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Financial Focus

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Foreword



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We are pleased to present our Annual Financial Services Journal 2018.

Technology, regulation and changing customer expectations are challenging traditional business models within financial services (FS) and with this comes a whole new set of skills and organisational demands. Bringing people strategies up to speed with disruption and change is an opportunity to innovate, differentiate and engage more closely with customers. The risks of falling behind are highlighted by the 72% of FS CEOs who in our 20th annual global CEO survey indicated that they see the limited availability of skills as a threat to growth. This discussion forms the crux of our feature article in this year's Journal; *"Confronting the big talent challenge in Financial Services"*.

One of the changes we are seeing is the increased influence of FinTech on the FS landscape. Using insights from our 2017 Global and Nigeria FinTech Surveys, we examined what these disruptive changes are in our article *"FinTech disrupting the FS landscape"* and what incumbent players must do to avoid being caught in the back of the pack. Similarly, we explore the resilience of the Insurance sector in the face of disruption in the article *"Is the Insurance Industry fit for growth?"*

Nigeria's economy has turned a corner. In Q2'17, the economy exited recession recording a positive growth rate of 0.5%/y. In the article *"Nigeria's economic recovery: Defining the evolution of economic growth"* we have developed three scenarios that show Nigeria's potential economic performance over the next 5 years.

In Nigeria, coverage of pension in the informal sector is nonexistent, prompting moves by the National Pension Commission (PENCOM) to set up an appropriate micro-pension structure. We discuss the concept of Micro-pension and its implementation in Nigeria in our article *"Micro pension – The New frontier."*

The Federal Government as part of efforts to increase tax revenue introduced the Voluntary Assets and Income Declaration Scheme in collaboration with all 36 states governments. Our article *"Tax Amnesty- Implication of VAIDS on the FS Industry"* looks at the tax strategy outlook for financial institutions post VAIDS and how they can best support their customers.

Internal Auditors often struggle to articulate the value they bring to their organisation. Our article *"How Internal Audit (IA) can add value to the Financial Services organisation"* highlight the peculiarities of the FS industry on how the IA function can rise up to the challenge.

Our two last articles, *"IFRS 9: Classification and Measurement – practical issues around the business model assessment"* and *"IFRS 17: Will You Be Ready For 2021"* beam the light on IFRS specifically, discussing the readiness for adoption and implications of the provisions of the various new financial standards on the industry.

Annually, our FS journal brings to the front burner, critical issues of the day which have significant impacts on the future of the industry. It is my hope that this year's edition provides in-depth insights on these current trends in the industry and that the information presented will be beneficial to you and your organisation. We are always happy to further discuss any of the topics with you in detail while looking forward to your comments and feedback.

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Confronting the big talent challenge in financial services

20 years inside the mind of CEOs...What are they thinking?

Demographic shifts, rapid urbanisation, realignment of global economic and business activity, and scarcity of resources, are among the megatrends affecting the world that we have been studying for the past 20 years. These are the shifts that have affected the CEOs mindset.

Our 20th global CEO survey explored what executives in 2017 think about. Three imperatives emerged:

1. Managing man and machine to create a workforce that's fit for the digital age;
2. Preserving organisational trust in a world of increasingly virtual interactions; and
3. Making globalisation work for everyone by ensuring the benefits are distributed more fairly.

From cost, productivity and the impact of automation and artificial intelligence (AI) to how to re-engage with disillusioned customers and connect with the younger generations coming into the workforce, talent considerations are central to the thinking of CEOs.

The FS CEOs we spoke to anticipate significant changes in the types of people they need and how they attract, engage, deploy and develop them. Further challenges stem from the fact that while people strategies have in the past solely focused on employees, the scope is now broadening to managing talent from both within the organisation and those working in joint venture partners, third-party providers and other areas of today's more extended commercial networks.

Shifting talent demands and mounting skills gaps

As CEOs ask themselves “how should we compete?” and “do we have the necessary capabilities?”, they clearly need to ensure they have the right people in place. Technological transformation has made these questions more difficult than ever. Some roles are disappearing in the wake of increasing automation and digitisation, while others could soon follow. Yet, if anything, skills gaps are widening as customer demands become more exacting and FS organisations strive to sharpen innovation and differentiation in a fast-changing marketplace.

FS CEOs' resulting anxieties over the availability of key skills (72% are concerned, up from 70% last year) have continued to rise in line with parallel worries about the speed of technological change (73% are concerned, up from 70% last year). Along with cyber threats (73%), FS CEOs' concerns over technology and skills top their list of business threats to growth.

With FS organisations facing tough competition from industries like technology to attract people with these sought after skills, new approaches to hiring and development are needed. Typically, these would include:

- Recruiting talent from technology organisations and think-tanks, rather than just from within the FS industry.
- Developing robust learning modules to enhance the skills of executives, IT, and non-IT staff.
- Taking more active steps to create and foster a culture of innovative thinking.
- Increasing engagement with third-party sources of talent, which could eventually include the development of 'talent exchanges'.

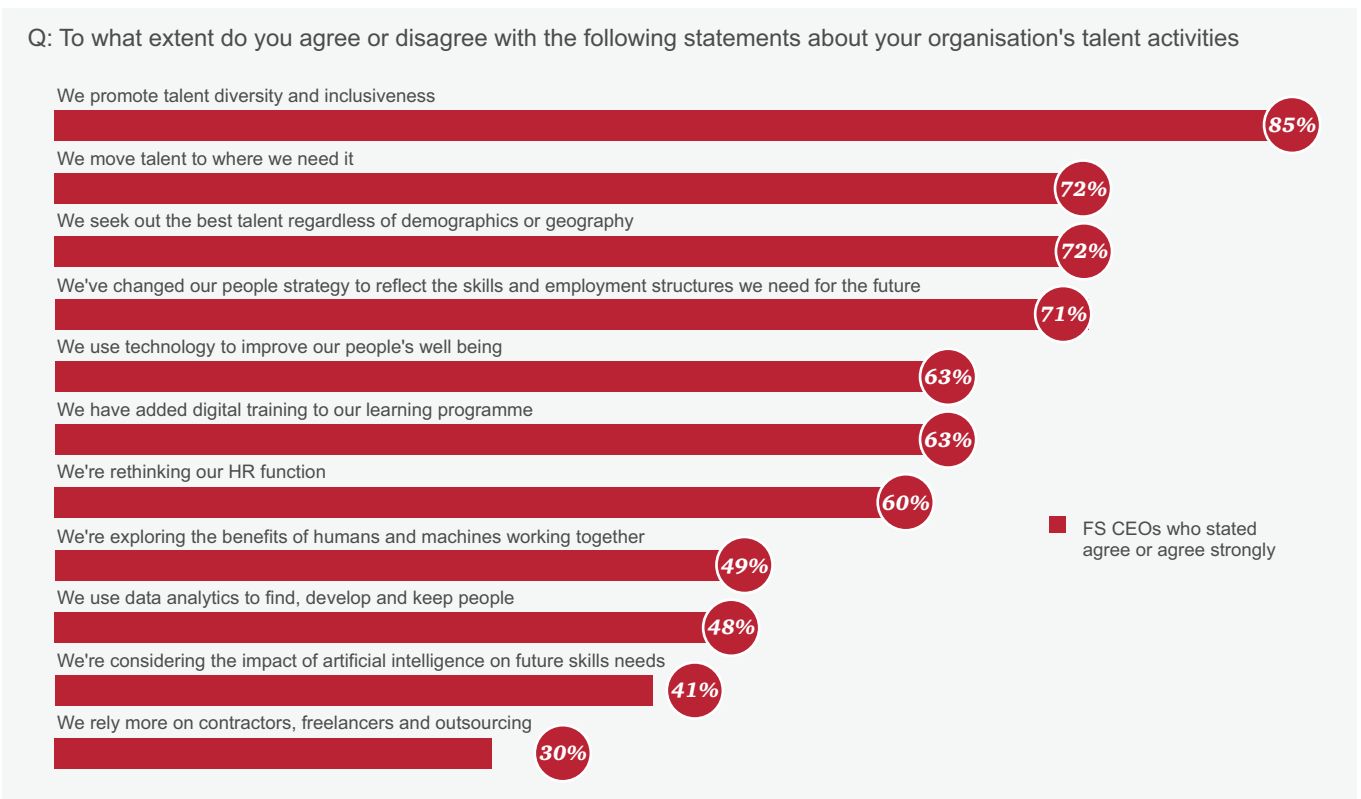
FS CEOs prize many of the skills that can't be replaced by machines, including creativity, adaptability and collaboration, while digital skills and emotional intelligence are further down the list of priorities. As Figure 1 highlights, FS CEOs are rethinking people strategies to meet these evolving skills demands. This includes moving talent around and seeking the best people, no matter who or where they are (we look at diversity and inclusion further on).

The CEOs we spoke to highlighted the importance of adaptability and regular updating of skills to keep pace with market events or changes in business model. They also recognised that their changing skills demands and the underlying issues of education, labour inclusion and employment in an ever increasing automated world are areas that their organisations can't tackle alone.

This underlines the importance of collaborating more closely with government and other stakeholders to develop solutions. Examples include working with colleges to update curricula and develop more work-ready capabilities.

As FS organisations rethink their HR functions (60% are planning this), it's important to ensure investments in HR technology include robust data analytics and visualisation capabilities. It's also important to recruit and develop HR talent with data modelling skills, as well as the ability to interpret data and understand its business implications.

Figure 1: Rethinking people strategies



Source: FS CEOs participating in PwC's 20th CEO Survey

Exploring the full possibilities of technology

Technology is clearly one of the key factors shaping customer expectations and skills demands. Nearly a fifth of FS CEOs (19%) believe that technology has completely reshaped competition in their industry over the past five years and a further 44% believe that it has had a significant impact. Over the next five years, an even bigger 28% believe it will completely reshape competition and a further 49% have a significant impact.

As FS organisations look to keep pace, 63% have added digital training to their learning programmes. Nearly half (49%) are exploring the benefits of humans and machines working together and 41% are considering the impact of AI on future skill needs.

It's vital that leaders get up to speed with the possibilities that new technology brings and how to harness the potential in areas ranging from automation and AI to how to take advantage of new ways to interact, collaborate and engage.

Reining in costs and boosting productivity

While the bars for innovation and customercentricity are rising, so is the need to drive down costs – FS organisations have to do much more for much less. As a result, retrenchment is gathering pace within many FS organisations.

The findings of the CEO Survey are more nuanced, with regions, sectors and functions moving in different directions. While more than half of FS CEOs are planning to cut costs to drive profitability and growth over the next 12 months, a similar proportion actually intend to take on more staff in 2017.

Are FS organisations now moving onto a more cost competitive footing and how will this affect staff numbers and deployment? Effective workforce planning is the key to ensuring that people and resources are directed where they can foster innovation and differentiate the business, while other areas are cut back or outsourced. Does app development need be carried out in-

house when a dedicated tech partner could do it better for less, for example?

The cultural considerations include moving from a mind-set of proprietary self-sufficiency to closer partnerships with start-ups, other sectors and even competitors. Re-training and re-assignment within the workforce are also gathering pace. For instance, while more and more basic banking business is transacted online, the demand for people who can provide higher value advice and support within branches and call centres is increasing.

These operational developments underline the need for a much more fundamental rethink of people strategy than most FS organisations have so far embraced. This includes judging the impacts of new technologies (e.g. robo-advice) on job roles, accountabilities, skills and mindsets. It also includes re-designing job frameworks (capabilities, roles and pay) to take account of emerging new business models and disruptive technologies.

Diversity as a differentiator

Greater diversity allows FS organisations to better reflect, understand and engage with the increasingly diverse set of clients they serve. It also broadens the range of ideas and experiences upon which key decisions and new commercial developments can draw. Moreover, our research shows that smart people want to work for inclusive organisations.

FS CEOs' strong backing for diversity and inclusion is evident. Yet barriers remain in areas ranging from the difficulties of winning buy-in from middle management to a tendency among leaders to favour people like themselves for promotion ('unconscious biases'). Experience

shows that policies can't overcome these barriers on their own. What's needed is a change of mindset that stretches from more agile ways of working to how performance and potential are judged. And this should be backed up by targets for inclusion (e.g. promotion) and tracking against them to ensure this is an organisation-wide priority.

These measures have the further advantage of helping to make people more mindful of potential biases and their impact. In this competitive job market, reporting of diversity targets and transparency around progress can also strengthen the brand with customers and potential recruits.

So what's at stake?

A slow and uncertain response to today's talent demands will leave organisations on the back foot – facing growing skills gap, swathes of people doing work that's been rendered redundant or operating from the wrong place in the wrong way when competitors have already moved on.

By contrast, there are huge opportunities for FS organisations that can bring their people strategies up to speed. FS has people who are smart, analytical and good at problem-solving. It has always been good at innovating and adapting. Honing and harnessing these capabilities will enable organisations to get ahead of the curve in a marketplace that is opening up as perhaps never before.



Nigeria's economic recovery: Defining the evolution of economic growth



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Nigeria's economy has turned a corner

The oil price shock, which started in mid-2014, severely affected the Nigerian economy. In 2015, the economy slowed sharply, as annual real GDP growth declined to 2.7%y/y from 6.2%y/y in 2014. By 2016, the economy recorded its first recession since 1991, recording a growth of -1.5% y/y, as oil production shortages exacerbated the decline in oil price. Notably, the underperformance in the oil sector spilled over to the non-oil sector through the exchange rate channel, with the non-oil sector contracting 0.2% y/y to record its worst performance since 1984.

By Q2'17, the Nigerian economy exited its recession, recording a positive growth rate of 0.5% y/y, this improved to 0.7% by the end of 2017. The recovery was in part due to a sharp recovery in the oil sector, driven by an improvement in oil prices and production volumes. In addition, the non-oil sector recorded a positive growth for the second consecutive quarter, spurred by ongoing recovery in the manufacturing sector due to improved Foreign Exchange (FX) liquidity. Investments will benefit from an improving investment climate although of this growth will be offset by uncertainty usually associated with election cycles in Nigeria.

