two examples come to mind:

- Many companies failed to identify key "what-if" scenarios that have significant implications on solvency as well as strategic decisions. For instance, many companies were subsequently caught by the increased volatility in capital requirements as a result of changing credit spreads.
- The share prices of Delta Lloyd and Aegon (see Figure 1) tumbled in the wake of announcements about missed capital targets, amongst others. Although a drop in share price is to be expected following such announcements, it is our opinion that better communications strategies would have cushioned the fall.

Our study consisted of a series of in-depth discussions between FTI Consulting and senior executives from a number of insurance firms (including reinsurers) to understand their views on IFRS 17's implications for their businesses. These conversations took place in late October and November 2019. We also spoke with analysts and supplemented our research with observations from our day-to-day work with clients. We would like to express our thanks to all those who participated in the study.

Share price drop in August 2015*

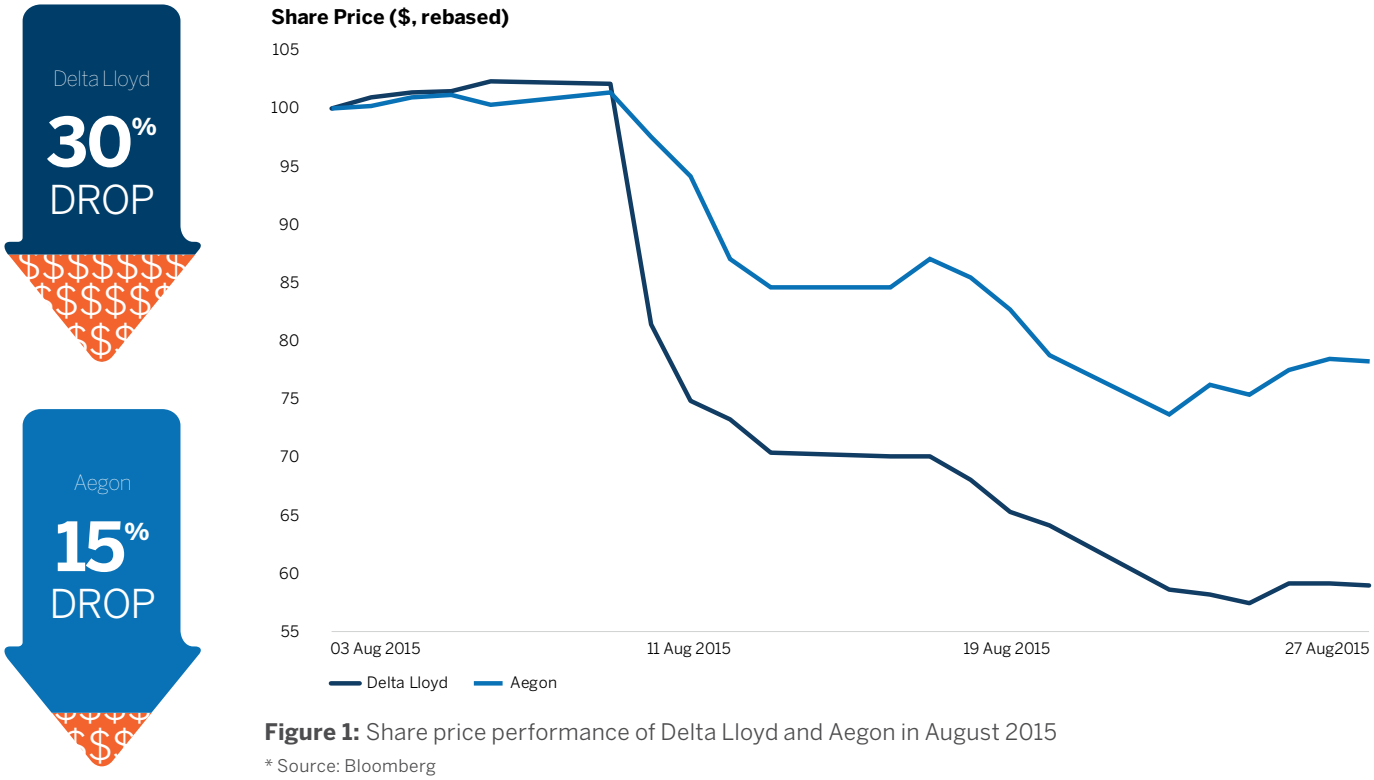


Figure 1: Share price performance of Delta Lloyd and Aegon in August 2015

* Source: Bloomberg

How well do firms' strategies address risk?

Greater boardroom involvement is much needed

Without a committed level of engagement from top management, large change programmes are bound to under-achieve. A small number of companies, most of which operate on cash and capital metrics but which also report financial performance on the new standard, are running this risk as a result of the little value they associate with IFRS 17 transformation and the consequential lack of engagement from C-suite executives.

Elsewhere, executive committee members are generally engaged with the transformation exercise to a suitable level.

