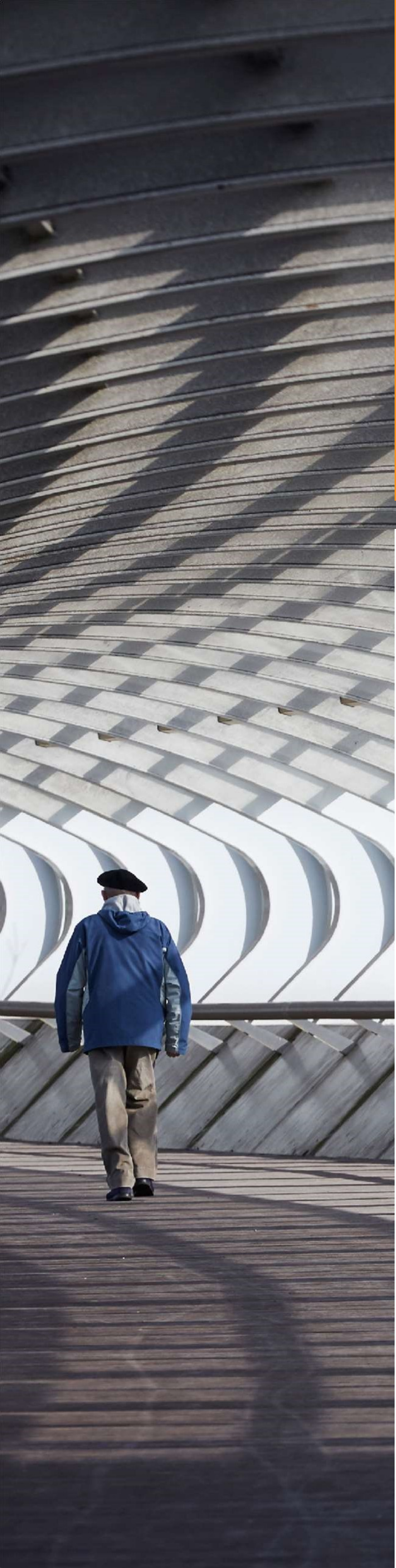
New measures, new perspective

The impact of IFRS 17 on insurance performance and reporting

March 2019



Introduction

IFRS 17 will not change the amount of profit you make over the lifetime of your insurance business, but it has the potential to massively shift the trajectory of these profits. The impact will not just be felt in your financial statements, but also many of the key performance indicators (KPIs) that you use to run your business and which shape how your business is judged by analysts and investors.

In this first edition in our 'IFRS 17: Impact on IFRS 17 on insurance performance and reporting' series, we analysed the suite of KPIs communicated to the markets by 20 of the largest European insurers, assessed how these metrics are likely to be affected by IFRS 17 and how companies may need to respond to this.

Changing the way your business is judged

The new insurance contract reporting standard (IFRS 17) does not come into effect until 1 January 2022[1]. Yet analysts are already beginning to ask questions about the impact on reported earnings and some insurers have started communicating expectations to the market.

So, what's changing? More or less everything – IFRS 17 rebuilds performance measurement from the ground up in areas ranging from a new definition of insurance revenue to the elimination of upfront profits and spreading of profit across the lifetime of the contract. As revenue and profit measures shift, so will many of the KPIs that insurers use to run their business, provide the basis for incentives and frame market perceptions of their business.

One of the big challenges is that, in some cases, there is no easy adjustment from the existing KPIs to KPIs derived from the new IFRS 17 reporting model. Some KPIs will be turned on their head such as adjusted operating profit (AOP), which for many insurers is the paramount measure of underlying performance. The definition of AOP and supporting disclosures will be needed to help management explain the drivers of performance. The insurance industry may benefit from a consistent approach to alternative performance reporting to aid comparability.

We might also see new KPIs emerge, for example, around the IFRS 17 contractual service margin (CSM) concept – a measure of unearned profit on new and existing business from an accounting lens.

Understanding the implications and explaining the new KPIs to analysts, investors and the business are critical in providing an effective basis for decision making and ensuring that your market valuation reflects the genuine performance and potential of your business.

So, where are we going to see the biggest impacts, what are the implications for market valuation and how can you manage the shift?