Asides the improvement in real GDP, which we estimate to grow to 2.0% in 2018 based on net exports and domestic demand, the performance across several other macro-indicators suggest that the economy is on track for a broad-based recovery as discussed in the following paragraphs:

Trade surplus maintained for 3 consecutive quarters

Nigeria has recorded a trade surplus for five successive quarters since Q4'16, owing to a sharp recovery in exports.

The trade surplus moderated to N4.04trillion by the end of 2017 representing a significant improvement to the deficit of N290.1billion in 2016. In 2017, exports increased 59.47% y/y to N13.5 trillion, supported by a rebound in crude oil production and increases in export of agricultural goods, solid minerals and raw materials. Imports on the other hand grew by 8.5% y/y in 2017 to N9.56 trillion, a reflection of improved demand due to the increase in foreign exchange availability.

Purchasing Managers' Index (PMI) above threshold for six consecutive months

The Purchasing Managers' Indices for both the manufacturing and non-manufacturing sectors have risen persistently above the 50 points threshold since April 2017. Overall, the indices which expanded for the twelfth consecutive month was 56.7 points for manufacturing in March 2018, and a 57.2 points for non-manufacturing sector in March 2018, representing an expansion in the non-manufacturing sector for the eleventh consecutive month. These expansions were driven by improvements in business activities, production and employment across most sectors. The index had consistently stayed below the 50 points threshold between January 2016 and March 2017, mirroring the contraction in economic activities during this period.

Headline inflation at a 16-month low at 15.9% y/y in September

Headline inflation moderated for the fourteenth consecutive month, reaching a low of 13.34%y/y in March 2018, from 14.33% and 15.13% in February and January 2018 respectively. This has been driven largely by the softening impact of imported inflation due to an improvement in FX liquidity. We note that the moderation in headline inflation has been offset by a higher food

inflation, which though moderated at 16.08%/y in March 2018 (down from 17.59% and 18.92% in February and January 2018 respectively) was attributable to rising domestic food prices.

Foreign Reserves up to 34-month high

Between March and October 2017, the gap between the official and parallel market exchange rates narrowed significantly from NGN123/USD to NGN57/USD. The introduction of the Investors and Exporters window (I&E) in April 2017 improved price discovery in the interbank market, resulting in increased market participation and FX liquidity. In addition, increased foreign investments and proceeds from government's external borrowings have resulted in net inflows to foreign reserves, which peaked at a five-year high of USD47.3 billion on 5 April 2018.

Nigeria's economic growth prospects: The three scenarios

We have developed three scenarios that show Nigeria's potential economic performance over the next 5 years. In these scenarios, we examine the impact of political shocks, and the implementation of structural reforms and economic diversification on key economic indicators in Nigeria. In our analysis, we assume that oil continues to be the main driver of fiscal and export revenues over the forecast period. As such, the extent to which the Nigerian economy moves towards its near-term development aspirations is dependent upon the success of its import substitution policies.

Assumptions

In the first scenario, oil price rises from an estimated average of USD55/bbl in 2017 to USD60/bbl in 2018 and remains at this level through to 2022. Domestic oil production rises to 2.0mbpd in 2018, and increases further to 2.2mbpd by

2019, remaining at this level through to 2022. Also, the implementation of structural reforms is fast-paced, particularly those related to the business environment.

In scenario 2, oil price remains stable at an average of USD60/bbl through the forecast period and domestic oil production stays firm at 2.2mbpd from 2018, through to 2022. Implementation of structural reforms is sluggish, with the drive for import substitution progressing at a slow pace.

Scenario 3 reflects a situation of heightened political risk. We assumed oil price rises to USD60/bbl in 2018, and stays firm over the forecast horizon. Oil production disruptions resurface in the Niger-Delta. As a result, average oil production collapses to an average of 1.7mbpd by 2019, before a gradual recovery to 2.2 mbpd by 2022. Political tension accelerates in the wake of 2019 general elections, negatively impacting policy implementation.



Our findings

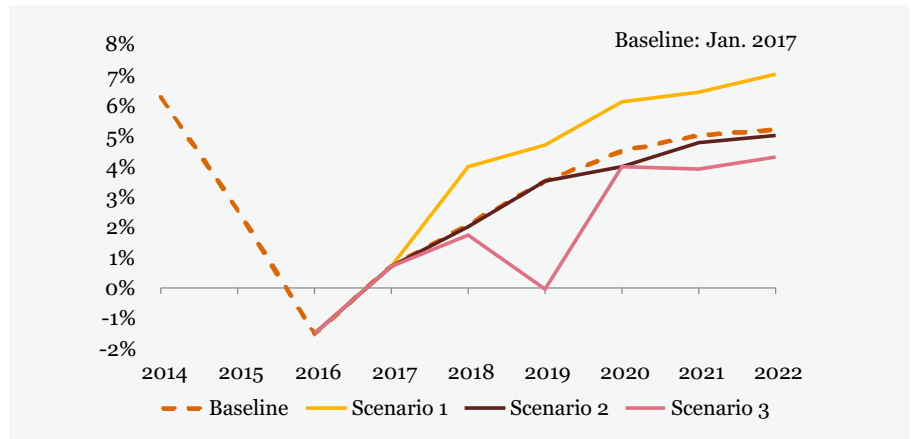
Real GDP Growth



In scenario 1, real GDP growth peaks at 7.0% in 2022 and remains in line with trend, reflecting the implementation of structural reforms, and successful traction in the execution of import substitution policies. The resultant improvement in the macroeconomic environment leads to increased investment and per capita GDP. However, in scenario 2,

the implementation of key reforms evolves at a slow pace and economic growth averages 3.3% over the forecast period, reaching 5.0% in 2022. A mix of political and security shocks in scenario 3 brings about a significant decline in revenues result in no growth (0.0%) in 2019. Subsequently, growth recovers to 4.3% by 2022.

Figure 2: Real GDP Growth



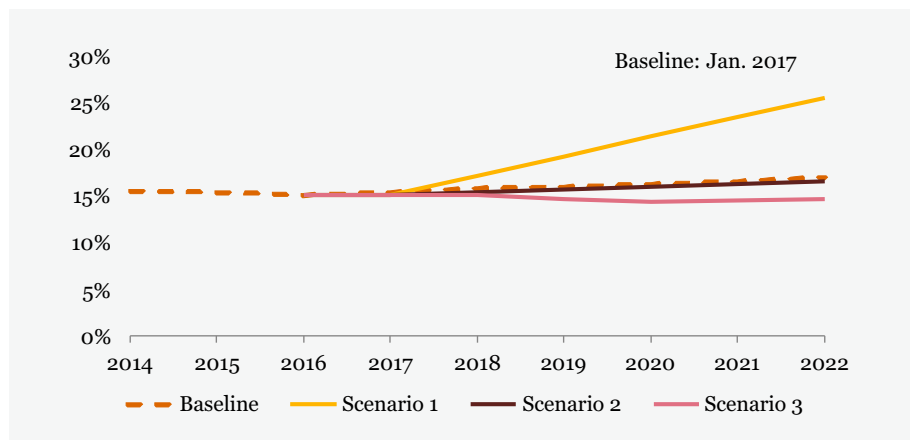
Investment to GDP

Investor confidence improves and investment to GDP peaks at 26.0% in 2022 in scenario 1. This is resulting from the successful implementation of reforms which leads to a broad improvement in the business environment. In particular, the ease of doing business records a notable improvement and Nigeria's economic freedom reaches new highs. In scenario 2, the sluggish pace of reforms in the foreign exchange market continues to create some uncertainty for foreign investors, leading to only a marginal increase in investment to GDP to 17.0%. However, this increase is significantly above the average of 15.1% recorded in the five years leading to the recession. In scenario 3, investment to GDP dips to 14.0% as insecurity

and rising political tensions come to the fore in the wake of the 2019 elections. Subsequently, the government's mediation efforts

results in stability in the macro-environment and investment to GDP increases to 15.0% for the remainder of the forecast period.

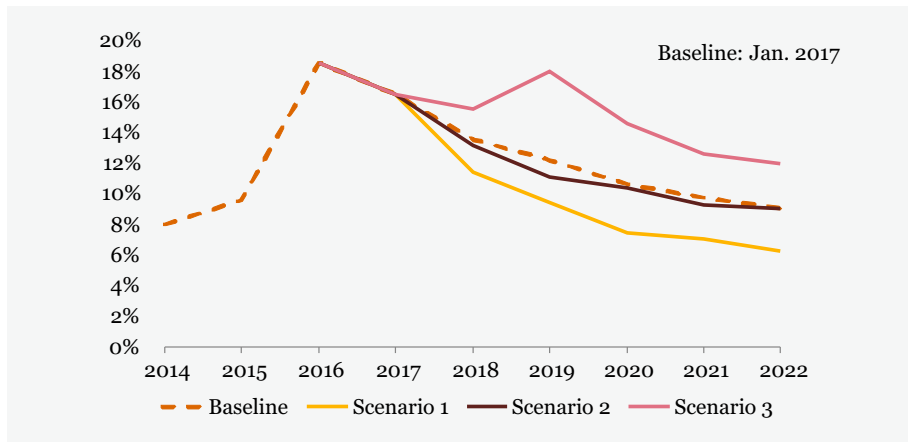
Figure 3: Investment to GDP



Inflation

In scenario 1, inflation moderates to 6.2%/y/y in 2022, supported by increased domestic food production, a significant reduction in food and fuel imports and a stable foreign exchange regime. In scenario 2, inflation declines slowly, reaching 9.0%/y/y in 2022, as food import substitution progresses at a sluggish pace. In scenario 3, inflation remains largely elevated, staying at double digits through the forecast period. As a result, interest rates remain at a high level over this period, as the CBN tightens policy rate to reduce inflationary pressures.

Figure 4: Inflation



Micro Pensions – The New Frontier



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Introduction

Governments around the world have historically been plagued with the challenge of providing financial and social support for the elderly. This has resulted in the introduction and implementation of various retirement benefit schemes which have evolved with various reforms into the global pension landscape as we know it today. Despite the success of some of these schemes, extending pension coverage to those who have worked in the informal sector has remained a herculean task. In Nigeria, coverage of pension in the informal sector is non-existent, however, the National Pension Commission is currently in the process of setting up an appropriate micro-pension structure.

What is the Informal Sector?

There is no universally accepted definition of the Informal Sector, however the International Labour Organisation (ILO) defines it to be *“very small-scale units producing and distributing goods and services, and consisting largely of independent, self-employed producers in urban and rural areas of developing countries, some of which also employ family labour and/or few hired workers or apprentices; which operate with very little capital or none at all; which utilize a low level of technology and skills; which therefore operates at a low level of productivity; and which generally provides very low and irregular income and highly unstable employment to those who work in it”*.

The informal sector plays an important role in world economies as it creates jobs, boosts entrepreneurial activity, minimizes unemployment and underemployment, alleviates poverty and contributes to economic growth. The impact of the informal sector has been however constrained by its inaccessibility to a wide range of

financial services such as micro-credit, micro-savings, micro-insurance, remittance products and micro-pensions. Moreover most informal sector workers have limited understanding and awareness of such financial services products and as a result pension coverage is usually limited to the formal labour market. Today, over 80% of the working population in Sub Saharan Africa are not covered by any pension arrangement due to general unemployment, low income, poor saving culture and pension arrangements which typically favor workers in the formal sector. This scenario becomes even more precarious when it is considered based on analysis that by 2050, the majority of retired/aged people in the world would be in Africa.

Nigeria has a large and fluid informal sector with over 59 million workers growing at a rate of 3% p.a. which makes up approximately 70% of Nigeria's total labour force while its contribution to GDP has been estimated to be 57.9% hinting at the earning power available. Nigeria has the right indices for a strong micro pension industry to thrive which include a well-developed financial services system with total assets of over N37.3 trillion, an internet and mobile penetration rate of approximately 81% - the highest in West Africa and mobile payments exceeding a total value of N381.4 billion in July 2016.

The Concept of Micro Pension

A micro pension scheme is a voluntary, defined contribution, individual account plan for the informal sector (or low income earners). It has no plan sponsor and allows for voluntary savings to be accumulated over a long period of time. Micro pension schemes are usually long term savings products or hybrids between pension schemes and savings products.

Informal sector workers do not formally retire as in the case of employees in the organized sector, however there is still a need for them

to prepare for the reduction in earnings capacity that accompanies old age primarily as a result of decline in health. It is also crucial to

provide a pension arrangement peculiar to their economic profile due to their low and irregular incomes.

Figure 5: Who should micro pension cover in Nigeria?

The informal sector in Nigeria covers three (3) key subgroups;



The semi-informal sector

The semi informal sector is primarily made up of Micro, Small and Medium Enterprises (MSME) with a steady flow of income. They are usually more financially informed than the other informal sector groups and belong to organised cooperatives and/or unions. They are mostly sole proprietors which employ more than 3 people, mostly family members and/or lowly paid artisans. They would easily understand the concept of pension but may be unwilling to come under the formal contributory pension scheme or register their staff due to the cost implications. However, Employers in the informal sector which have more than 15 employees are mandated to comply with the provisions with the PRA 2014.



The organised informal sector

The organised informal sector just like the semi-informal belong to organised cooperatives and/or unions however they are mostly self-employed workers with relatively less stable flow of income compared to semi-informal sector workers. Their businesses generally have low start-up costs and sometimes short life-spans, however, they do require some specialist skills. These self-employed workers will understand the concept of pension but may procrastinate making contributions due to current income conditions.



The unorganised informal sector

The unorganised informal sector workers are characterised by very low and unstable income. They are generally employed by the other informal subgroups as well as the formal sector and mostly do not belong to organised cooperatives and/or unions. These workers are generally uneducated and will need sustained educational campaigns to understand the concept of pension, why it is necessary and significant handholding.

Potential Value of the Micro Pension Industry

If Nigeria's 59.6 million informal sector workers had put aside N100

weekly in 2016 as pension contributions which was invested by the pension industry at a real rate of returns of 4.5% p.a, Nigeria's micro-

pension industry will be worth approximately N61.1 billion at the end of 2017 and grow to be about N1.7 trillion by 2020.