Some of the best practice we observed include:

- **The Board receiving formal training on the subject**
- **The appointment of a designated project sponsor, usually the CFO**
- **Involvement of all relevant functions**
- **Regular monitoring of progress, key risks and issues, as well as costs**

Having said that, we are concerned that risk management does not appear to be fully enshrined in the transformation process at the top level. It is questionable whether CROs have a meaningful seat at the board table, and this may explain why IFRS 17 implementation has not made it to the Board's top 10 risks. In our opinion, this is far from best practice and should be remediated without delay. Failure to do so may lead, amongst others, to poor business planning as a result of an incomplete assessment of sensitivity of the balance sheet and profitability.

> *From our perspective, IFRS 17 is a necessary evil.*
>
> **CEO Life, Insurer**

Investing for the future

Companies are wisely seizing the opportunity to make up for past under-investment in finance systems and processes. IT infrastructures are undergoing significant upgrades to handle the increased granularity and quality of data required by IFRS 17 and to enable a better flow of information between different systems. Steps are being taken to improve accounting and finance systems, such as the general ledger and group consolidation, and to eliminate fragmentation which is a common feature in finance function technology.

> *Certainly, some initiatives which have seen push-back on budget requests in the past are now going through as a part of IFRS 17 – while the bonnet is open, let's have a proper look!*
>
> **CEO Life, Reinsurer**

Some insurers are also streamlining finance processes to reduce manual interventions and make the end-to-end reporting process more efficient. There is no doubt that the new accounting standard is proving to be an agent for technological change in an industry facing relentless disruption from insurance technology start-ups.

However, for the more strategically-minded firms, the scope exists to introduce or accelerate technological upgrades in the wider business and across the full insurance lifecycle, from policy issuance to claims processing – data analytics, robotic process automation and blockchain technology to name but a few areas. Astonishingly few companies have taken this more holistic approach despite the achievable cost benefits. We recommend that companies reassess the objectives of their transformation exercise in this context and identify where additional value could be gained.

> *We run our business on our own economic capital model. Why would we suddenly say, 'Oh this particular product in this geography makes no sense and we won't sell it any more'? This seems very odd.*
>
> **Group IRO, Insurer**

Business continues as usual

On the wider business strategy front, covering areas such as risk, investment, innovation, growth, product design and pricing, most European insurers and reinsurers do not expect the new standard to have significant implications as their businesses are run on economic capital measures, independently of the accounting regime. Some of these players even question whether business strategy should be influenced by the accounting story, noting that while the new standard will affect cashflow recognition, the economic substance of financial statements will not change.

Similarly, with regards to reinsurance strategy, significant implications are not foreseen. However, reinsurers are surprised at the lack of engagement from insurers on the potential implications, however small they might be, for their reinsurance programmes. There is a somewhat familiar feeling that considerations around reinsurance optimization will only come towards the end of the implementation exercise.

Whether these opinions are well-informed remains to be seen, given that financial results from production runs – if these have been completed – have not filtered through to the Board at this stage. It would serve insurers and reinsurers well to keep the strategic questions on the radar until they are fully answered through impact assessments supported by real data.

In Asian markets, information to assess the impact of IFRS 17 on strategy has also not made its way to top management to date. However, with economic capital not yet a prevalent regime, IFRS 17 represents a game changer and many market participants anticipate material consequences on business strategy. Companies are minded to review the appropriateness of onerous product terms (e.g. products with guarantees, loss-leading products), to invest in the development of less onerous products, and to revisit selling practices. Having said this, it is worth mentioning that in some of the Asian countries an economic capital regulatory regime is also being introduced at around the same time as the new accounting standard and this may have fuelled the difference in opinions between the two geographical markets.

> *We are amazed at how few questions we have had on IFRS 17 from insurers – it has been incredibly quiet.*
>
> **CEO Life, Reinsurer**

Are firms positioned for sound communications?

New disclosures and metrics will be complex

The investor community is generally positive about the new accounting standard and expresses high hopes of improved comparability in disclosures. Some analysts expect to get a far clearer handle on the quality of the businesses they scrutinise as a result of the increased granularity in disclosures. A few of them also display an appetite for even more information – for example, details on different product characteristics with performance of different business vintages year on year.

Many insurers expect to produce additional information in the form of supplementary disclosures, but these are not intended to satisfy the appetite of these evangelical analysts. Instead they will aim to capture performance metrics which support the investor story despite not featuring in the new accounting

> *IFRS 17 will not be the holy grail of insurance accounting that analysts believe it will be. Everything will not work economically beautifully.*
>
> **Group IRO, Insurer**

regime. Regulatory capital, cash generation, value of new business, combined ratio, operating profit and embedded value are a few examples.

According to insurers, analysts are in for a shock if they expect IFRS 17 to be the holy grail of insurance accounting. Many insurers run their business on cash and solvency capital metrics. This is not likely to change, and business leaders will continue to treat accounting key performance indicators as 'nice-to-have' measures. Moreover, despite the increased size of disclosures, the evaluation of insurance companies will remain highly complex. Analysts should not expect the ability to pinpoint the performance of some arbitrary part of the business without extra work.