[1] Subject to IASB exposure draft and due process later in 2019

Profit

IFRS 17 will lead to significant shifts in the numbers underlying the main accounting profit metrics.

IFRS profit

All listed European insurers must report profit under IFRS – 75% of the insurers we analysed currently present it as a primary KPI. Such profit metrics enable users of accounts to compare companies on a reasonably consistent basis, both within the industry and outside.

Is IFRS profit a primary KPI?

IFRS profits will look very different as a result of the move to IFRS 17. The elimination of profit at inception will lower initial returns from new business. For some insurance products (e.g. annuities in some countries) the release of earnings through the lifetime of the policy (through the CSM) rather than upfront will defer the recognition of profits. For some non-life insurance products, immediate recognition of onerous contracts will mean earlier recognition of losses.

The impact of transition to IFRS 17 is still uncertain. Conceivably, in future there could be recycling of past profits or loss of future profits with the balance taken to equity on transition. Both of these effects could have consequential impacts on actual tax paid depending on local tax rules. There is also the additional consideration of whether transitioning to IFRS 17 impacts the ability of insurers to generate distributable reserves, and hence dividends and cash from subsidiaries (depending on local rules).

So how useful is the new IFRS profit number? ***Accounting profit won't lose relevance, especially for generalist investors looking to compare insurers with investment opportunities in other industries. Yet, the usefulness of profit measures driven by IFRS 17 results could be impaired by accounting mismatches, to the extent these exist***. The areas where extensive judgement is required, for example in setting the discount rate and risk adjustment, may also make comparison across insurers more challenging.

Adjusted operating profit (AOP)

All but three of the insurers we analysed present an adjusted operating profit (or an equivalent measure) as a KPI. The measure is viewed to be a more representative long-term indicator of performance than IFRS profit.

Is adjusted operating profit a KPI?

AOP measures were designed, in theory, by insurers to help users understand the performance of the company by removing short-term factors and one-offs that are out of management's control. However, IFRS 17 may create challenges that may make it harder to link management's explanation of underlying performance with the insurance service result. More disclosure is therefore likely to be needed to link earnings and performance measures. Indeed, bridging between such measures is required by European Securities and Markets Authority (ESMA) guidelines on alternative performance measures[2].

So, will an AOP still be relevant? ***We view that many insurers will continue to headline AOP***. However, establishing the mechanisms needed to adjust IFRS profit to AOP under IFRS 17 may be more complex than today.

Adjustments to IFRS profit when deriving the AOP could include adjustments to the aggregation of contracts, the treatment of reinsurance ceded and hedging, along with using longer term investment performance evaluations (similar to today). To maximise the value for users of accounts, consistency across the insurance industry in the type of adjustments made would be beneficial. A later article in this series will explore further the potential adjustments that may be made.

Combined ratio

Combined ratio is a crucial internal and external KPI for non-life insurers. This isn't an IFRS requirement, but a common industry measure to assess profitability. The insurers we analysed writing non-life business do emphasise this KPI.

Is a combined ratio disclosed?

To some extent, the insurance service result required under IFRS 17 is similar to the underwriting result and combined ratio, though it makes three departures from the practice currently used:

- Discounting of cash flows.
- Only includes 'qualifying' expenses under IFRS 17.
- A timing difference due to losses on onerous business.

So, will a combined ratio still be disclosed? ***We view that non-life insurers will continue to disclose a combined ratio, however, it is still to be determined whether market practice will adjust for the above mentioned changes to today.***

Claims incurred ratios, a sub-set of the combined ratio, will no longer be readily available in the financial statements. This is because claims will be combined with qualifying expenses in 'insurance service expenses'. Although claims paid information may appear in the disclosures of cash flows, this doesn't equate to current incurred metrics. It's therefore important to take account of this change within the management information used to measure and run the business.

[2] https://www.esma.europa.eu/press-news/esma-news/esma-publishes-final-guidelines-alternative-performance-measures

Cash

Cash-type metrics – often called operating free cash flow, cash surplus, cash inflow, free surplus generation and cash generation – aren't usually sourced from IFRS financial information (more likely Solvency II or local rules) and are therefore likely to continue in their current form. There may be second order implications though. ***We expect that investors will need to be taken on the journey of how the cash metrics relate to the disclosed IFRS 17 profit.***

Is a cash based KPI disclosed?