Figure 6: Potential Value of the Micro-Pension Industry

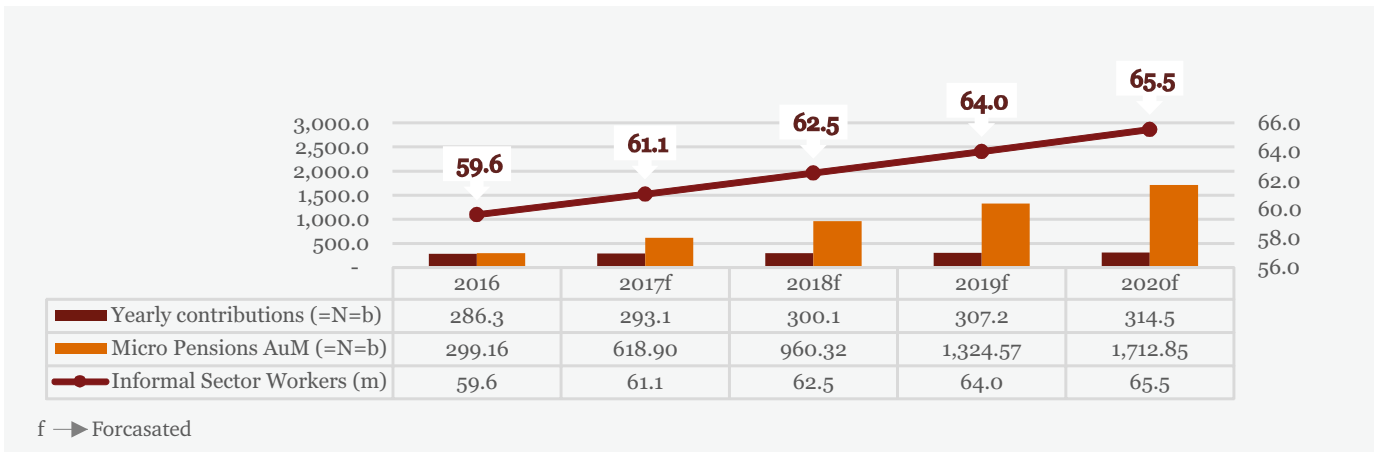
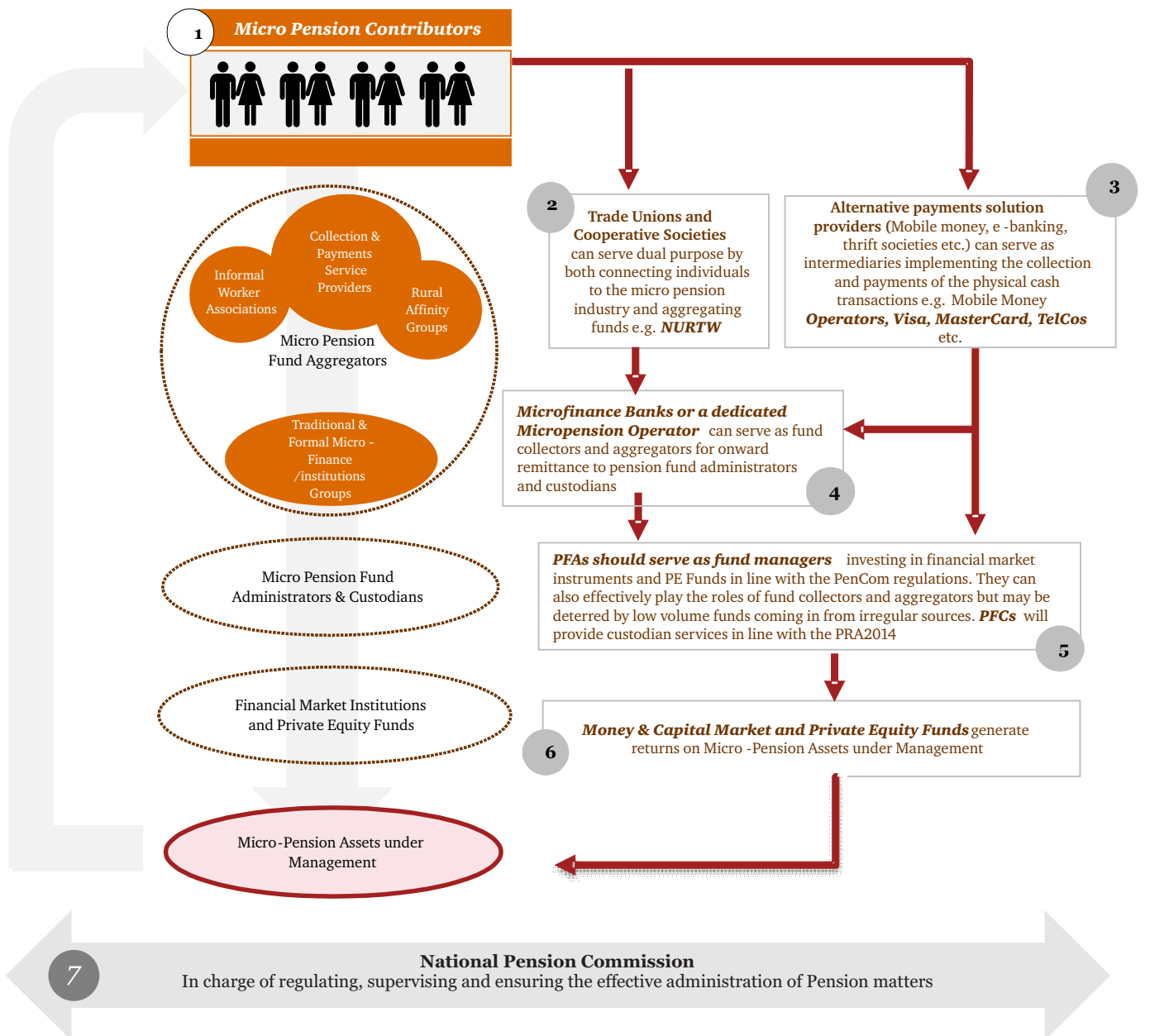


Figure 7: Probable Micro Pension Players
(There are seven probable players within the Nigerian micro pension industry)



Overcoming Implementation Challenges

There will be challenges faced in implementing a micro pension scheme which will range mostly from creating awareness and engendering trust to operational difficulties. Nigeria should learn from the success stories of other developing countries such as Kenya, Indonesia, Vietnam and Jamaica which have put in place strong institutional structures for micro pension to facilitate fund administration and made use of technological platforms including mobile money to increase coverage, remit pension contributions and pay retirement benefits.

Most implementation challenges can be overcome through sustained communication and education campaigns as well as the development and implementation of an appropriate micro pension framework. Mass sensitization and awareness can be achieved through innovative and cost effective platforms such as social media while utilizing a robust technological

platform (mobile apps) that would effectively support the provision of customer services to the target population.

However, there is a segment of Nigeria's population whose main challenge is to meet basic needs e.g. food, clothing and housing and it would be very difficult to bring these individuals into a formal micro-pension scheme. An important Government policy might be the creation of a social assistance programme to provide for the poorest elderly on a non-contributory basis using a means tested or universal approach. Countries like Australia, Spain and Greece have introduced multi-pillar pensions schemes where a pillar supports voluntary contributions with government co-contributions for low income earners subject to predetermined eligibility criteria.

Conclusion

Nigeria has the right indices to consider a micro pension scheme. Key considerations for implementing a micro pension scheme include:

1. Define micro pension coverage parameters and determine who it should cover in Nigeria.
2. Identify key players within the Nigerian micro pension industry and clearly specify their roles. Possible players have been identified as contributors to the scheme, cooperative societies, trade unions, microfinance banks, pension fund operators as well as collections and payments service providers.
3. Realize there will be challenges faced in implementing the micro pension scheme, therefore sustained communication and education campaigns will be required to overcome them
4. Government needs to consider a social assistance programme which will provide for the poorest elderly that were unable to contribute meaningfully to a formal pension scheme during their working lives.



FinTech-a dynamic force disrupting the FS Landscape



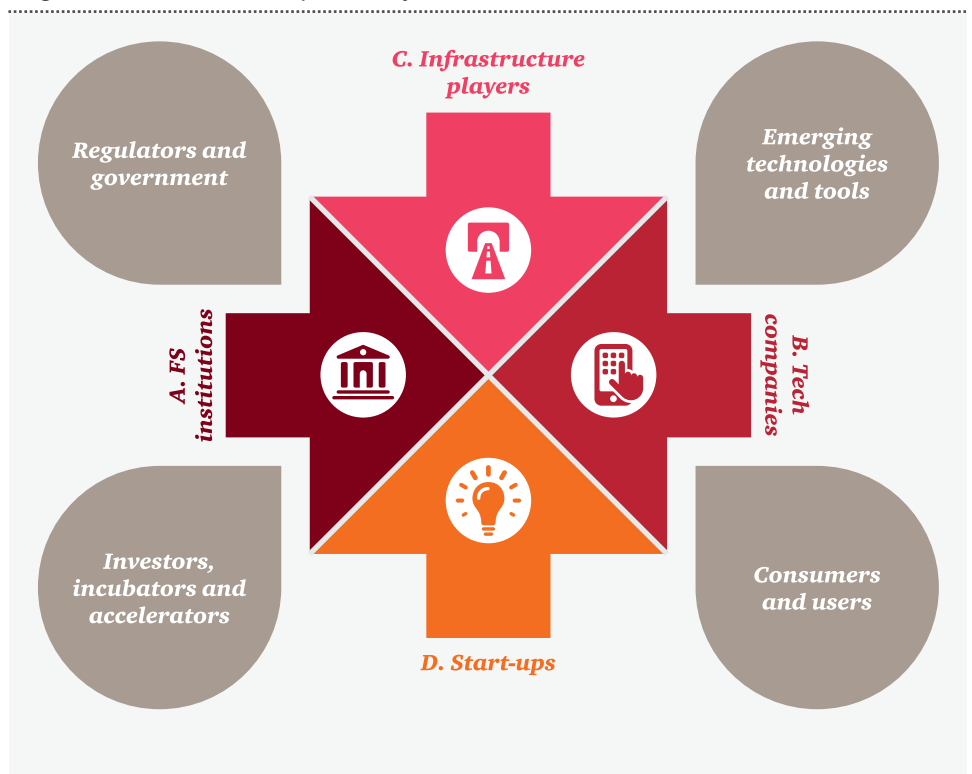
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It is difficult to imagine a world without the internet or mobile devices. They have become core elements of our lifestyle and have brought a high degree of disruption to virtually every area of business. The financial services (FS) industry is no exception; the digital revolution is transforming the way customers access financial products and services.

technology-focused companies and new market entrants innovate the products and services currently provided by the traditional financial services industry. As such, FinTech is gaining significant momentum and causing disruption to the traditional value chain. The FinTech ecosystem is redefining the competitive landscape, blurring the lines that define players in the FS industry (see Figure 8).

FinTech is a dynamic segment at the intersection of the financial services and technology sectors where

Figure 8: FinTech is a complex ecosystem



Funding of FinTech start-ups is on the rise. According to research based on data from PwC's DeNovo platform, funding of FinTech startups has increased at a compound annual growth rate (CAGR) of 41% over the last four years, with over US\$40 billion in cumulative investment. In Africa,

FinTech investments is estimated to have increased by a CAGR of over 58% between 2014 and 2016 to US\$800 million, and could possibly be valued at US\$3 billion by 2020; with Nigeria and South Africa receiving a significant portion of these investments.

PwC's 2017 Global Fintech Survey Report shows that the pace of change in Financial Services is increasing – as does the urge for the industry to react. The forces shaping this change have led to a reconsideration of the role of finance, more as an “enabler” than a provider of financial products and services. The influence that FinTech is having on the market is growing and the long-term potential is even greater. Mainstream Financial Institutions are rapidly embracing the disruptive nature of FinTech and forging partnerships in efforts to sharpen operational efficiency and respond to customer demands for more innovative services.

This article focuses on the continued rise of new business models and emerging technologies in the Financial Services sector.

The epicenter of disruption

New digital technologies are reshaping the value proposition of current financial products and services. While we should not underestimate the capacity of incumbents to assimilate innovative ideas, the disruption of the financial sector is clearly underway, and consumer banking, funds transfer and payment sectors will be the most impacted in the near future; followed by insurance and asset management according to our Global Fintech Survey report. Data obtained from PwC Nigeria 2017 Fintech Survey also corroborate the assertions from the Global FinTech Survey Report.

Respondents to the PwC Nigeria 2017 Fintech Survey are of the view that the emergence of online platforms allows individuals and businesses to give commercial and consumer loans. Lending innovation also manifests itself in alternative credit models, use of non-traditional data sources and powerful data analytics to price risks, develop customer-centric lending processes and lower operating costs. In recent years, the payments industry has also experienced a high level of disruption with the surge of new technology-driven payments processes, new digital applications that facilitate easier payments, alternative processing networks and the increased use of electronic devices to transfer money between accounts.

Although a high level of disruption triggered by FinTech is already beginning to reshape the nature of lending and payment practices, a second wave of disruption is making inroads in the asset management and insurance sectors. The pace of change in Insurance is faster than earlier envisaged with the emergence of mobile applications designed for easy access to transactions, Insurance quotes, claims support or even roadside assistance. Results from the PwC Nigeria 2017 Nigeria Fintech Survey indicate that players seemed well aware of this revolution, with 78% of respondents indicating some part of their business is at risk to being lost to stand-alone FinTechs.

In the Asset and Investment Management sector, Respondents indicate that FinTechs are creating

new solutions across the customer investment journey, from financial planning to investment management. The result of the survey indicates that the emergence of Robo-Advisors that automate the asset allocation process and provide a personalized user experience at a much lower cost compared to services provided by traditional firms may pose a significant threat to local players.

The Financial Institutions will need to adapt their mindsets to be open to FinTech innovations in order to embrace these developments and retain their customers.

