IFRS17, Economic Volatility, and Reinsurance

Industry insights on preparing for the imminent new global accounting standard

RGA

Insurers buy reinsurance for a variety of reasons, but an insurer's accounting rules and solvency regulations are inevitably at the heart of the decision. Whether they are primary drivers or simply help insurers judge acceptable pricing for a risk- or service-motivated transaction, these rules and regulations are a key part of the equation.

IFRS17 is the imminent new global accounting standard for insurance (outside the U.S.), and a few countries also link solvency regulations directly to IFRS. It is therefore natural to think IFRS17 might be a major factor in insurers' reinsurance buying decisions. To prepare for this, RGA has met with life and health insurers around the globe over the past several years to better understand and predict how those decisions might eventually change.

The transition experience from IFRS4 to IFRS17 could be different in every country and for every insurer, but there are clear, recurring themes. This article will explore those themes and share some of the related insights RGA has gained in the process leading up to IFRS17, as well as the challenges insurers are experiencing as they adjust to the new standard.

Recurring Insurer Themes

IFRS17 requires the adoption of a prospective economic valuation method for insurance liabilities with an updating of the assumptions in the valuation at each future reporting date.

The feedback gained from clients globally when discussing IFRS17 revealed three major areas of concern about the new standard:

1. Cost and complexity of implementation, including data collection, IT systems development, and management processes
2. Volatility in earnings over time due to use of current assumptions
3. Slow pattern of expected earnings emergence

IFRS17's prospective economic valuation has entailed costly and challenging implementation efforts for insurers, especially life insurers. Paradoxically, IFRS17 first required insurers to focus on the past to collect large amounts of data and to recreate history to project the future based on IASB beliefs. Needing to then perform individual policy level projections repeatedly is the next-level challenge. IFRS17 also requires companies to track, recalculate, and amortize assorted values (e.g., "Loss Component" and "Contract Service Margin"), which have complex links to other values at different points in time. The final challenges will be understanding, explaining, and ultimately using these outputs. These combined challenges have proven formidable and caused the cost of implementation projects to grow beyond original budgets. Bemoaning this ever-expanding cost and complexity has become a constant refrain from insurers in the global IFRS17 environment.

Only after companies make significant progress in implementing IFRS17 systems are they typically ready to start meaningful discussions on the IFRS17 accounting values. At this stage, volatility in earnings is a consistent complaint. This volatility boils down to two distinguishable items:

1. The period-to-period fluctuations in the total income statement (Consolidated Statement of Comprehensive Income) as assumptions are updated and experience emerges
2. Division of the total income statement into the Consolidated Statement of Profit or Loss (P&L) and Other Comprehensive Income (OCI), thus separating financial data that belong together and causing P&L volatility

Once companies understand the sources of this volatility and try to minimize it, they typically express dissatisfaction with the inherent pattern of IFRS17 earnings emergence. Though this overlaps somewhat with the problem of volatility, there is indeed a distinct issue and underlying cause here. The core issue is that IFRS17's foundational beliefs and chosen methods lead to slow earnings emergence.

IFRS17 Fundamental Observations

After receiving feedback from many clients over the years about their challenges and frustrations with IFRS17, RGA has explored a range of potential solutions. In the process, we have deepened our own understanding of IFRS17, investigating the foundations of the standard to consider its implications. Based on that journey, we believe the recurring insurer themes noted above derive from an incompatibility between IFRS 17 design elements and the insurance environment.

A broader, clearer understanding of these underlying issues will allow companies to determine which problems to tackle and how to solve them. While reinsurance solutions will help address new IFRS17 issues, much of the transition will require familiarizing internal and external stakeholders with earnings patterns that simply look different but are fundamentally neither better nor worse than those seen before IFRS17.

1. **Beliefs of IFRS17 authors**

   Volumes have been written on IFRS17's creation, but the following paraphrased subset of International Accounting Standards Board (IASB) beliefs underlying IFRS and IFRS17 is most relevant to this article:

   - Insurance profit should be recognized gradually over time, as insurance services are delivered. Conversely, no profit should be recognized at inception (since no insurance services have been provided).
   - The income statement can be split into two parts (i.e., P&L and OCI), one of which (P&L) is more relevant to evaluating management's performance and the other (OCI) is much less so.
   - Some investment results should be separated from overall insurance product results and shown in the "less accountable" (OCI) section of the income statement.

2. **Wishes of IFRS17 users**

   Investors naturally wish to own businesses that generate profits in ever increasing amounts with no surprises. IFRS P&L is one of their tools to evaluate performance of managers in this area. Company managers naturally wish to demonstrate they are delivering on expectations and running their businesses in a way that produces healthy accounting profits every period and leads to predictable increases in subsequent years.

3. **Reality to which IFRS17 applies**

   Two elements in this are notable. First, life insurance products globally are predominantly savings vehicles versus simply serving as a means of risk protection. Owners of life insurers offering savings vehicles expect a material portion of total profits to come from investment performance, and that their managers will operate the overall business to optimize this performance.

   Second, applying a prospective economic valuation framework to insurance liabilities reveals that these values are very sensitive and that capturing the corresponding change in assets supporting those liabilities is necessary to achieve stability.

Considering these three elements in relation to the client themes discussed earlier, one can construct the following arguments:

- "Value" and "performance" are two distinct measures and having both clearly and correctly captured by one insurance measurement system may be too much to ask for.
- Volatility is inherent on both sides of an insurance balance sheet under prospective economic valuation, and even well-managed portfolios may show material net volatility that will be difficult to keep out of the P&L statement.
- IFRS17 effectively contains two compounding levers to defer investment profits on typical life insurance savings business, so this business will naturally have a very long profit signature.

