Management information

This article is one in a series of articles (which can be found here and here) published on behalf of the IFRS 17 CSM Working Party. Members are Antoon Pelsser, Asim Ghosh, Brendon Thorpe, Carmen Iftode, Clarence Er, James Thorpe, Joanna Stansfield, Kruti Malde, Leong Tan, Natalia Mirin (Deputy Chair), Richard Dyble, Rob Walton, Timothy Berry, Weihe Qin and Wijdan Yousuf (Chair)

1. Introduction

As it currently stands, management information (MI) packs contain a wealth of information used by businesses to assess their financial position and performance. These packs often include: key performance indicators (KPIs); risk opinions as well as details to inform future strategic commercial or capital initiatives. In an earlier section, we looked at possible impacts on KPIs as a result of transitioning to IFRS 17. In this section, we consider how the CSM affects three particular aspects of MI: new business profitability, sensitivity analysis and return on equity.

Note, considerations applicable to the PAA have not been included as there is no CSM calculable.

2. New Business Profitability

Currently in Europe, the Solvency II (SII) value of new business (VNB) often informs management's understanding of new business profitability. However, the specific manner in which new business profitability is reported can vary a great deal between life insurance companies. One common approach is to determine the new business margin (NBM %) by key product lines which is calculated as the SII VNB divided by the present value of premiums.

With the introduction of the CSM, we anticipate a fair amount of change with regards to how new business profitability might be reported in an IFRS 17 world. SII, with its greater degree of prescribed rules, focuses on a prudential view of capital a company ought to hold in respect of the risks it is exposed to whereas IFRS 17, with its greater reliance on entity-judgement, focuses on the amount and timing of profit or loss recognition. Consequently, the majority of life companies may choose to consider a new business metric aligned to IFRS 17 as this may be deemed more reflective of the business they write.

For example, (recognizing that the manner in which life companies choose to report new business profitability for MI may vary widely between companies) one possible approach could be to calculate the NBM % as the CSM divided by the present value of premiums.

Even if a new metric is introduced, there may also be an expectation, for the first few years, from management that a reconciliation be shown between the old metric (using SII VNB) and the new one (using IFRS 17 CSM). The discussion below consequently looks at why the SII VNB and IFRS 17 CSM (at initial recognition) might be different.

Impact of onerous contracts

Onerous contracts are identified separately and recognised straightaway as losses in the P&L under IFRS 17. Under the SII VNB, there is no such distinction: any VNB calculated would also include expected losses on onerous contracts. The CSM for new business would thus only represent the expected profits for groups of profitable contracts.

Impact of contract boundaries

Contract boundaries may be quite different under each metric. For example, under SII, there is a requirement to split contracts into various components, where they may be different contract boundaries for each component (e.g. bundled products). Under IFRS 17, for the same product, contract boundaries can be assessed in its entirety for the single contract. This could mean that we have a longer contract boundary under IFRS 17 for some types of products. Further details on differences in contract boundary definitions between SII and IFRS 17 have been published in an earlier article.

Impact of expenses

The allowance for expenses in future cash flows under new business can have differences under SII and IFRS 17 which may lead to different levels of profitability reported under either metric. For example:

- **Expense allocation**
  IFRS 17 requires entities to identify expenses which are directly attributable towards acquiring and fulfilling/maintaining the new business and those which are not. Directly attributable acquisition expenses, such as underwriting costs and initial commission paid, will no longer be recognised in the P&L when incurred and instead will be spread over the lifetime of the group of contracts. On the other hand, non-directly attributable acquisition expenses, overheads and one-off exceptional expenses will typically be recognised in the profit or loss account immediately when incurred. The proportion of directly attributable and non-attributable costs at inception will change the pattern at which expenses are recognized (including the impact on day 1).

- **Investment management expenses**
  Whilst reporting new business profitability under SII, in general, most companies include the investment management expenses in future cash flows under SII. The allowance for this may differ between SII and IFRS 17; indeed the extent of this is still a topic of discussion due to tentative changes to the Standard agreed in this respect by IASB in February 2020.[1]

3. Sensitivity Analysis

The MI pack could possibly include a number of standalone sensitivities on the CSM and the risk adjustment. These sensitivities could include a standard set of economic and non-economic stresses. Economic stresses would be most relevant for product lines that follow the VFA but may also be of interest for products under the GMM approach (e.g. interest rate stresses may indicate the impact of any asset liability mismatches including the impact on other comprehensive income (OCI)).

The results of these sensitivities would depend on whether we only stress assumptions that relate to the current reporting period or whether we stress assumptions for all future years. The latter would impact the CSM (as it is in respect of future service) whilst the former would go through the P&L immediately but also have an impact on the CSM depending on whether the stress impacts the cash flows in respect of past/current and future service. For example, consider a whole of life protection contract where an upwards stress is applied to mortality rates for the current reporting period only, i.e. we assume we will have a higher claims levels over the current reporting period but that this won’t result in a change to long term mortality assumptions. This stress could result in the following changes to cash flows:

- Increased claims volumes during the stressed period — since incurred claims reflect current service, this variance will go through P&L immediately
- Reduced premiums received in period — if it is determined that, for this product, all premium variances are attributable to future service, this variance will adjust the CSM and not go through the P&L.
- Changes to future cash flows due to fewer policies in force to pay premiums and make claims etc. — these cash flows will be in respect of future service and hence will adjust the CSM.