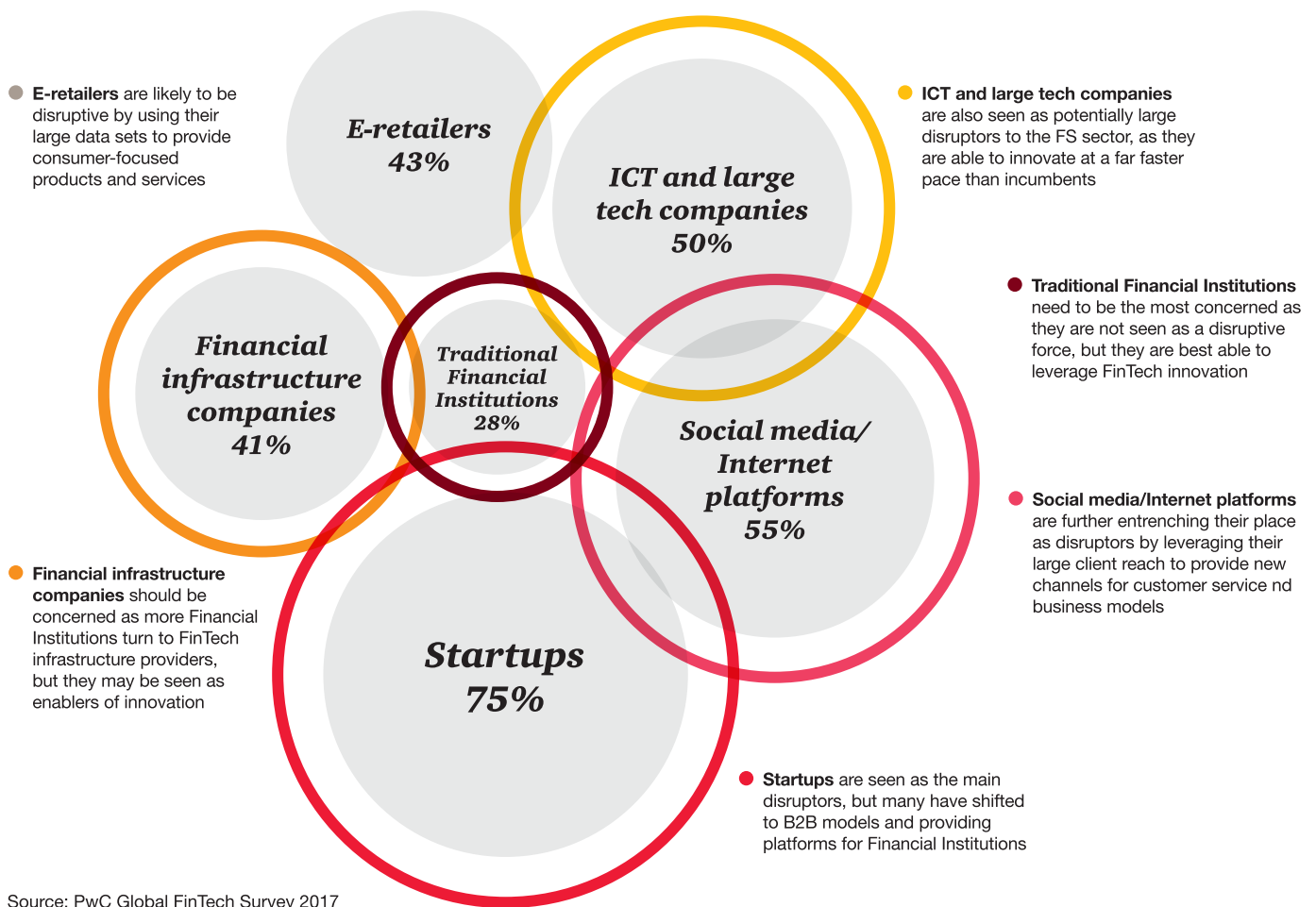
FinTechs and Financial Services are coming together

Over time, FinTech has evolved from startups that want to take on and beat incumbents, to a broader ecosystem of different businesses looking in many cases for partnerships. FinTech startups don't just need capital, they need customers. At the same time, incumbents need new approaches to drive change and deliver innovation.

PwC's 2017 Global survey also highlights how innovation is coming from outside financial services and being driven by a variety of sources including tech companies, e-retailers, and social media platforms (see Figure 9). This approach certainly has been prevalent in some Asian markets. The new partnering approach offers alternative strategies for both new entrants and startups but it also carries with it a new set of risks.



Figure 9: FinTech and Disruptive entities.
Percentage of respondents who believe entities are likely to be disruptive in the next 5 years



Source: PwC Global FinTech Survey 2017

Financial Institutions are embracing the disruptive nature of FinTech

The global financial crisis heralded a prolonged period of business-wide transformation programmes. For many customers and clients, basic products and services look and cost much the same as they did before. Many are therefore looking to embrace FinTech as a way to break this cycle. This embrace is not just about the Technology, it's about culture, ways of working, problem solving, customer engagement and new ideas of leadership.

Financial Institutions are putting disruption at the heart of their strategy with 56% of respondents in our Global survey agreeing with this statement. In Nigeria, more than 70% of respondents from the Insurance sector have FinTech at the heart of their strategy; the highest proportion compared to other sectors (Banking – 48% and Asset Management and Investment –

40%). By becoming self-disruptors, Financial Institutions seek to appropriately respond to innovation and thereby empower their customers. To address customer retention in the context of new “FinTech competition,” Financial Institutions will want to focus on intuitive product design, ease of use, and 24/7 accessibility.

Financial Institutions will also need to disrupt their own operations or processes, which will introduce culture and mindset challenges. Globally, 77% of respondents expect to increase internal innovation efforts over the next three to five years. This can occur in a variety of ways, including adopting newer technologies such as Artificial Intelligence (AI) or blockchain or changing the cultural environment to one that fosters innovation.

Financial Institutions are learning to Partner and Integrate

FinTech companies create an ecosystem that fosters the collection of vast amounts of data and build trusted relationships with their clientele. Financial Institutions have realised the importance of these ecosystems and are attempting to make innovation a way of life.

Partnering with innovators will allow incumbents to outsource part of their R&D and bring solutions to market quickly. FinTech companies also benefit from these partnerships. As they develop new theories and models, in order to test them, they need access to large data sets that incumbents already have. Partnering also gives them access to an existing and large customer base. This is further emphasised by FinTech segments that are starting to transition from purely Business to Customer into Business to Business.

The integration of FinTech companies and incumbents is made more difficult by differences in management and culture, as well as regulatory uncertainty and legacy technology limitations. Financial Institutions labour behind a system of checks and balances that can stifle the innovation process, while FinTech companies are generally able to adapt more quickly due to technology advantage and a lack of bureaucracy.

Workplace culture will play an important role in the coming years and incumbents will need to renew their purpose and brand to align with changing expectations in strategic areas such as career path, diversity, flexibility and delivering social value. By implementing a new cultural mind-set, companies will be able to find alternative talent sources that will help drive innovation and make working with FinTech companies less challenging.

Blockchain is moving out of the lab

While blockchain was initially explored by the Financial Services sector, the potential of this technology is now being realised by other sectors, including Energy, Telecoms, etc. The technology is moving from hype to reality and we will likely see business use cases becoming more common. This process is still underway, but as more companies are realising the business use cases of blockchain, funding for the technology is increasing. In fact, according to data in PwC's DeNovo platform, funding in blockchain companies increased 79% year-on-year in 2016 to US\$450 million.

Using blockchain in the business will not occur overnight. But with 55% of respondents planning to adopt it as part of a production system or process by 2018, and 77% by 2020, it will rapidly become a common element found in business processes. Some businesses are already making use of the technology. At the end of 2016, a large European bank completed instantaneous payments between two of its clients on a cross-border basis using blockchain technology. This highlights the benefits of using the technology that can eliminate unforeseen charges, delays and processing mistakes.

Implementing this technology will not come without uncertainty and risks. While most of the technological risks are currently being addressed by developers, academics, and businesses, there is still a lot of regulatory and legal uncertainty for some of the emerging business use cases. With mainstream blockchain arriving soon, regulators need to re-evaluate policies and processes given the enhanced transparency the technology promises.

Conclusion – Don't be caught napping

The Financial Services industry will be unrecognisable in five years. Younger generations entering the market will expect the same level of service and innovation obtainable from social media and other e-commerce sites.

To remain a major player in the industry, the innovation journey should be part of an overall strategic agenda and align with all company's objectives. While navigating through regulatory compliance, legacy IT

issues, cybersecurity, or talent retention risks, innovation needs to be embedded in all aspects rather than being treated as a separate initiative. A focus on the following will help players stay ahead of the pack:

Encouraging and incubating innovation

Players need to re-learn how to innovate and attract talent with the right mix of technical and commercial skills. This involves a mind-set change from the traditional 'leadership-down' management style to a model that encourages innovation.

Adopting a FinTech mind-set

Large corporate structures are not necessarily the best fit for success in the FinTech revolution. Established players will need to experiment with new business arrangements (such as partnerships and joint ventures) to gain access to the talent and the innovation needed to identify ground-breaking products. This would require incumbents to understand what their customers really value, and how their organisation's differentiating capabilities deliver that value.

Creating an agile enterprise

FinTech start-ups operate in a very different way than established FS businesses do. They move quickly, fail fast and are not afraid to take risks. They are not restrained by legacy systems and regulatory requirements. Incumbents need to think about how this agile mind-sets fits with their current business processes and operating models and how to align this new way of working to their value proposition.

Tax Amnesty - The implications of the voluntary asset and income declaration scheme on the Financial Services industry



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What is VAIDS?

The Voluntary Assets and Income Declaration Scheme (VAIDS) is a time-limited opportunity for taxpayers to regularise their tax status relating to previous tax periods.

Taxpayers have a one-off opportunity between 1 July 2017 and 31 March 2018 to regularise their tax status in exchange for immunity from prosecution of tax offences, waiver of penalty and full or partial waiver of interest, depending on when payments are made.

Figure 10: VAIDS implementation schedule

Month	Liability	Interest	Penalty
July 1 - Dec 31 2017	Yes	No	No
Jan 1 - Mar 31 2018	Yes	Yes	No

To benefit from the exemptions under VAIDS, the following conditions must be jointly met:

- Declarations must be Voluntary
- The declaration must be full, frank, complete and verifiable disclosure
- The application must include VAIDS forms; and
- The assessment of tax payable must be carried out by relevant tax authority. Since the law already provides for self-assessment, the applicant may lodge a self-assessment which may be verified by the tax authorities through the normal administrative processes.

What are some of the key expectations of the Government from VAIDS

The clear motivation for VAIDS is the country's low tax to GDP ratio of 6%. Due to the decline in crude oil revenues, the government recognises that there is a huge potential revenue it was previously not collecting which it may be more equipped to collect by expanding the tax net and creating a more sustainable base for revenue administration.

1. High net-worth individuals

One of the key targets of VAIDS is high networth individuals. It appears that the government believes that this group of individuals have not contributed their fair share to public revenue and therefore, they have contracted forensics and asset tracing companies to analyse the wealth of these individuals across the world and build a profile for wealth which they intend to compare with the amount of taxes paid over time.

2. Indigenous companies

The scenarios covered by the VAIDS do not suggest that there is a major transfer pricing or multinational focus, even though these are within its scope. More focus is being given by the tax authorities to local tax compliance and instances where there has been previous willful default by companies registered in Nigeria and indigenous companies also.



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3. **Banks and Financial institutions**

There is a two edged focus on banks.

- Financial institutions are likely to be targeted for their customers. Due to the custodial and wealth management functions, they hold a large chunk of valuable data that the tax authorities would require for building the tax profile of individuals and corporates. Hence, the government may look to the banks and other financial institutions for support in this regard and may consider how best to utilise the Bank Verification Numbers (BVN) to achieve its objectives. There is a risk that the tax authorities may trigger the provisions of the Personal Income Tax Act and the Companies Income Tax which allows the tax authorities to request for information from Financial Institutions.
- The banks and financial institutions themselves may be of particular interest for VAIDS. There has always been a perception by tax administrators that banks and financial institutions are easy targets for tax collection because their trade and assets are in money. This perception may have no substance and most of the money belongs to customers, but this has been the perception for many years.

4. **Government and related Ministries, Departments, Agencies and Bodies**

The policy for VAIDS was initiated by the Ministry of Finance. The Ministry may therefore expect that all regulators support the initiative to ensure that it is successful in the end. There may, therefore, be some inter-agency cooperation in this regard. For example, in July 2017, the Securities and Exchange Commission (SEC) issued a public notice that all Public Limited Companies and all Capital Market Operators are expected to either produce a VAIDS clearance in the future to continue operating or be able to demonstrate that they have been cleared from all taxes.

What would the tax environment look like after VAIDS

There is an expectation that after the VAIDS, the tax authorities will be more aggressive towards tax administration. It is impossible to predict with certainty what this would look like as the tax authorities are already aggressive. However, the “aggression” is usually not backed up with either proper capacity to understand the issues or with proper data and evidence to properly analyse the issues.

The overall attitude of government may be a good indication to predict the tax behaviour into the future. There appears to be a drive to use the BVN as a means to analyse unidentified wealth with a view to either controlling the funds or taxing them. It would not be too long before the government gets it right on biometrics and data. It is a no-brainer that they have to consolidate all the fragmented data at some point that are currently being collated in silos.

In addition, the tax authorities have been exploring the idea of technology to give them visibility of the transactions of taxpayers. For example, the Federal Inland Revenue Service is trying to introduce Application Programming Interface (API) in companies that will give a direct reading of VATable transactions. They may also consider technology for withholding tax in the future. Companies have been pushing back on APIs plugged into their system due to data security and confidentiality issues, in addition to the fact that there is no law supporting such approach by the tax authorities.

If the legislature and the executives gains some alignment, the passage of laws that allows for these technologies may happen very quickly and taxpayers would have to react.