Growth

The marked shifts in the revenue definition and measurement model mean that metrics to assess 'growth' may change.

Revenue

The vast majority of the insurers we analysed (over 75%) emphasise some form of revenue metric. Under the general model in IFRS 17, revenue reflects a combination of the release of CSM and risk adjustment, along with the timing of claim and expense cash flows. It also includes non-insurance revenue under IFRS 15.

Gross written premium

While Gross Written Premium will be replaced by a new revenue measure, some insurers might continue to determine this widely used KPI and publish it as part of their voluntary disclosures.

Value of New Business (VNB)

VNB is reported on a Solvency II (adjusted or unadjusted) or Embedded Value basis by a number of the growth-focused life insurers we analysed. This is often reported alongside a volume measure such as Annual Premium Equivalent (APE) or Present Value of New Business Premium (PVNBP).

Is revenue a KPI?

Is gross written premium a KPI?

Is new business value disclosed?

Will the KPI still be relevant? ***It remains to be seen whether revenue on an IFRS 17 basis will continue as a KPI as it would need to be reconciled to real cash flows in order to relate it to dividend potential***. Insurers may therefore prefer to disclose a cash based revenue metric in its place.

We don't expect a direct impact on VNB calculation due to IFRS 17, but will VNB still be relevant? ***It may continue to be useful for investors, however, the new business CSM may become an alternative measure for new business.*** New business CSM represents the present value of future IFRS profits from business written in the period (that are being deferred). CSM is the most relevant measure in IFRS 17 of the value of future profits from in-force business and could be the new value measure (be adjusted or unadjusted).

Value and other measures

Key value and other measures include, for example, return on equity (RoE) and the Solvency II coverage ratio which will remain one of the prime focus areas for analysts. The Solvency II coverage ratio is not directly driven by IFRS accounting numbers, but there could be an indirect impact, e.g. through tax.

Are value based measured disclosed?

Getting up to speed

Your suite of KPIs is the foundation for the management packs used by your board and the models used by analysts to value your business. It will also influence senior remuneration. While IFRS 17 doesn't go live until 2022[3], boards, analysts and investors will want to know long before then what the most critical KPIs will look like under the new bases of evaluation. That's why it's vital to understand the impact and what drives it. How can you prepare for this?

1. Run the new numbers

Calculate your most important KPIs under the new bases. You can then pinpoint where the biggest shifts will be, look at possible levers for managing impacts that don't reflect your underlying performance (e.g. removal of mismatches caused by the accounting approach in IFRS 17) and develop an explanation for what you can't reasonably adjust. It's also important to look at the impact on profitability by product line and wider business strategies and how this could be optimised. You will need enough time to adequately stress test the options identified to make sure they are fit for purpose.

2. Judge how your KPI suite needs to change

Some metrics will continue to be headline KPIs, albeit with information needed to explain any changes. However, others could be less relevant. There are also opportunities to introduce new KPIs that provide a more relevant foundation for your investment 'story'. Examples might include adjusted or unadjusted new business CSM. There could be early mover advantages for leading the way in introducing new KPIs that could eventually become benchmarks for market evaluation and comparison.

3. Reach out to analysts and investors

Educating analysts and investors is crucial to the perception of your company. The importance of their understanding is heightened by the need to separate any mismatches caused by the accounting approach from more 'real' movements in underlying earnings. Proactive planning of who you will speak to and when, well in advance of IFRS 17 implementation will be key to making sure this is successful.

Our annual IFRS 17 events for insurance analysts are helping to increase market awareness and enable us to gauge levels of understanding within the investor community. These events and other interactions with analysts underline the importance for your business of early and effective analyst and investor education. Many analysts are still getting to grips with Solvency II and have yet to focus on the ins-and-outs of IFRS 17.

To help insurance analysts understand the impact of IFRS 17 on your results, it is likely they will need a bridge to an existing basis they are more familiar with such as Solvency II and/or current accounting.

[3] Subject to IASB exposure draft and due in process in 2019

Coming up

In coming articles, we'll be looking in more detail at how to get up to speed with the KPI changes in areas ranging from the design and drivers of new KPIs to ensuring the validity of internal management information. We'll also be looking at what analysts want from your business to help them understand your performance.

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