Sensitivities may also be used to gain insight into the projected value of the CSM released over time. For example, how would a 25% increase in mortality rates (for all future years) for the protection

[1] See February 2020 IASB AP2A “Contractual service margin attributable to investment services”

business affect the amount of CSM released in the next 5 years? Note that such a stress would also affect the coverage units.

In the same vein, each product line will have one or more key risks inherent it. For example, mortality risk would be key for protection products of any life company. Given the CSM is floored to 0 (for direct underlying contracts), various sensitivities would have a maximum stress parameter tolerable before a certain number of groups of contracts became onerous. For example, a rise of 20% in the mortality rate might completely deplete the CSM for the most recent cohorts of protection contracts.

Considerations of these sorts would enable the volatility of the CSM to both economic and operating variances to be understood. When viewed in conjunction with existing risk practices, these would consequently provide valuable inputs into key strategic areas:

- Underwriting, policyholder retention practices, pricing and product development, or even seeking reinsurance cover (e.g. where premium reviews are not possible such as guaranteed premiums for individual protection policies).

- Business planning and capital management. For example, assume for a particular line of business that a sustained greater than expected fall in CSM has been observed over a period of time in addition to a low maximum tolerable stress parameter. Considering this information against other factors, such as the impact of greater digitalisation, data science and artificial intelligence affecting business insights and consequently profit margins for that business, may prompt a company to re-evaluate how this business fits against its strategic objectives.

4. Return on Equity

Return on equity (ROE) is a widely used metric to compare the capital efficiency of different companies by assessing the net profit generated as a percentage of the equity provided. With the adoption of IFRS 17, there is a fair amount of distortion expected for this metric for a number of reasons. We cover a few considerations briefly below:

Onerous business

Contracts that are onerous at initial recognition are identified and recognised straightaway in the P&L. Other things remaining the same, this has the impact of depressing the ROE margin in the year in which that business is written compared to a profitable contract. At subsequent measurement of that onerous business, depending on actual experience emerging as well as possible assumption updates, there is a possibility that the onerous business becomes profitable (or less onerous) and starts contributing to the ROE. Aggregate figures at a company level would consequently require a careful understanding of the sources of increased/decreased ROE between groups of contracts and between different reporting periods. These sorts of complications may necessitate further discussion in the notes accompanying the MI pack.

Treatment of acquisition costs

Under IFRS 4, many insurers recognise an intangible deferred acquisition cost asset which is subsequently amortised in a systematic way to generate an expense in the P&L.

The IFRS 17 approach for insurance contracts measured under the GMM and VFA requires (directly attributable) insurance acquisition cash flows in the CSM thereby decreasing the CSM. In doing this, IFRS 17 implicitly defers the impact of acquisition costs through the CSM (as it reduces the CSM recognised in revenue in future reporting periods as services are rendered).

This fundamental difference in the treatment of acquisition cash flows would cause a difference in the profits considered for ROE calculations under IFRS 17 and IFRS 4.

The calculation of ROE

Both the numerator and denominator of ROE are expected to undergo significant changes with the adoption of IFRS 17. Given this, there may be adjustments required to the ROE ratio to ensure it provides an accurate representation of the performance of the entity. Any aspect that affects the measurement of the CSM would affect the ROE and would have to be considered carefully in comparing the ROEs of two companies with similar profiles.

5. Conclusion

To summarise, the key difference between IFRS 4 and IFRS 17 is the creation of the CSM, which represents all unearned profits and the subsequent recognition of the same in the P&L through the provision of services for insurance contracts.

Given this, all KPIs which have a direct link to profitability would have to be reassessed for relevance and usability. We have looked at possible new measures of profitability using the CSM for in-force and new business. Historically, most KPIs and MI have been discrete metrics which looked to measure performance at a specific point in time (typically the end of the current reporting period). However, consistent with the theme of deferral, the KPIs may need to be reconsidered to fully incorporate the impact of IFRS 17 and this is reflected in the possible angles discussed in the relevant section.

The changes to MI will cover several areas. Insurers could be interested in how the CSM may be affected under a variety of stresses (both economic and non-economic) and this viewed in conjunction with other factors can provide valuable strategic insights for the company. New business reporting is a critical area of MI reporting where we expect a number of changes with current practices followed in the industry (Solvency II VNB). With the adoption of IFRS 17 there may be an expectation that a reconciliation bridge is provided between any new metric adopted and the Solvency II VNB approach.

Some insurance companies also have compensation structures for management which are linked to certain measures of profitability (Solvency II VNB, EEV etc.). ROE, a fundamental measure of any life company is also expected to undergo a fair degree of change once there is added focus on the CSM.

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