Outlook for Banks and financial institutions' tax strategy after VAIDS

There are tax risks arising from many areas, but the following risks are pervasive for banks and financial institutions:

1. **Transaction taxes:** Due to the high volume of transactions, Banks and other financial institutions have to rely on automated systems for WHT and VAT compliance. The tax function of these organisations cannot review every single transaction. For example, think of the significant man-hours that would be required to comply with WHT on interest on term deposits which has been a focus of State tax authorities in recent times. It would require significant analytical tools to actually deal with tax audits, which would occur after the significant time spent on addressing routine compliance. The lack of oversight over such transactions may lead to risks. The reliability of these systems in addressing these risks should therefore, be tested from time to time. In addition to this, stamp duty has been a significant risk since the CBN mandated banks and other financial institutions to charge N50 on specific transactions. These open up organisations to multiple audits from other agencies such as the Nigeria Postal Service (NIPOST) and the Revenue Mobilisation Allocation and Fiscal Commission (RMAFC) in addition to the audits carried on by the States and the FIRS on the trial balance of these organisations. The fact that there are other transactions of the organisations such as loans, guarantees, etc. that are subject to stamp duties increases the need for proper processes and technology to review transactions and treat the transactions properly for transaction taxes.
2. **Personnel taxes:** Due to the significant amount of additional exposure crystallised from historic audits within this industry in the past, organisations need to assess whether their strategy of dealing with issues retroactively through audits will be sustainable. There are risks with regards to benefits that do not necessarily reflect through payroll. The tax authorities (such as the Lagos State Internal Revenue Service) are showing even more competence by issuing public

notices on areas which they have ignored in the past. Organisations should therefore assess their compliance or legal arguments against such positions being taken by the tax authorities. For example, the issue of the deemed interest on employee loans and planning options around voluntary pension contributions may have to be reassessed for their sustainability as they are quite common in this industry.

3. **Uncertain tax positions:** Using the insurance industry as an example, there are multiple issues around interpretation which the Nigerian Insurers Association have been trying to reach a consensus with the tax authorities on for the past 4 years. Previously, the potential exposures around these issues were ignored. However, there are a few trends that may portend that organisations need to revise their tax strategy. These are:

(a) The tax authorities (now including the FIRS) are using consultants to carry out their audits. These consultants are paid on a success fee basis. Sometimes, they could be competent tax professionals as part of those tax audit teams. The motivation for the consultants to earn more commission may lead to them putting pressure on the FIRS to stick to positions that are adverse for taxpayers.

(b) The government, at all levels, is short of revenue to finance projects and sometimes to pay salaries. It is therefore logical to expect aggression from the tax authorities. There are instances where tax authorities have threatened enforcement proceedings even when their positions on tax technical issues are weak. They may now be even more keen to pursue enforcement when their positions are stronger.

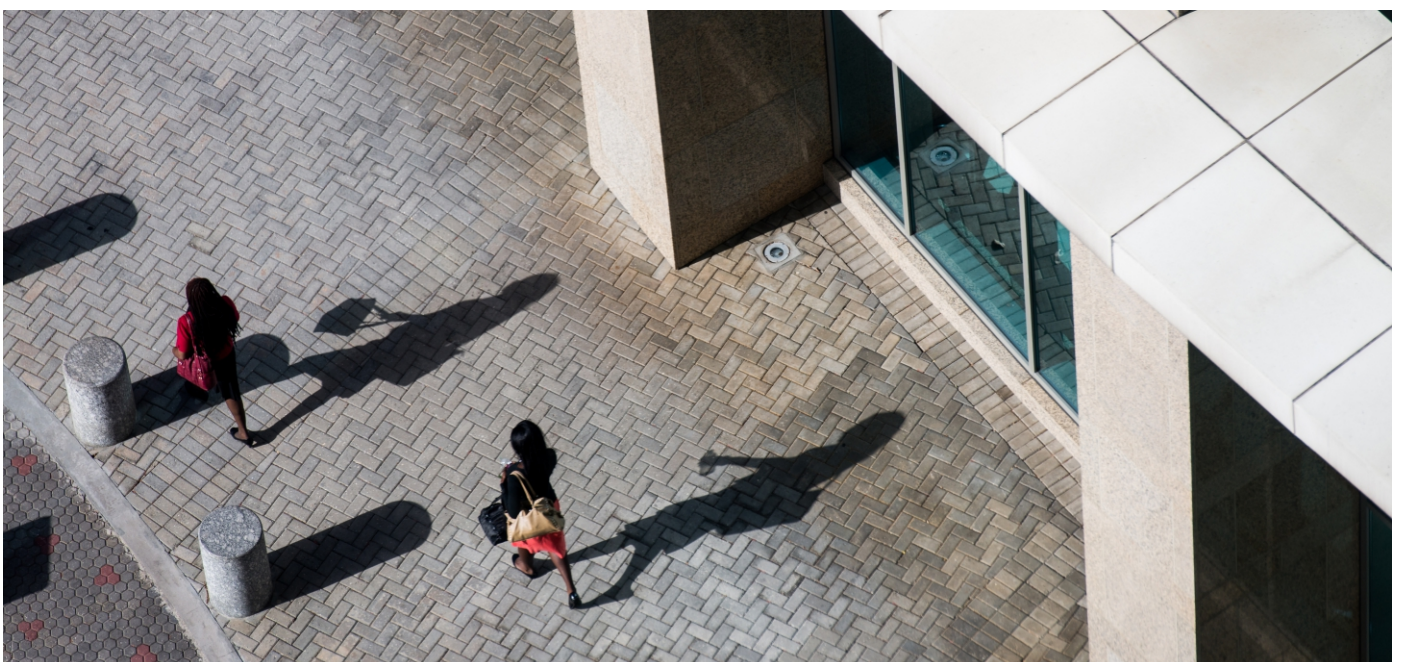
How banks and other financial institutions should react for themselves during VAIDS

Tax must become a boardroom issue as it is a significant risk of doing business under the current environment where oil can no longer fund the government and when there are no funds, it is only natural to look at the banks and financial institutions for help. The government has raised quite a lot of debt already. They may begin to ask themselves if the lenders do not first of all owe them money. Organisations should therefore revisit or redefine their tax strategy and then begin to drill down and address all tax risks within their various lines of business. In the end, if the organization makes a decision to retain a risk, it must be sure that the risk has been properly analysed and acknowledged at the highest level within the organisation. Where there is no structure in place to identify and

monitor these risks, the directors may only become aware when the tax bill has been issued.

What financial services institutions should be doing to support customers during VAIDS

Already, some foreign banks and asset management companies, as part of their client validation processes for Nigerian clients, have made it a condition for customers to confirm whether they have duly considered the VAIDS and how to take advantage of it. There is no obligation on banks and other financial institutions to impose rules for their customers to consider VAIDS similar to what some of these foreign banks have been doing. However, they should be able to provide education to their customers on the process to go about it. Some customers may also consider it value added services if they are advised on the VAIDS scheme and how best to go about it. Banks and other financial institutions are usually partners to government as they fund government projects, assist government in raising debt and also act as collecting agents for the government. They should therefore, consider how best to collaborate with the government as well as their customers to ensure that they continue to foster a good relationship with both. This is a difficult balancing act, but has become the reality today for all companies in this sector.



How internal audit can add value to financial service organisations



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The Internal Audit Dilemma

The Institute of Internal Auditors (IIA) define internal audit as an “Independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. It helps an organisation accomplish its objectives by bringing a systematic approach to evaluate and improve the effectiveness of governance, risk management and control process.”

Internal Audit (IA) by its definition should be designed to add value to the organisation. However, internal auditors often struggle to articulate the value they bring to their organisation. As a result of this, their stakeholders tend to perceive them as a cost of doing business. It is therefore not uncommon for the internal audit department to be one of the first departments to be impacted during periods of budget cuts.

Peculiarities of the Financial Services Industry

To be an Internal Audit function designed to add value to stakeholders, IA’s strategy, structure, processes and people should be set up to address the areas critical to that organisation.

The Financial Services (FS) industry is peculiar because there are several unique issues plaguing financial institutions that are either non-existent or have less impact in other sectors. Some of these key issues include regulatory compliance, cyber fraud and complex risk management practices. These issues and more are what keeps stakeholders- the board of directors, management, regulators, awake. Internal audit can position itself to provide assurance and consulting activities in these areas.

How Internal Audit can add value

1. Regulatory compliance

The Financial Services sector largely underpins any economy. Given this critical nature, the industry is highly regulated.

There are a myriad of regulators and regulations that FS organisations are expected to comply with and report to. In Nigeria, apart from the sectorial regulators such as the Central Bank of Nigeria (CBN), the Nigerian Deposit Insurance Corporation (NDIC), the National Insurance Commission (NAICOM), National Pensions Commission (PENCOM), Securities and Exchange Commission (SEC) etc. there are numerous other regulators that these organisations are answerable to. The effort required to keep up with all these regulations is complex and expensive. For example the CBN in its annual report for 2015 stated that it issued 81 policy circulars and supervision guidelines in the year 2015 alone!

However, the cost of non-compliance can be greater as sanctions may not only be limited to payment of fines but reputational damage or even threats to the going concern status of the organisation.

Internal audit should play a strategic role in helping the organisation comply with the relevant regulatory obligations. The IA function should drive organisational compliance and help entrench a compliance culture.

It is interesting to note that regulators do acknowledge the strategic role of IA. The Basel Committee on Banking Supervision addressed extensively the role of the IA function of a bank in its Principles for Enhancing Corporate Governance issued in 2015.

Equally, the CBN's Code of Corporate Governance for Banks and Discount Houses in Nigeria assigns the responsibilities for removal and appointment of the head of Internal Audit to the Board of Directors subject to ratification by the CBN. The CBN's competency framework for the banking industry also spells out the qualification and experience of the head of Internal Audit.

The IA function may be the focus for regulatory supervisory review, for this reason it is imperative that the function demonstrates its understanding and ability to perform in line with the expectations of regulators.

2. Cybercrime and fraud

There has been significant technological advancements in the Financial Services sector within the last decade. The increased adoption of social media, smart mobile devices and artificial intelligence has brought about phenomenal changes in the way business is conducted. Customers have the ability to conclude almost all their financial transactions from anywhere in the world using the internet and/or their mobile devices etc.

Nigerian banks have made significant changes to their business model through technology based innovative solutions. Examples of some of these innovative solutions include internet banking, mobile banking, Automatic Teller Machines (ATM), Point of Sale (POS), Unstructured Supplementary Service Data (USSD) banking, bills payments etc.

Other industry players such as capital market operators are not left out with innovations such as dematerialization of share certificates, e-dividend, e-registrars etc. to improve market operations and efficiency.

These innovations essentially put Financial services at a high risk of cybercrimes such as identity theft, account cloning, fraudulent payments or transfers, etc. As they increasingly rely on technology,

they become more susceptible to security breaches and unpredictable outages that can cause disruptions.

Cyber criminals have also become highly sophisticated and security solutions deployed by companies can be hacked in a matter of weeks. This implies that management cannot rest on their oars. They must continue to secure their networks from malicious and fraudulent attacks in the cyber space.

The WannaCry and Petya cyberattacks in May and June of 2017 were major global attacks that affected thousands of computers of governments and large organisations (including financial institutions) across over 150 countries. WannaCry was particularly high profile, bringing down networks on parts of Britain's National Health Service (NHS), Spain's Telefónica, FedEx and Deutsche Bahn.

In the Global Threat Impact Index released in May 2017 by Check Point Software Technologies Limited, Nigeria was listed as one of the countries with the highest risk of cyberattacks.

This is a serious cause for concern for board of directors and regulators as the impact of cyberattacks can be catastrophic to the operations of an organisation.

Internal Audit functions need to help their organisations navigate the risks presented by new technologies by providing assurance in this area. These activities include:

- Reviewing the organisation's cybersecurity governance, policies and processes.
- Ensuring cybersecurity risk is properly integrated in the audit plan.
- Increasing the board's awareness and knowledge of cyber security risks.
- Keeping abreast of the impact of emerging technologies and trends on the organisation's cybersecurity risk profile and response plan.

- Providing consulting support through their proactive involvement in the development of the cybersecurity strategies.

To be able to effectively support their organisation and truly add value, Internal Audit need to ensure that they have the required knowledge to evaluate their organisation's cybersecurity programs against the relevant frameworks and best practices. If the expertise doesn't exist in-house these gaps should be addressed through engaging experts externally to provide support in achieving some of these objectives.

3. Risk Management Practices

Risk management for Financial Services has become increasingly complex and expensive due to the ever changing risk landscape and regulations. The directors and management are required to define their organisation's risk appetite, develop models to assess and monitor risks and entrench a risk culture within the organisation. Significant resources are being deployed to effect these requirements and stakeholders need to have comfort that their investments in risk management are worthwhile.

In the banking sector, the risk management process is made more complex by regulatory requirements to adopt robust Enterprise Risk Management frameworks and Basel standards. Banks have to develop complex models such as Value at Risk, Internal Capital Adequacy and Assessment Process (ICAAP) model, Internal Liquidity Adequacy Assessment Process (ILAAP) model etc. to meet these requirements. Regulators are highly concerned about the accuracy and effectiveness of these models.

Internal Audit is responsible for giving assurance over the effectiveness of their organisation's risk management practices, they are expected to independently evaluate the enterprise risk management process including the risk management practices, risk

models and stress testing processes. They face a number of challenges such as lack of quantitative skills to review complex models, data quality and availability. Internal Audit functions need to address the challenges in order to independently help management and board of directors understand the limitations of their models so that they can make better decisions and comply with applicable regulatory requirements.

Conclusion

Stakeholders' response to intermittent financial crisis, governance, risk management and internal control failures within the financial services sector emphasizes the role of an influential and effective IA function. An effective, independent Internal Audit function is a valuable source of assurance to the board, regulators and management.

Internal Audit leaders need to rise up to these challenges by:

- Ensuring that the IA function has the requisite knowledge and experience to provide assurance and consulting services in these areas. Where the expertise does not

exist internally, IA leaders should engage the skills of external subject matter experts to support on a periodic or ad-hoc basis.

- Employing technology driven auditing approaches and tools such as advanced data analytics for continuous monitoring, audit management technology solutions etc. to increase effectiveness and efficiency.
- Collaborating with other lines of defense to ensure a holistic approach is adopted to governance, risk management, internal controls and compliance in other to protect and enhance value for their organisation.



Is the Insurance Industry Fit for Growth?



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The Forces reshaping insurance

As disruption mounts, insurers and reinsurers are facing huge strategic challenges in maintaining competitiveness, driving change and delivering all-important growth. Perceived wisdom has been that these are mutually exclusive goals, but this article sets out why they can coexist if insurance organisations are committed to being fit for growth.

Late last year, PwC polled 25 insurers for its Fit for Growth (FFG) insurance survey¹ to help gain a better understanding of the issues they face regarding reducing expenses and investing for growth. Drawing on the survey findings, as well as insights from PwC's 20th Annual CEO Survey², this paper outlines why moving the business forward requires a rethink of strategy, costs and, most important of all, how they align.