Value Versus Performance

The clear focus of IFRS reporters and their investors is P&L, which is used to measure performance. Much less attention is paid to the IFRS balance sheet, and those who do start with the balance sheet to assess company value inevitably make fundamental adjustments. (A topic for another day is the degree to which IFRS17's Contract Service Margin [CSM] and Risk Adjustment [RA] might reduce the need for analysts to make these adjustments.) It is notable that most of the newest life insurance solvency regimes – which are essentially measuring the value of the business in different scenarios – created their own prospective economic balance sheets instead of using that of IFRS.

The most prominent of these regimes is Solvency II, which does not include an income statement. This makes us wonder whether an economic balance sheet is simply incompatible with traditional performance measurement. Our conclusion is that some of the persistent dissatisfaction with IFRS17 comes from the new standard introducing value measures to the balance sheet that can be difficult to reconcile with income statement expectations.

Two examples of this are Deferred Acquisition Cost (DAC) and Loss Component (LC).Neither appears on the IFRS17 balance sheet because the prospective economic liability valuation naturally captures the DAC effect and produces the relevant LC effect and passes them via the P&L statement into balance sheet equity.

The theoretical IFRS17 income statement, therefore, does not need to include future explicit amortizations of either of these values (they happen naturally, implicitly via the liability revaluation.) However, presumably to satisfy pre-IFRS17 practices regarding performance measures that need reporting, the income statement post-IFRS17 will include amortizations of DAC and LC. Each of those amortization valueswill actually show up twice in each income statement – once as a minus and once as a plus – in order to reflect their net-zero impact on the balance sheet.

Financial statements generally provide supplementary disclosures that are valuable to investors, but to take this information and insert it into the mathematically derivable income statement is a new step and contributes significantly to the implementation challenges of IFRS17.

Unavoidable Volatility?

Consider an income statement to be the difference of differences among four large numbers:

$$\left[\left(\begin{array}{c}\text{end-of-period}\\ \text{assets}\end{array}\right) - \left(\begin{array}{c}\text{end-of-period}\\ \text{liabilities}\end{array}\right)\right] - \left[\left(\begin{array}{c}\text{beginning of}\\ \text{period assets}\end{array}\right) - \left(\begin{array}{c}\text{beginning of}\\ \text{period liabilities}\end{array}\right)\right]$$

IFRS17 will make the liability components volatile. For IFRS, the P&L is seen as the "more accountable" subset of that total result, and parties involved generally prefer that it not be volatile. There are at least two layers of challenge in getting P&L stability from this liability volatility.

1. If the liabilities were perfectly matched by the assets (which is rarely the case in reality) and if the accounting for both the assets and the liabilities were perfectly synchronized (which does not appear to be the case), then a non-volatile total income statement might be possible.
2. If accountants then try to split out a P&L for management performance measurement and leave OCI for items outside their control, they will need to find, and then meticulously codify, the dividing line between P&L and OCI.

As IFRS17 has evolved, numerous amendments to address both issues have emerged. Synchronizing the asset and liability accounting, for example, is aided by discretionary policy elections and classifications in IFRS9 and IFRS17. The split between P&L and OCI, meanwhile, was refined late in the process with the introduction of the Variable Fee Approach (VFA) and the extension of the Risk Mitigation Option to also apply to reinsurance.

It is our impression that the IFRS17 P&L remains more volatile than many stakeholders would like. We believe, however, that there are meaningful limits to the effectiveness of further attempts to reach greater P&L stability without changing underlying beliefs.

Double Deferral of Spreads

Many commentators have written about the late emergence of profits under IFRS17, especially for business which falls under the VFA. This phenomenon is a direct result of IFRS17's decisions to (1) initially not account for some of the significant investment profits

that companies do, in fact, expect; (2) defer all initially expected profits; and (3) further defer unexpected investment profits when they do arise.

The first element in that chain refers to the setting of liability discount rates that include only partial credit spreads. The two subsequent elements are simply the intended effects of the Contract Service Margin (CSM). The CSM mechanics on their own would likely have produced late-emerging profits, but the extra effect of the VFA and credit spreads has produced a situation clearly at odds with the wishes of management and investors.

Closing Thoughts

We have shared these ideas in ongoing discussions with life insurers, who have found them helpful in selecting more effective commercial paths.

To respond to insurers' challenges with IT systems, we have found some small ways to make their lives easier. We can't reduce the number of times they need to fully project individual policies (twice as often if it is reinsured), but we can modify reinsurance conditions or underlying policy conditions to make some of those projections simpler and better aligned.

As far as reducing income volatility, a significant portion of the "solution" has been companies gradually starting to accept the inevitability of this effect and the need to address it in their explanations when rolling out each period's results. In addition, the usual full range of reinsurance solutions can play a role.

Finally, accelerating the pattern of income emergence is the most active area of our current IFRS17 client engagement. The basic story is very similar to that of volatility, both in acceptance and reinsurance relevance.

The generalized lesson from these last two paths is that reinsurance can indeed help with volatility or the natural shape of earnings, but that reinsurance is generally most helpful to insurers who have a range of financial priorities and constraints (not just IFRS) and who have a clear strategy for how to prioritize and optimize those challenges.

Contact RGA to discuss these concepts and to work together to develop practical solutions for your business.