

## Indonesia: Key issues and challenges of IFRS 17

### Introduction

In November 2020, the Financial Accounting Standards Board (DSAK) of the Institute of Indonesian Chartered Accountants (IAI) ratified the exposure draft of the PSAK 74, Insurance Contracts, (PSAK 74) reporting standard. This is the Indonesian equivalent of IFRS 17, Insurance Liabilities, published by the International Accounting Standards Board (IASB). The proposed changes to PSAK 74 mirrored the amendments to IFRS 17 published by the IASB in June 2020 with the exception of the preparation of how interim reports are prepared. PSAK 74's effective date is 1 January 2025, meaning Indonesian insurers will be required to report under PSAK 74 two years after the effective date of IFRS 17, unless they opt for early adoption.

In addition to the challenges that insurers implementing IFRS 17 face globally, there are several unique challenges in adopting PSAK 74 for companies in Indonesia. This e-Alert considers some of them.

### Reinsurance

PSAK 74 requires that reinsurance contracts held are to be reported separately from the underlying insurance contracts issued. Currently, many Indonesian insurers do not fully model reinsurance cash flows in their actuarial projection model. Companies will need to update existing models so that reinsurance contracts are correctly accounted for under PSAK 74. Companies may also need to modify their models to separately identify reinsurance cash flows pertaining to different reinsurers or treaties, depending on the level of aggregation adopted for reinsurance contract groups and the granularity at which reinsurance nonperformance risk (e.g., default risk) assumptions are set.

Contract boundaries for reinsurance contracts held are determined separately from the contract boundaries for the underlying insurance contracts. In many cases these boundaries may not be aligned under PSAK 74. Consequently, the fulfilment cash flows (FCF) for reinsurance contracts held may include reinsurance cash flows arising from underlying insurance contracts which have not yet been written. This poses a challenge as it requires insurers to explicitly quantify cash flows arising from future new business.

The measurement of contractual service margin (CSM) for reinsurance contracts held is affected by the CSM for underlying contracts issued. This occurs, for example, when:

- The reinsurance contracts' CSM is adjusted for losses on initial recognition of an onerous group of underlying contracts
- Changes in the 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 measure the CSM for reinsurance contracts, companies will have to map changes in the FCF of reinsurance contracts held to changes in the FCF of the corresponding underlying contracts, which is not straightforward. There may not be a one-to-one correspondence between groups of underlying contracts and groups of reinsurance contracts. For example, a single product may be reinsured under multiple treaties in different proportions, or a product's riders may be reinsured separately. Such arrangements are not uncommon in Indonesia.

### Syariah

There is debate over whether IFRS 17, and hence PSAK 74, applies to Syariah insurers. Insurers receive a Wakalah fee from policyholders for managing the contracts and Syariah represents risk pooling between policyholders, rather than a risk transfer from the policyholders to the company. However, the general industry consensus in Indonesia appears to be that PSAK 74 will apply to Syariah business. At the time of writing, no specific guidance on applying PSAK 74 for Syariah business has been issued by the DSAK. Conventional insurers that also sell Syariah business may have made less progress in implementing PSAK 74 for their Syariah business than their Conventional business. This is attributed to an absence of specific guidance on Syariah business and to Conventional insurers focusing on their larger blocks of Conventional business. The relative lack of progress in implementing PSAK 74 by standalone Syariah insurers can also be attributed to the shortage in the availability of skilled resources.

## Syariah spin-offs

In Indonesia, more Syariah “windows” (i.e., the Syariah business units of conventional insurance companies) exist than standalone Syariah insurers. Conventional insurers have been mandated to either “spin-off” their Syariah window into a standalone Syariah entity or transfer their portfolio to another standalone Syariah insurer by 17 October 2024. The deadline to spin-off or exit the market is less than three months before the effective date of PSAK 74. Whether to prepare for implementing PSAK 74 before spin-off presents an additional consideration for companies.

- Companies intending to spin-off their Syariah window would most likely want to prepare to implement PSAK 74, because the PSAK 74 reporting requirement will also apply to the spun-off entity. There would likely be substantial time and cost savings for progressing the implementation while being part of the conventional company.
- However, for companies that choose to not spin-off their Syariah window (but instead transfer the portfolio to another insurer), it is not as straightforward a decision. On one hand, it makes sense not to invest time and resources in implementing PSAK 74 given the intention for the portfolio to no longer be on the insurers’ books on the effective date of PSAK 74. However, these companies face the risk of noncompliance should the planned exit fail to materialise before the effective date of PSAK 74, or if the deadline to spin off is extended.

Retrospective application of PSAK 74 is not required before the transition date so the calculations for business spun-off and transferred as part of a portfolio transfer will be simpler. Depending on the length of time between the formation of the spin-off company and the PSAK 74 effective date, this can make PSAK 74 application closer to a fair value transition approach.