The focus of Fit for Growth is to optimise, rather than just cut, expenses to ensure your business can sustain

competitive relevance and maximise its potential. This means investing in good costs (capabilities that differentiate your business, move it closer to customers, and enable it to develop new value propositions) and eliminating bad costs (non-essential areas of spending).

Change and disruption

The insurance industry globally continues to be the most disrupted of any sector. In our work with insurers, we've noticed anxiety about the technological changes coming from current competitors, start-ups, and Silicon Valley that are reshaping the industry. When we asked them what posed the greatest threat to their operating models, the most popular response (44% of all Fit for Growth survey respondents), was "market disruption or the use of new technology." Second on the list was "changing customer needs and offerings from new market entrants" (24%). These responses outweighed concerns about lack of customer insight, availability of talent, regulatory change, and the economic environment combined.



1. http://www.pwc.com/us/en/insurance/publications/fit-for-growth-survey.html?_ga=2.31882750.1134016194.1504177577-782303347.1499967272
2. <http://www.pwc.com/gx/en/ceo-survey/2017/industries/pwc-ceo-20th-survey-report-2017-insurance.pdf>

Disruptive shifts in the way insurance business is transacted include growth in insurance-linked investments or similar structures. These lean and agile vehicles are forcing insurers to either adapt their business models to compete or set up their own structures to participate, which is putting traditional ways of transacting business and placing risks under pressure. While one company is finding more efficient ways to execute its current processes, the competitor is bypassing them altogether. The threat of new entrants, whether in the form of alternative capital structures or start-ups, is a concern for almost two thirds of insurance CEOs.

Technology could have an even bigger impact, with 86% of insurance CEOs believing that it will either completely reshape or have a significant impact on their sector over the next five years and 83% seeing it as a threat to their growth prospects³.

Need to grow

Most companies know that growth is critical to long-term success. Most are somewhat confident or very confident in their ability to grow, with many having growth targets that

far outpace those being achieved in the industry as a whole. We therefore expect there to be haves and havenots. The haves include companies that believe they can outperform competitors through better execution of the tried-and-true strategies that are common in the industry. We expect have-nots to have the self-awareness to know that they are not out in front of the market and are therefore waiting for the storm to pass.

As we expected, not all carriers are pursuing growth at all costs. Only 30% of FFG survey respondents said that top line growth was their primary strategic focus. However, only 9% were willing to admit that growth was of minimal focus, while the remaining 60% of carriers took a more balanced view.

Containing Expenses

Expense management is undoubtedly a constant boardroom topic, but was a number one priority for only 20% of FFG survey participants. More than half thought that their expense structure was worse than competitor's, and only about 20% of them felt that expenses were on-par with the

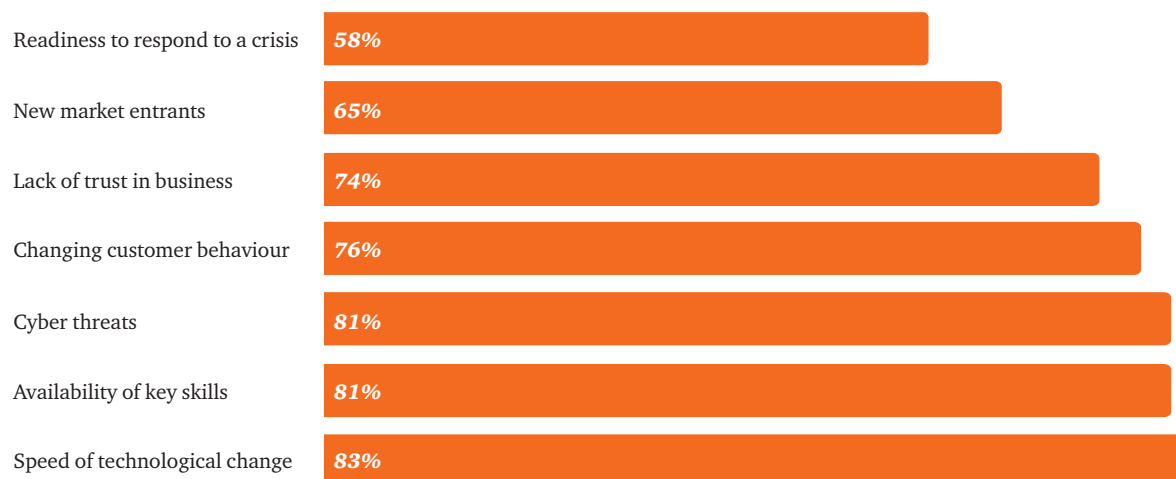
competition. 20% felt that they were doing better.

It's clear that cutting costs has become "business as usual", but rarely is it a top strategic priority. Three-quarters of FFG survey respondents have been at companies which have undergone expense reduction programmes in the last three years. While reducing expenses is a near universal battle, it's typically only as serious as a low grade fever.

However, when we asked, "Do you believe your company's management of expenses is optimised to profitably achieve its strategic objectives over the next 3 years?", almost 75% indicated a need to further improve.

At many companies, inadequate expense management is affecting spending on key strategic initiatives, perhaps indicating the degree of difficulty in moving spend from one area to another. We believe that a range of efforts including the use of robotics to eliminate some work roles – to not just reduce costs, but eliminate them – will be increasingly common among companies that are intent on realising an improved cost curve.

Figure 11: How concerned are you about the following business threats to your organisation's growth prospects



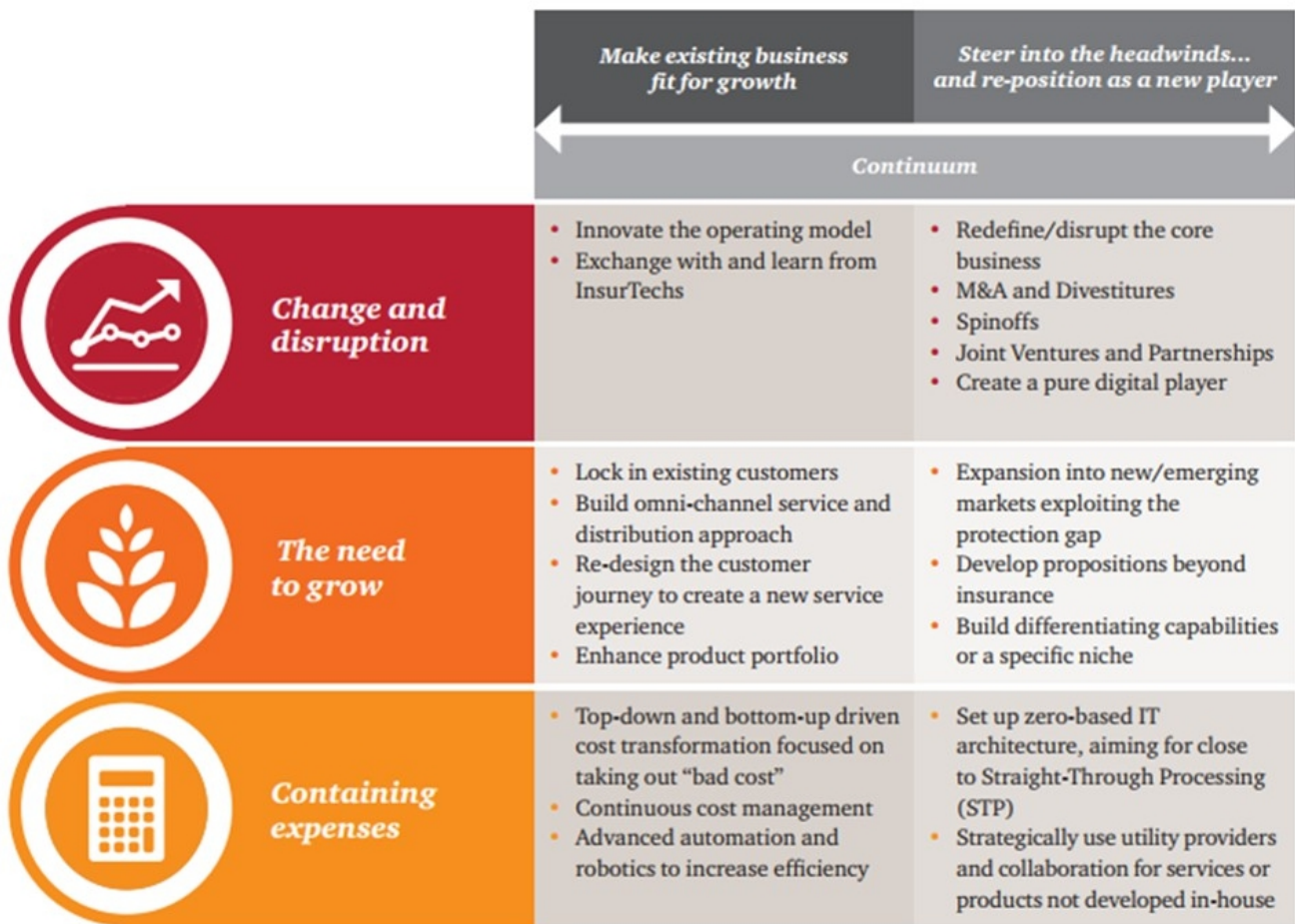
Source: Insurance CEOs Participating in PwC's 20th Annual CEO Survey

3. 'Embracing possibility, boosting innovation: Key findings in the insurance industry from PwC's 20th CEO Survey' (<http://www.pwc.com/gx/en/ceo-survey/2017/industries/pwc-ceo-20th-survey-report-2017-insurance.pdf>)

In the face of change, insurers are adopting two basic approaches

We continue to believe that virtually every company needs to achieve sustainable cost savings so that they can channel investment into the areas that will fuel growth. We compare these two broad strategic approaches or ways to play below:

Figure 12



Source: PwC

Make your core business fit for growth

A conscious decision to wait for the disruptive storm to pass may be a reasonable approach for many insurers. Capital constraints are real. Channel conflict is real. Risk tolerance is real. Opportunities are not necessarily clear or apparent. It's critical to know when to step into the arena and when to stay on the sidelines. Change happens – and in the current environment, it's coming fast and furious. The changes are also irreversible and therefore transformation is necessary and inevitable.

Through disciplined expense strategies, supported by robust change management and talent strategies, some companies can target competitive market positions, top-quartile expense structures, and

leading products and services. These insurers are looking for opportunities to arrive at scale, whether through various organisational refinements, process improvement, selected off-shoring or outsourcing, and by generally maintaining an “expenses first” mindset. They typically look to gradually gain market share by entering adjacencies, and avoid structural change or pursuing high-risk strategies because they hold one or more of the following to be true:

- Disruption is basically outside the planning and risk management horizon, so the best course is steady as she goes and focus on transforming the core business.
- Real innovation is beyond the risk appetite of the company (or they think they're just not good at it).
- There is a lack of critical mass to pursue opportunities that would lead to major shifts – either the

organisation is too small, or the budget/free capital doesn't exist, or both.

This approach to the market makes sense for companies with successful franchises and relatively little free capital to pursue other strategic options. These companies can find themselves positioned to opportunistically respond to market opportunities, even acquisitions in some cases.

Marginal efficiency savings can no longer guarantee survival and success. Insurers need to pinpoint resources and sharpen operational capabilities in a way that enables them to sustain relevance in a fast-evolving marketplace.

Embrace change and re-position as a new player

Some companies are taking a more aggressive approach. They are responding to any or all of the market forces that have motivated them to embrace the long-term forces shaping the industry and re-position themselves in terms of expense management:

- 1) Technology-driven change that is creating opportunities to significantly change cost curves;
- 2) Market activity (i.e., acquisitions, divestitures, and spin-offs);
- 3) New approaches to aggressively partnering with market entrants, notably InsurTech, that are creating both opportunities and disruption;
- 4) Regulatory changes, whether global, US (FSB, Dodd-Frank, FOI) or European (Solvency II); and
- 5) Tax law changes that may cause insurers to change insurance agreements and reexamine where their workforce is and where they make their investments.

The crucial priority isn't the costs you cut, rather where you focus resources to stimulate growth and differentiation – strategic cost reduction. This includes digital

transformation that can not only sharpen the precision of risk selection and pricing, but also deliver more tailored and targeted client solutions at a fraction of the cost.

Beyond technology are opportunities to refocus resources away from low-returning businesses towards higher value and higher return opportunities, both in fast growing geographical markets and underinsured exposures such as cyber and environmental risks. Indeed, the key differentiator within strategic cost reduction isn't technology so much as the strategic ambition and underlying culture of innovation and customer focus within the organisation.

Companies that have the risk tolerance, capabilities and capital – and want to be in the middle of disruption and innovation – pursue some or all of the following:

- Mergers and acquisitions
- Investments in Innovation/InsurTech
- Captive Shared Services Centres
- Moving IT infrastructure to the cloud

Becoming fit for growth

The desire to demonstrate growth is as real as the cost challenge facing

insurance companies. Disruption is occurring around us, with technology and capital creating seismic shifts in the competitive landscape and how business is transacted. Companies are attuned to these forces, but the degree of urgency in response is varied across the market. Fit for Growth is just one framework or way of thinking which can help make the strategic focus on optimising cost a core part of how your business chooses to play.

The margin for error and opportunity to create returns have never been more compressed, so companies need to have a defined strategy, as well as be agile in response to these forces. In our view, the ability to optimise cost through the utmost discipline, whether business-as-usual or initiative-driven, needs to be as much a core competency in successful insurance businesses as risk selection or capital allocation. Only through a strategic focus on cutting bad costs can scarce resources be freed up to invest, allowing (re) insurers to grow and compete with new services, products or geographies. As the most disrupted of any industry, the need to be fit enough to stay ahead has never been greater.



IFRS 9: Classification and Measurement – practical issues around the business model assessment



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Introduction

Since its issuance on 24 July 2014, IFRS 9 Financial Instruments continues to be the buzz word for most banks and financial institutions. This is the final version of the Standard and supersedes all previous versions, and is effective for annual periods beginning on or after 1 January 2018, with earlier application permitted. For banks this accounting standard will have the largest impact of any new standard since the introduction of IFRS.

