Edison Explains

IFRS 17

Impact on life assurance companies

IFRS 17 could result in a global standard for life assurance analysis, reducing complexity and encouraging investment.

IFRS 17 is the new accounting standard for insurance companies. It will have a meaningful impact on disclosure, including the determination of IFRS equity and the presentation of earnings.

The radical shift in the recognition of earnings over time and how earnings is reported is likely to change the way that investors analyse life insurers in particular and their performance metrics.

IFRS 17 could result in the phasing out of embedded value (EV) disclosure as European insurance companies embrace the new standard. Most companies have indicated that they will align this disclosure with their existing Solvency II disclosure.

For the first time in this millennium, the new standard may result in financial reporting that provides more useful disclosure, allowing more comparability across companies and territories. This should lead to easier screening by investors, thereby closing the complexity gap with other financial companies, like banks.

An income statement that is easier to understand

Income statements for life assurers will be much simplified under IFRS 17 by clearly disclosing the two key sources of earnings, namely (a) insurance (underwriting) result (the earnings directly related to the provision of insurance services); and (b) investment result (the earnings resulting from investing insurance premiums received well in advance of insurance services provided).

It will eliminate two key problem areas related to IFRS 4 disclosure, namely (a) premium income (open to distortions caused by the receipt of premiums well in advance and the accounting of deposits as revenue, instead of a more logical balance sheet item); and (b) change in policyholder liabilities (a black-box pot used to reverse deposit accounting, dealing with the advance receipt of premiums, reserving adjustments, etc.).

IFRS 17 will recognise these two key earnings sources as and when insurance services are rendered, will allow segregation between insurance and reinsurance items and will allow other earnings items, including short-duration insurance (ie property and casualty earnings or group benefits), asset management and other fee-based earnings, and non-attributable expenses, to be explicitly monitored and tracked.

A store of value will be created and released over time in a predictable and measured way

For long-term insurance contracts, IFRS 17 will create a store of value in the form of the contractual service margin (CSM), calculated as the discounted cash flow of future profits to be released in a measured fashion based on clearly defined coverage units like sum assured or fund value.

The CSM will be determined in conjunction with policyholder liabilities (on a best estimate basis) and a risk adjustment (RA), which is an additional margin to increase confidence levels with regards to non-financial assumptions (like mortality, lapses and expenses).

This store of value will be released over time into the income statement in a predictable way, based on an assessment of the insurance services provided in a given period. It will grow from period to period in line with the accretion of a locked-in interest rate at the transition date for the book of in-force business. This locked-in interest rate will change for cohorts of new business that is subsequently written in the future. It will further grow as new business is written and a new business CSM (NB CSM) is determined and added.

In addition, there will be a release of RA into the income statement every period as risks associated with a particular period of coverage expire.

IFRS equity will be restated at transition and future IFRS earnings will be affected

At transition to IFRS 17, IFRS equity will be affected by (a) the elimination of intangibles like deferred acquisition costs; (b) the release of IFRS 4 margins; (c) the setting up of the RA and CSM; and (d) changes in the earnings release profile.

For most European insurers, the IFRS 17 basis is more conservative than IFRS 4, resulting in a reduction in equity and a slower release of future earnings. South African companies will generally see an increase in IFRS equity and a faster release of future earnings.

Simplistically, annuity earnings, which is more prevalent for European insurers, will accrue more slowly under the new dispensation, while risk product earnings, which is more prevalent in South Africa, will accrue faster. The simplistic impact on the back-book is for European insurers to accrue more value in their CSM, which will result in lower equity at transition and higher future earnings releases. For South African insurers, on balance, less value will accrue to the CSM, with higher transitional equity and lower back-book earnings. In reality, the extent to which companies add new business (which will either release earnings more slowly or faster), will have an impact on the net earnings outcome.

IFRS 17 will allow structural growth for long-term business to be more readily measured, forecast and compared across companies and territories

The development of CSM over time and hence the release of CSM into the income statement (driving earnings growth) is a factor of three main drivers: the term over which CSM is released (the duration of the existing book); the interest on CSM (determined by the locked-in discount rate); and the NB CSM (the ability to add to CSM during each period by writing new business).

For most companies, the interest on CSM will be lower than the release of CSM in a given period (with the exception of companies who write very long-tail business). The net decline in CSM after taking account of these two factors will be easily measurable and forecastable. The ability to replenish CSM and to deliver growth will be dependent on the ability of NB CSM to make up for the net decline above and to exceed it.

Once sufficient datasets have been disclosed, structural growth will become a simple calculation based on the three factors (interest, CSM release and NB CSM), with NB CSM being the most important variable.

What is key is that structural growth comparisons under IFRS 17 will be easier to make across companies and regions, without the need for additional disclosure like EV and/or company-specific metrics (which have increasingly become the norm).

A global standard to embrace

Life insurance companies have been notoriously difficult to analyse on a consistent basis across regions due to the difficulties associated with the IFRS 4 income statement. Unlike global banks, there is no global standard that allows investors to easily apply high-level comparative screening of companies across different countries. Investors have hence been forced to expend additional effort simply to determine whether a life insurance company is deserving of deeper analysis prior to portfolio inclusion.

It is our opinion that the complexity in analysing life insurance companies, difficulty in forecasting results and the additional effort required to make an investment decision has resulted in a sustained rating discount on these counters relative to other financial stocks, like banks.

We believe that IFRS 17 may offer a solution to this discount by introducing the information set and tools to allow for a global standard, empowering investors to more readily screen and analyse such companies. This global standard, once developed and adopted, could increase interest in life insurance companies and expose them to new and growing pools of capital.

However, for individual companies to participate in this potential upside, it is important to embrace the new standard and be party to its development. Many companies may be comfortable in their historical way of dealing with investors, which includes a great level of education on how they specifically operate (and their unique company-specific disclosures). These companies may be better served by embracing IFRS 17 and amending their disclosures and investor communications, having the end-goal of a global standard in mind.

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