Some analysts do concede that new disclosures will be complicated and may be less useful than the already established, comprehensive and more familiar Solvency II reports. Certain analysts go as far as to question how long the new standard will endure and raise the possibility of embedded value principles rising from the ashes – a view that, somewhat surprisingly, is echoed by some insurers.

Communications and IR involvement: the time is now

Most insurance companies believe it is too early to engage with the investor community regarding the new standard, and to date, they have only recorded limited enquiries from investors. Nonetheless, there is recognition that work will be required in this space and most firms agree that they should start to articulate an engagement strategy at least 12 months prior to disclosing the first set of numbers. For now, insurers think it might be a little early.

On the other hand, very few analysts consider that it is too early to expect insurers to engage with the investor community. Strangely enough, a significant number comment that insurers don't seem interested in what analysts would like to see in disclosures under the new accounting regime. Most analysts of course recommend that IR teams do not leave it too late to engage with the investor community.

We agree with the above recommendation from analysts and would caution insurers against the consequences of poor communications, especially in light of the mistakes from previous transformations referred to earlier in the article. The insurance industry is widely perceived as one of the most complicated sectors for investors to analyse. Equity analysts have long been grappling with the concept of insurance company valuation, attempting to quantify it with a plethora of metrics. It is also no secret that insurance company shares tend to trade at a discount as a result of perceived inconsistency and opacity in disclosures across the industry.

In our opinion, a thoughtful external communication strategy will help insurers to bridge the gap between their perceptions and those of analysts. Therefore, insurers should start to think about how they will engage with the investor community around the new accounting standard. They should also consider when and how IR and Corporate Affairs functions can work together to develop or to maintain a compelling investor story.

In an age where many insurance companies seek to align themselves with the long-term interests of their customers whilst promoting greater awareness of how they are fulfilling their social purpose, further perceived opacity or reticence to engage will be received negatively. It is, therefore, necessary to carefully think about how the new reporting metrics will be received, not only by the investor community, but also by other important stakeholders including the media and internal audiences.

Messages must be clear

Many of the interviewed insurers emphasise the importance of clarity and coherence in their corporate communications. To achieve this, there is consensus that:

- Information from preliminary impact assessments is not enough;
- Production runs with real data are needed; and
- Internal discussions must be completed before going external.

We expect those communications to include some form of IFRS 17 training despite the research that analysts will have done. With this in mind, we recommend that IR teams consider how to deliver sessions to the investor community and other selected stakeholders groups aimed at educating them on the new standard in the context of what matters to the company. It will be important to keep such sessions light and not to lose the attention of the audience halfway through them.

We expect to see educational sessions for investors, but who in the industry is going to take the initiative?

Group VP and IFRS Project Lead, Life Insurer

Non-specialist investors need special treatment

One investor relations executive expressed concerns about the rise of generalist investors, who now outnumber those with insurance expertise. Although this may not have come across as a widespread worry during the study, we believe that this is a very pertinent issue, not to be dismissed by IR directors. In fact, we recommend that they consider changes to established practices, such as the ones below:

- Employing additional resources to support the IR team;
- Bringing back capital market days and introducing some form of investor education; and
- Investing in more direct communications with a wider investor audience.

Avoiding the quagmire - three key tips

1 Address risk management early

- Fully involve the CRO from the beginning – don't wait for a crisis to occur.
- Modify existing 'business as usual' governance structures to encompass transformation risks.

2 Seize the opportunity to update technology

- Look for ways to adopt new data analytics, machine learning and artificial intelligence technology in the wider business during the implementation exercise.

3 Anticipate communication needs

- Start to formulate a broad-based communications strategy at least 12 months before going live with the new disclosures.
- Ensure that Investor Relations (IR) teams are adequately resourced in the run-up to live disclosure.
- Consider how IR teams messages will affect standing with other stakeholders beyond investors, including media and employees. IR teams should map problem areas, test messaging and run scenario planning sessions with Corporate Affairs teams well ahead of launch.

To find out more about our study or about how FTI Consulting can help you with IFRS 17 or other business transformation projects, please contact:

Simon Grout
Managing Director, Global Insurance Services
+44 203 727 1618
simon.grout@fticonsulting.com

Allister Fowler
Managing Director, Strategic Communications
+44 20 3319 5704
allister.fowler@fticonsulting.com

About FTI Consulting

FTI Consulting is an independent global business advisory firm dedicated to helping organisations manage change, mitigate risk and resolve disputes: financial, legal, operational, political & regulatory, reputational and transactional. FTI Consulting professionals, located in all major business centres throughout the world, work closely with clients to anticipate, illuminate and overcome complex business challenges and opportunities.

www.fticonsulting.com

909- 01/20