The standard covers classification and measurement of assets and hedge accounting but the largest impact on business is likely to be the new approach for measuring impairment using an Expected Credit Losses (ECL) approach.

While a lot of banks and financial institutions have been giving a lot of attention to the ECL impairment requirements, some complexities and impact that may arise in applying the classification requirements should not be overlooked as some of these could give rise to unintended P or L volatility on adoption.

The new classification model at a glance

The IFRS 9 classification model is distinguished between equity instruments and debt instruments and is streamlined such that the same thought process is applied in determining the classification of all

debt instruments and this is more principles based as against the rules based approach for IAS 39 classification.

If the financial asset is a debt instrument, management should consider whether both the following tests are met:

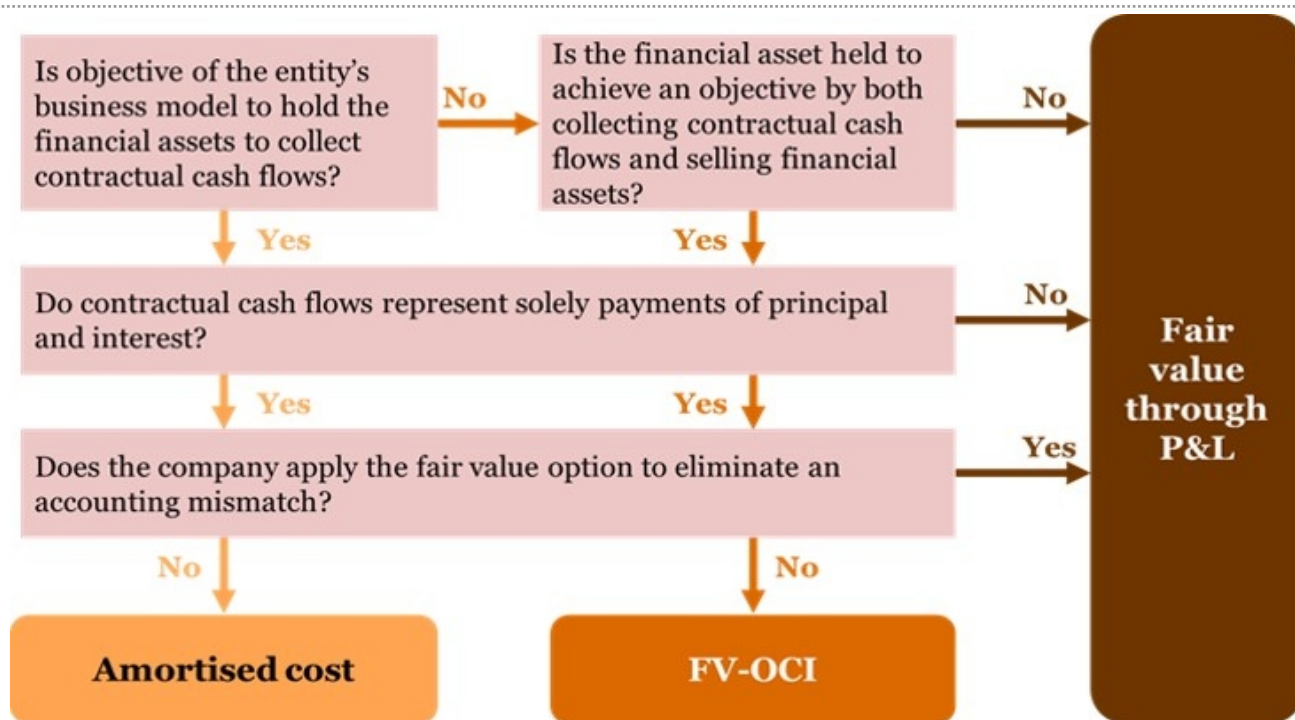
- The objective of the entity's business model is to hold the asset to collect the contractual cash flows; and
- The asset's contractual cash flows represent solely payments of principal and interest (SPPI).

Interest is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time and may include consideration for other basic lending risks and a profit margin.

If both these tests are met, the financial asset falls into the amortised cost measurement category. If the financial asset is held both to collect contractual cashflows and to sell and the cashflows meet the SPPI criteria, the financial asset is classified as fair value through other comprehensive income (FVOCI) and if the financial asset does not pass either of both tests, it is measured at fair value through profit or loss.

Even if both tests are met, management also has the ability to designate a financial asset as at fair value through profit or loss (FVPL) if doing so reduces or eliminates a measurement or recognition inconsistency ('accounting mismatch').

Figure 13



Practical issues - business model test

What is the business model test?

A business model test is an assessment of how an entity manages its financial assets in order to generate cashflows. IFRS 9 prescribes two business models: holding financial assets to collect contractual cash flows; and holding financial assets to collect contractual cash flows and selling. FVTPL is the residual category which is used for financial assets that are held for trading or if a financial asset does not fall into one of the two prescribed business models.

Determining the business model

The business model is determined by the entity's key management personnel in the way that assets are managed and their performance is reported to them.

An entity's business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the business model. Management will need to use judgement. The business model for managing financial assets is not determined by a single factor

or activity. Instead, management has to consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:

- How the performance of the business model (and the financial assets held within) is evaluated and reported to the entity's key management personnel;
- The risks that affect the performance of the business model (and the financial assets held within) and, in particular, the way that those risks are managed; and
- How managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or the contractual cash flows collected).

Examples of business model objectives that will suggest a hold to collect model might include:

- Debt instruments held to generate fixed returns and for no immediate cashflow needs or for stress case scenarios
- Debt assets held to match specific liabilities with similar maturities
- Trade receivables held with the intention of collecting the contractual cashflows in line with the entity's working capital cycle, with payments of fixed amounts on fixed dates

Examples of business model objectives that will suggest a hold to collect and sell model might include:

- Debt instruments held to manage everyday liquidity needs
- Debt instruments held for maintaining a particular interest yield profile
- Portfolio of financial assets held to match liabilities with differing maturity profiles e.g. Insurance liabilities, pension liabilities etc.

Examples of investments that will meet the trading business model might include:

- Investments held solely for market speculation. Even if contractual cashflows are collected, these are only incidental to the business model, the main driver of sales is changes in market value
- Investments that are monitored on a fair value basis and for which the managers are compensated on a fair value basis
- Investments with returns that are not solely payments of principal and interest eg equity or commodity linked returns
- Debt instruments held to settle liabilities that are measured on a different basis, and so designated at fair value through profit or loss to eliminate an accounting mismatch

Some practical implications...

- Financial assets that were designated at AFS under IAS 39 with the intention of managing P or L volatility may not necessarily meet the hold to collect and sell business model. No more arbitrary designation at FVOCI
- Investments held with a fund manager that are monitored solely on a fair value basis and/or the managers are compensated based on the market value of the investments may likely be classified at fair value through profit or loss, even if invested in fixed income securities
- Group companies that have a centralized treasury function, may have different business models for the same portfolio of

assets at the subsidiary level and at the group level as the business model at the subsidiary level may be to transfer/sell financial assets to the group treasury, whereas the business model from the consolidated position will differ based on the group's liquidity and investment strategies

- Under the current IAS 39 model, debt investments with a put option (granting the holder the right to demand early redemption) will not meet the Held to Maturity (HTM) classification. Under IFRS 9, early redemption is not considered sales and will not invalidate the hold to collect assumption as long as the redemption feature still meets the SPPI criteria.

Determining the level at which the business model condition should be applied

Another common area of concern is determining an appropriate level to aggregate assets for the business model assessment, this is an area where judgment is required. The business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. It is not an instrument-by-instrument analysis; rather it can be performed at a higher level of aggregation. Entities need an appropriate system for segregating the investments within the portfolios with different business models so that sales activities can be properly monitored and justified.

Observation

A single entity can have more than one business model for managing its financial instruments. For example, an entity can hold one portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to sell to realise fair value changes.

In some circumstances, it might be appropriate to separate a portfolio of financial assets into sub-portfolios to reflect how an entity manages those financial assets. For example, that might be the case if an entity originates or purchases a portfolio of corporate loans and manages some of the loans with an objective of collecting contractual cash flows and manages the other loans with an objective of selling them.

Another example is a liquidity portfolio where some assets are held for a 'stress case' scenario, (that is, holding them to collect contractual cash flows), while the remaining

assets are held with the purpose of meeting an entity's everyday liquidity needs resulting in recurring sales. It is expected that management will divide portfolios into sub-portfolios in order to reflect the business model. This will be a highly judgmental area as it might be difficult to distinguish within a portfolio which financial assets are held to collect, to collect and sell, or to trade. Proper documentation of each portfolio's details will be required from inception of the instruments to be able to monitor any occurring sales activities down the line.

Business model assessment: Syndicated loans

If a financial asset or group of financial assets is not held within the 'hold to collect' or the 'hold to collect and sell' business model, it should be measured at FVTPL. FVTPL is the residual category under IFRS 9.

Additionally, a business model in which an entity manages financial assets, with the objective of realising

cash flows through solely the sale of the assets, would result in an FVTPL business model. Even though the entity might collect contractual cash flows while it holds the financial assets, the objective of such a business model is not achieved by both collecting contractual cash flows and selling financial assets. This is because the collection of contractual cash flows is not integral to achieving the business model's objective; instead, it is incidental to it.

Illustration

An entity's business model is to lend to customers and hold the resulting loans for the collection of contractual cash flows. However, sometimes the entity syndicates out portions of loans that exceed their credit approval limits. This means that, at inception, part of such loans may be held to collect contractual cash flows and part may be held for sale. The entity therefore has two business models to apply to the respective portions of the loans.

Figure 14



Assessing the level and significance of sale

Although the objective of an entity's business model might be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Thus an entity's business model can be to hold financial assets to collect contractual cash flows even where sales of financial assets occur or are expected to occur in the future.

IFRS 9 provides guidance on the particular considerations that should be taken into account when assessing sales within the hold to collect business model:

- The historical frequency, timing and value of sales.
- The reason for the sales (such as credit deterioration).
- Expectations about future sales activity.

Sales themselves do not determine the business model and therefore cannot be considered in isolation. Rather, information about past sales and expectations about future sales provide evidence related to the entity's objective for managing the financial assets and, specifically, how cash flows are realised and value is created. Credit risk management activities aimed at minimising potential losses due to credit deterioration are not inconsistent with the hold to collect business model. Selling a financial asset because it no longer meets the credit criteria specified in the entity's documented investment policy is an example of a sale that has occurred due to an increase in credit risk. However, in the absence of such a policy, the entity could demonstrate in other ways that the sale occurred due to an increase in credit risk.

Some sales or transfers of financial instruments before maturity not related to credit risk management activities might be consistent with such a business model if they are infrequent (even if significant in value) or insignificant in value either

individually or in aggregate (even if frequent).

There is no bright line for how many sales constitute 'infrequent' or 'significant'; an entity will need to use judgement based on the facts and circumstances. An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with an objective to hold financial assets in order to collect contractual cash flows, if an entity can explain the reasons for those sales and demonstrate why those sales do not reflect a change in the business model. In addition, sales might be consistent with the objective of holding financial assets in order to collect contractual cash flows if the sales are made close to the maturity of the financial assets and the proceeds from the sales approximate to the collection of the remaining contractual cash flows.

Some examples of permissible sales within the 'Hold to collect' business model would include:

- the sale of a financial asset if it no longer meets the entity's investment policy, because its credit rating has declined below that required by that policy;
- sales so close to maturity or the financial asset's call date that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;
- sales in response to a change in tax law that significantly affects the tax status of the financial asset, or a significant change in regulations (such as a requirement to maintain regulatory capital) that directly affects the asset;
- sales in response to a significant internal restructuring or business combination;
- sales to execute a liquidity crisis plan when the crisis event is not reasonably expected; and
- other than the above, sales due to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.

What is the reference point for 'insignificant'?

IFRS 9 does not specify a particular reference point for significant sales. However, two reasonable reference points that could be applied are:

- the size of the portfolio subject to the business model assessment – if this reference point is used, the value of the sales is compared to the value of the portfolio subject to the business model assessment; and
- the total return of the portfolio – if this reference point is used, the gains and losses from the sales are compared to the total return of the portfolio subject to the business model assessment.

It would be inappropriate to use the entity's total as a reference point because this does not relate to the portfolio that is subject to the business model assessment.

If more than an infrequent number of sales are made out of a portfolio, management should assess whether (and how) such sales are consistent with an objective of collecting contractual cash flows. The frequency of the sales is more important than the reasons for the sales. However, management should be clear about the reason, for determining if sales would prevent a group of financial assets from being classified within the 'hold to collect' business model in future. Entities might consider setting up a process to track this information.

It should be noted that in all of the above circumstances where the business model is considered to have changed, the assets themselves are not reclassified, as long as the entity considered all relevant and objective information that was available at the time that it made the business model assessment. The change in model only impacts future asset acquisitions after the change in model.

IFRS 17: Insurance Contracts



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Introduction

IFRS 17 was released in May 2017 and it is quite a complex standard. The standard replaces IFRS 4 (Insurance Contracts) – an interim standard – which does not particularly prescribe a measurement policy for insurance contracts. If you take a look at various insurance contracts around the world, you would find that they are accounted for using different measurement frameworks. What the new standard does is that it tries to achieve a consistent insurance accounting framework, which inevitably means that there are a lot of changes for everyone who issues insurance contracts. This newsletter highlights the key provisions of IFRS 17, including its scope, recognition requirements, measurement models, disclosure requirements as well as an overview of the impact of the new standard.

Definition of insurance contract

The definition is the same as under IFRS 4 which is a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

Scope

IFRS 17 applies to:

- Insurance contracts, including reinsurance contracts, an entity issues - there are no significant changes in the scope compared to IFRS 4.
- Investment contracts with discretionary participation features an entity issues, provided the entity also issues insurance contracts.
- Fixed fee service contracts- An entity can make an irrevocable choice to

apply IFRS 15 instead of IFRS 17, if these contracts meet pre-defined conditions. The choice can be made on a contract by contract basis.

- Financial guarantees- With these, IFRS 17 also provides a choice. If the insurance company previously asserted that these are insurance contracts under the previous insurance standard, then that continues under IFRS 17 but if they have previously been classified under the financial instrument standard, then the Company can carry on with that classification.