## Profitability and mutualisation

Surplus generated from Syariah operations is shared between participants and operators. Cross-subsidisation results in individual participants affecting the payments received by other participants sharing in the same fund, and the profitability to the operator for individual contracts cannot be determined without first considering the profitability of the fund in aggregate. As most Syariah companies’ models only project surplus arising on a seriatim basis, further model enhancements may be required to determine the overall profitability at a fund level, particularly if different surplus distribution rules exist for different product groups or if a Qard (an interest-free loan from the shareholders’ fund) exists.

In addition, due to the annual cohort requirement, contracts that are managed under the same Syariah fund may fall under different cohorts. PSAK 74 requires an adjustment to the contract liabilities to reflect the extent of cross-subsidies

provided to, or received from, other contracts (also known as mutualisation). For these contracts, an adjustment is required to the FCF to exclude the effects of mutualisation. The FCF should include the cross-subsidy made when a contract is cross-subsidising other contracts but exclude the cross-subsidy if the contract is being cross-subsidised.

The concept of mutualisation can be understood through the following example:

| Participant | Share of Surplus Arising (IDR m) | Actual Surplus Distribution (IDR m) | Mutualisation Adjustment (IDR m) |
|-------------|----------------------------------|-------------------------------------|----------------------------------|
| A           | (100)                            | 50                                  | (150)                            |
| B           | 200                              | 50                                  | 150                              |
| Total       | 100                              | 100                                 | 0                                |

Two participants, A and B, share the same pool of underlying assets. If A contributes IDR -100 million to the overall surplus, while B contributes IDR 200 million to the overall surplus, the total surplus arising to the pool of underlying assets is IDR 100 million. However, if due to the surplus distribution methodology both participants, A and B, receive an equal share of surplus arising at fund level, A would receive IDR 50 million in distributions, which is IDR 150 million above its share of surplus arising, and conversely participant B’s share of IDR 50 million is IDR 150 million below its share of surplus arising. This is the effect of mutualisation, which would be removed under PSAK 74.

The FCF and profitability of the group of contracts managed under the same fund as a whole are not expected to change from the mutualisation adjustments, as profits are redistributed between cohorts within the group. The purpose of mutualisation is to accurately reflect the contribution of each cohort to the profitability of all cohorts managed within the same fund as a whole. For example, if a cohort which is cross-subsidising other cohorts does not have the subsidy included in its FCF, it would be artificially profitable at inception because amounts payable to other cohorts from the surplus generated from this cohort would not have been recognised; conversely a cohort receiving a subsidy would be artificially unprofitable. This has implications on the timing of recognition for PSAK 74 profits, as expected positive profits are spread out over the duration of a cohort while expected losses are capitalised immediately at inception.

To determine this mutualisation adjustment, the contract’s share of the pool of underlying items will need to be determined. This might be challenging for Syariah business, as most Syariah companies in Indonesia do not calculate asset shares for their contracts. In practice, the surplus distribution is determined at a portfolio level, while the mutualisation adjustment is calculated at a contract or cohort level.

## Syariah reinsurance

Reinsurance on Syariah contracts potentially affects surplus distribution and the cash flows of the underlying contract. Despite PSAK 74 requiring reinsurance contracts to be measured separately to the underlying contracts, a fully separate measurement of the underlying and reinsurance Syariah contracts may not be possible in practice as their effects are interlinked (i.e., reinsurance cash flows will also affect the surplus arising for Syariah contracts). Syariah insurers may need to consider whether approaches such as measuring profitability on a net of reinsurance basis are more feasible. This adds an additional layer of complexity for Syariah insurers on top of the existing PSAK 74 reinsurance requirements.

## Syariah fund-level accounting

Syariah products involve cash flows from multiple funds such as the participants' investment fund, risk fund and operator's fund. There remains uncertainty whether Indonesian Syariah insurers are required to calculate the FCF separately for each fund and how the interfund cash flows would be accounted for under PSAK 74. In Malaysia, the Malaysian Accounting Standards Board has issued guidance on reporting each fund

separately (columnar reporting) in financial statements prepared in line with MFRS 17 (the Malaysian equivalent to IFRS 17). The industry anticipates clarity on the approach for Indonesia in the near future.

## Conclusion

Overall, the journey to PSAK 74 implementation presents significant challenges to the Indonesian insurance industry. Implementation progress varies across companies. Smaller Indonesian companies and Syariah units are in general lagging behind larger, conventional insurers and reinsurers.

Milliman has provided support to life insurance companies and Syariah insurers at various stages in the implementation of PSAK 74 and IFRS 17 in Indonesia and across Asia-Pacific. With a team of actuaries and consultants who are specialists in this area, we can guide you through the challenges of PSAK 74 implementation for any stage of the journey in which you need support.



Milliman is among the world's largest providers of actuarial and related products and services. The firm has consulting practices in life insurance and financial services, property & casualty insurance, healthcare, and employee benefits. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe.

[milliman.com](https://www.milliman.com)

### CONTACT

**Brian Colgan**  
[brian.colgan@milliman.com](mailto:brian.colgan@milliman.com)

**Chong Wen Ang**  
[chongwen.ang@milliman.com](mailto:chongwen.ang@milliman.com)

**Philip Jackson**  
[philip.jackson@milliman.com](mailto:philip.jackson@milliman.com)