IFRS 17 Key Performance Indicators (KPIs)

Potential Interactions with the Discount Rate

IFRS 17 will change the way insurance accounting works, with a new income statement, different balance sheet behaviour and a change in the way profit emerges. For insurers who manage their business on an IFRS basis this will require new ways to measure performance - which means new "IFRS 17" KPIs.

In this note we explore some potential new metrics, how they might be constructed and whether the way the discount rate is constructed will affect how the KPI's might behave. This is not an exhaustive list of KPIs – there are other possibilities, many of which might not interact with the discount rate.

Accounting under IFRS 17 leads to profits being deferred over the life of insurance contracts via a new accounting liability, the Contractual Service Margin, or CSM. A previous note written by the working party[1] discussed how, where products are sensitive to discount rates, the discount rate can influence the balance between the "Insurance" and "Investment" result. KPIs can be affected in a similar manner.

The metrics below can be calculated from the public disclosures required under IFRS 17.

New Business Profitability

Many insurers report new business metrics to demonstrate business is being written on profitable terms. For IFRS 17 the income statement does not show the profitability of new business directly, but the underlying reconciliations allow the profitability of business that's currently being written to be identified (the required disclosures are set out in paragraphs 101 and 104 of the standard).

A possible metric might be a "new business margin":

$$\frac{CSM\ for\ New\ Business}{Value\ of\ New\ Business\ Premiums}$$

The CSM is effectively a deferred profit measure, so this metric shows a profit margin for new business.

The CSM for new business will be dependent on the initial liability and risk adjustment, which means that there is a relationship between the discount rate and the initial CSM. Where the liability has a high sensitivity to the discount rate (annuities, say), the CSM will tend to be lower the lower the illiquidity premium assumed in the discount rate.

This relationship is clearer if we consider how the initial CSM is calculated when business is sold:

$$CSM = Max(0, Premium - BEL - Risk\ Adjustment - Initial\ Expenses)$$

BEL is the best estimate liability

Where a more prudent discount rate is used (say, due to a low illiquidity premium, or increasing the credit risk adjustment for a top-down rate), the BEL will be higher, leading to a lower CSM. This will flow directly into the new business profit margin, giving a lower result.

There is a similar effect from the Risk Adjustment, where, like the discount rate, the standard gives considerable freedom over how its set – a high risk adjustment will lead to a lower CSM and hence lower profit margin.

[1] The IFRS Income Statement and how this is affected by the Discount Rate Methodology

Profit margin

One of the aims of IFRS 17 is to move insurance accounting into line with other industries. The standard does this by aligning the recognition of revenue with costs incurred and profits made during the reporting period.

This should, in theory, give a meaningful profit margin, such as:

$$Profit\ Margin = \frac{Insurance\ Result}{Insurance\ Revenue}$$

In the same way as the new business margin described previously will interact with the discount rate, there is also an effect on the profit margin. However, this relationship is more complex since the CSM released will be dependent on the discount rate when business was originally sold for non-profit business such as annuities. Where historic discount rates have used a low illiquidity assumption (giving a lower CSM), less profit is recognised in the insurance result (since the release from the lower CSMs will be lower), with the difference being recognised in the investment result.

This will make comparison of profit margins complex - where a company has consistently high illiquidity premium assumptions over time (or, if a "top-down" discount rate is being used, low adjustments for credit risk), reported profit margins should be higher, but, where the methodology changes over time this relationship may be less clear.

Company valuation

Insurance company valuations are complex, with different ways of measuring "value". Historically embedded values were used to compare the value of different insurers but have largely fallen away in Europe (albeit still being used in other jurisdictions, such as China), with metrics such as "Solvency II Adjusted Own Funds" becoming more popular.

As IFRS 17 splits out a best estimate liability, it will be possible to construct a different "value" metric but using the IFRS balance sheet. IFRS Equity is readily available for shareholders, and the CSM and Risk Adjustment can be expected to fall into profit, so a potential "value" metric might be:

$$"Value"metric\ =\ IFRS\ Equity\ +\ \alpha\ CSM\ +\ \beta\ Risk\ Adjustment$$

Given the CSM and Risk Adjustment cannot be immediately realised (and will be taxed before they are released into profit), investors might be expected to place a higher value on IFRS equity than the CSM and Risk Adjustment, so α and β are in the formula above to reflect any discount that might be applied.

This measure has several attractive features beyond solvency – IFRS 17 will be used outside Europe and the metrics will be readily extractable from company accounts. Further, IFRS 17 has more detailed profit disclosures than Solvency II, so understanding over time is easier.

Initial publications from the Moody's and Fitch rating agencies suggest that insurer ratings may become dependent on this kind of measure (Fitch's proposals suggest a measurement based on IFRS Equity plus an after-tax CSM, whilst S&P's proposals have specific weightings for the CSM and Risk Adjustment).

However, like all the other metrics discussed above, this metric will be influenced by the level of discount rate – where a low illiquidity premium is used over time, the best estimate liability will be higher and, over time, lower CSMs will be recognised as business is written, so a lower "value" will be shown. Comparisons between different companies will require an understanding of the different discount rate methodologies used to ensure comparisons are meaningful.

This metric can be adapted to calculate leverage ratios, return on equity and so on, and measures may develop over time.

Conclusion

Publication of IFRS 17 results is not required until 2023, and it will take investors and analysts time to understand and use the new disclosures. Over time, new KPIs are likely to develop (and these may be quite different from the ones suggested above). Regardless, it'll be important to understand whether there are any interactions with the discount rate to ensure comparisons between companies (and over time) are valid.

IFoA "IFRS 17: Future of Discount Rates" working party (Jon Neale, November 2021)