It is worthy to note that IFRS 17 will not only affect traditional insurance companies, but also financial institutions with certain products, health insurance providers, service providers that issue bundle products, such as telecom services providers that attach insurance products to its services. Policyholder accounting is out of scope of IFRS 17 (except for reinsurance contracts held)

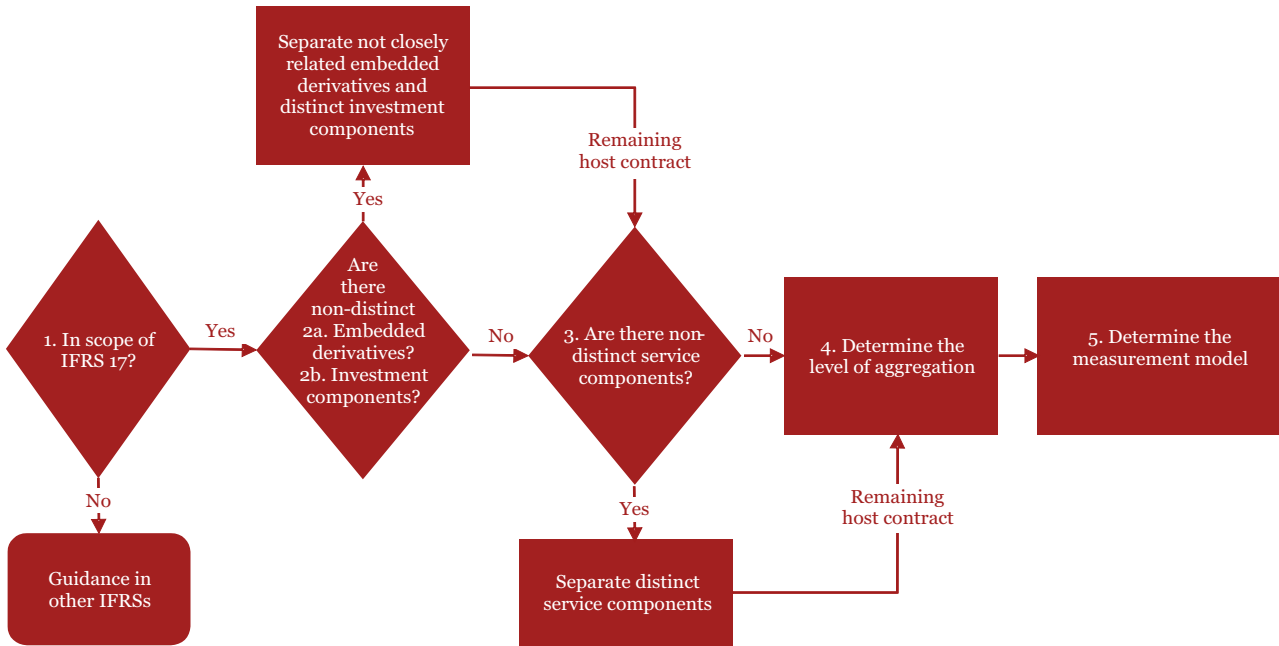
Initial recognition

On initial recognition, an entity shall measure a group of insurance contracts at the total of:

- a) **the fulfilment cash flows, which comprise:**
 - estimates of future cash flows ;
 - an adjustment to reflect the time value of money and the financial risks related to the future cash flows, to the extent that the financial risks are not included in the estimates of the future cash flows ; and
 - a risk adjustment for non-financial risk
- b) **the contractual service margin**

The diagram on the next page provides an overview of activities to be performed when a contract is initially recognised.

Figure 15






IFRS 17 measurement models

There are three measurement approaches under IFRS 17 for

different types of insurance contracts – the general model, premium allocation approach (PAA) and the variable fee approach (VFA). The

diagram below reflects an overview of the different approaches.

Figure 16

	 General model	 Premium allocation approach (PAA)	 Variable fee approach
Why is it needed?	Default model for all insurance contracts	To simplify for short term contracts with little variability	To deal with participating business where payments to policyholders are linked to underlying items like assets
Types of contract	<ul style="list-style-type: none"> Long-term and whole life insurance, protection business Certain annuities US style universal life Reinsurance contracts written Certain general insurance contracts 	<ul style="list-style-type: none"> General insurance Short-term life and certain group contracts 	<ul style="list-style-type: none"> Unit-linked contracts, US variable annuities and equity index-linked contracts Continental European 90/10 contract With profits contracts
Mandatory?	Mandatory	Optional	Mandatory

Reinsurance contracts

A reinsurance contract is an insurance contract issued by one entity (the reinsurer) to compensate

another entity for claims arising from one or more insurance contracts issued by that other entity. The diagram below describes contractual relations between a

reinsurer, insurer and policyholder, and the contracts that each party holds as a result of those contractual relationships.

Figure 17



Reinsurance contracts

A reinsurance contract is an insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity. The diagram below describes contractual relations between a reinsurer, insurer and policyholder, and the contracts that each party

holds as a result of those contractual relationships.

Modification and derecognition

IFRS 17 includes specific rules relating to when insurance contracts are derecognised and how they should be accounted for if modified after being issued.

The terms of an insurance contract can be modified after inception, for example by agreement between the parties to amend the contract or by a change in regulation. Companies should derecognise the original contract and recognise the modified contract as a new contract if certain conditions are met.

Figure 18

- **Modification** – amendment to an insurance contract.
- Exercise of rights under original terms is NOT a modification.
- Can result in derecognition, otherwise treated as a change in estimate.
- **Derecognition** – extinguishment, transfer or modification.
- Extinguishment - obligation expires, is discharged or cancelled.

Fulfilment cash flows

The present value of the *future cash flows* and the *risk adjustment for non-financial risk* that relate to the contract that is derecognised are eliminated.

Number of coverage units

The number of coverage units for the expected remaining coverage is adjusted to reflect the coverage units extinguished.

Adjustment of the CSM – different requirements for:

Extinguishment

Transfer

Modification

Transition and disclosures

An entity shall disclose qualitative and quantitative information about the:

- amounts recognized in its financial statements that arise from insurance contracts;
- significant judgements, and changes in those judgements, made when applying IFRS 17; and
- nature and extent of the risks that arise from insurance contracts.

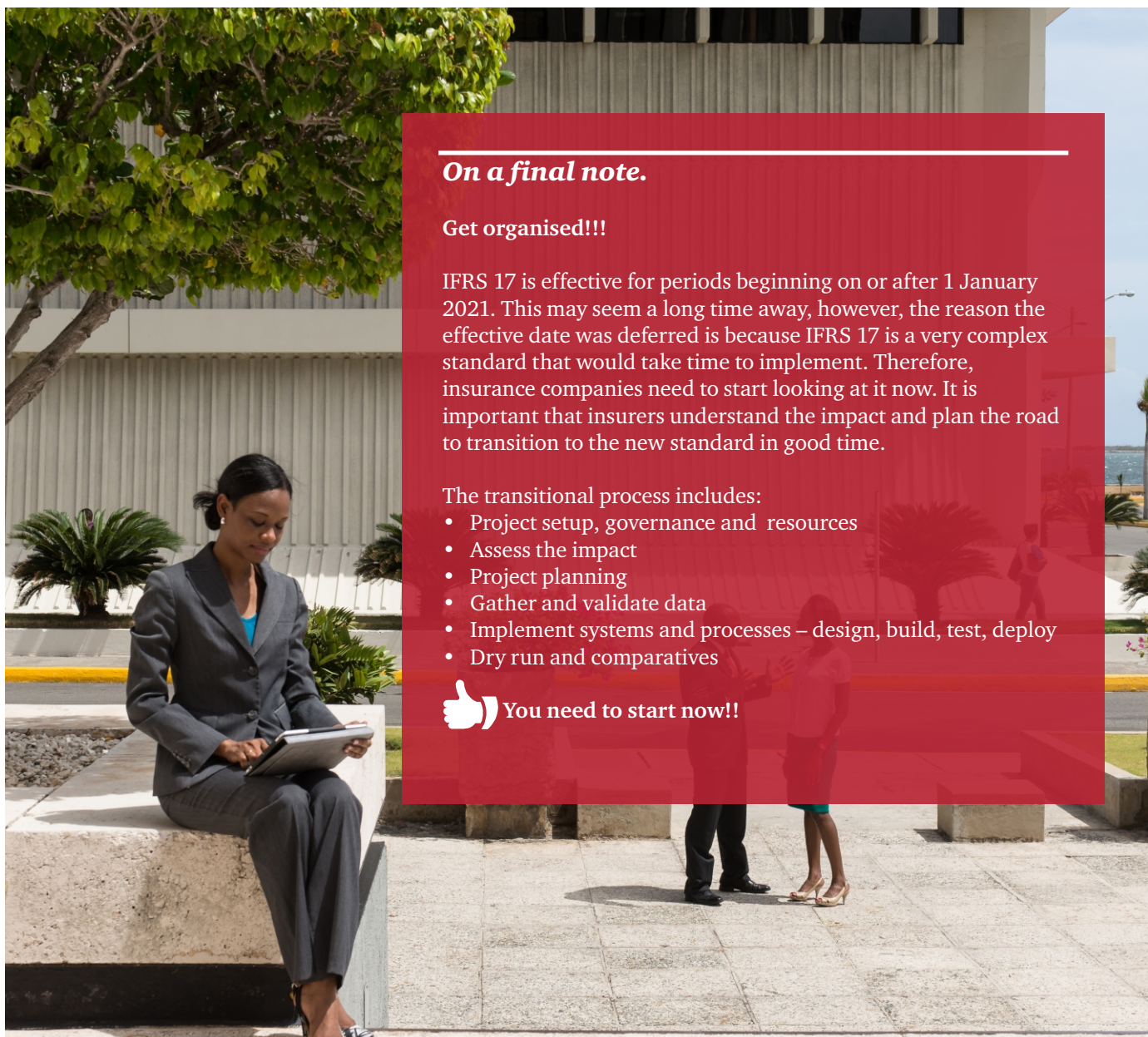
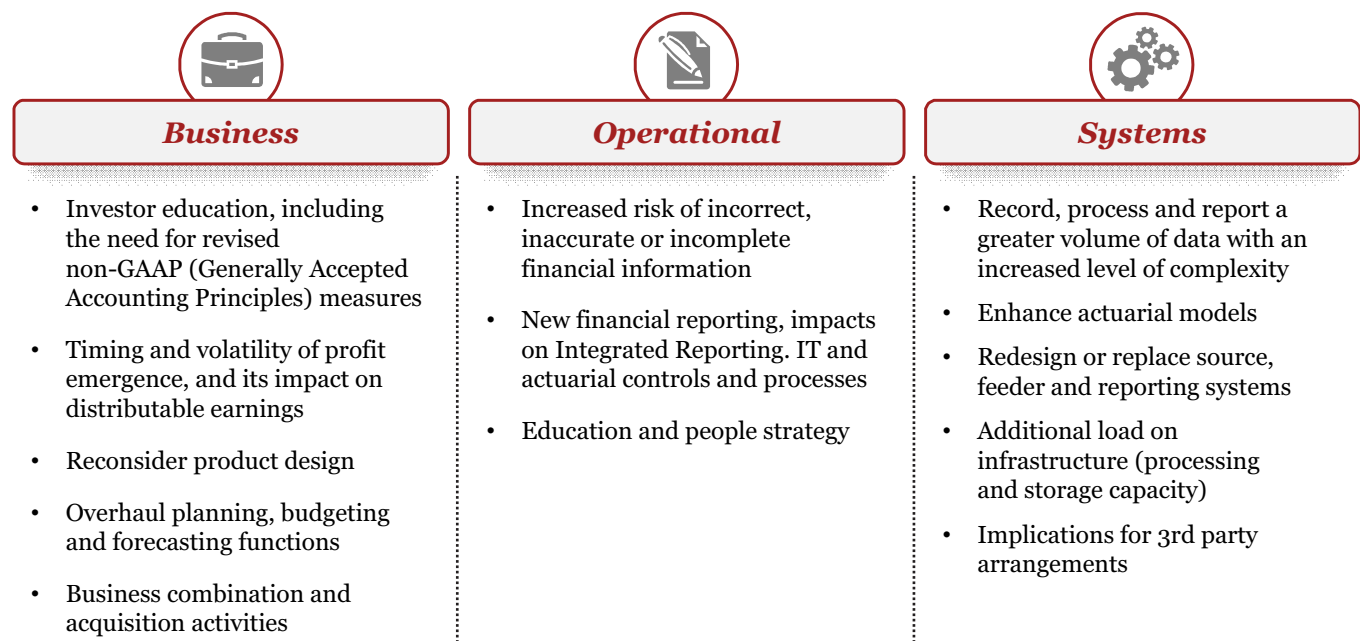
On transition to IFRS 17, an entity applies IFRS 17 retrospectively to

groups of insurance contracts, unless it is impracticable. In this case, the entity is permitted to choose between a modified retrospective approach (here, the entity applies transition requirements as at the transition date rather than on initial recognition of the insurance contracts) and the fair value approach (here, the insurance contracts are measured and recognized at fair value in accordance with IFRS 13).

Where is the impact?

The adoption of IFRS 17 will have wide-ranging and significant impacts on underlying processes, systems, internal controls, valuation models, investor education and other fundamental aspects of the insurance business as shown in the diagram below.

It is also interesting that the measurement model uses data that may not necessarily have been used in the past, so operational and system implications are huge around IFRS 17.




On a final note.

Get organised!!!

IFRS 17 is effective for periods beginning on or after 1 January 2021. This may seem a long time away, however, the reason the effective date was deferred is because IFRS 17 is a very complex standard that would take time to implement. Therefore, insurance companies need to start looking at it now. It is important that insurers understand the impact and plan the road to transition to the new standard in good time.

The transitional process includes:

- Project setup, governance and resources
- Assess the impact
- Project planning
- Gather and validate data
- Implement systems and processes – design, build, test, deploy
- Dry run and comparatives

 **You need to start now!!**

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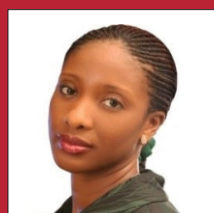
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