IFRS 17: Impact on Key Performance Indicators

[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, Clarence Er, James Thorpe, Joanna Stansfield, Kruti Malde, Natalia Mirin (Deputy Chair), Richard Dyble, Rob Walton, Timothy Berry, Weihe Qin and Wijdan Yousuf (Chair).]

1. Overview

This article considers how insurance companies' key performance indicators (KPIs) may be impacted by the CSM. Insurance companies typically measure their profitability, embedded value and solvency capital to understand how the business is performing and how well it is being managed. As part of this, insurers will closely assess impacts on their business arising from various sources e.g. changes in actuarial assumptions such as mortality, value created by writing new business and the impact from changes in financial market factors such as interest rates, inflation and credit spreads. Other items such as claims ratios and expense ratios are also used as headline KPIs for internal management information.

The introduction of the CSM under IFRS reporting will directly impact some of these existing KPIs and prompt the introduction of new KPIs.

2. Profitability

A key feature of the CSM is that it has the effect of smoothing the profits of long-term insurance business by aligning the release of profit over time with the amount of services provided for the insurance contracts. This deferral of profit recognition is fundamentally different to an approach, which for ease of reference shall be referred to as a market consistent approach here, which capitalises the expected economic profits upfront.

When profitable new business is written, the establishment of the CSM means that the IFRS profit will be set to zero at inception, even though positive economic value has been created for the insurer. The CSM acts as a balancing item, and, for a profitable contract, is set to an amount that is equal and opposite to the present value of the amount of expected fulfilment cash flows at the inception of a contract.

For existing or inforce business, if, for example, the mortality basis of an insurer changes, whilst this may have a substantial impact on embedded value and solvency capital, this will have only a limited impact on the IFRS profit recorded in the reporting period, as the effect of the change will be spread over the remaining duration of the group of contracts through the CSM.

Given these features of the CSM, those who favour a market consistent approach may therefore seek additional KPIs to help further understand the performance of their business. The motivation here is that the IFRS profit recognised in a reporting period on its own does not fully reflect the changes that have happened in that period, because changes that impact future service must be spread over the remaining coverage period. KPIs that can capture this change in the expected future IFRS profits and the change in the CSM should help address such concerns.

For new and existing business, a possible measure of profitability could be a ratio of the present value of expected future IFRS risk adjusted profits (i.e. the present value of releases of the CSM) divided by the capital required to support the new business. An insurer may alternatively prefer to use profits, rather than risk adjusted profits, in the numerator (i.e. by also allowing for the present value of releases of the risk adjustment) to assess its expected profitability without adjustment for risk. For new business, an alternative denominator could be the present value of premiums. When considering the suitability of such ratios it may be advantageous to allow for the economic effect of the profit being released over time and the timing of the related tax cash-flows. The KPIs may be further influenced by how the risk adjustment diversification is allocated amongst the groups of contracts as this impacts the size of the CSM for such groups.

Insurers can also have an expectation of the IFRS profit in the next reporting period based on projections available from the current reporting period, especially relating to the expected release of the CSM and risk adjustment. It may also be of interest to see how the latest expectation of the IFRS profit in the current reporting period compares to what had been expected for this value at the time of the start of the current reporting period however this could be an operationally onerous investigation

The grouping of business under IFRS 17 will allow KPIs at a more granular level, for example by line of business and year of issue. For example, the size of the CSM for each line of business may provide an indication of the relative amount of future profit being retained in each existing line of business. Expressing this amount as a percentage may be challenging, for example a denominator of the present value of future cashflows may be negative and the present value of future premiums may be zero for single premium business. However, the present value of future claims may be considered to be suitable for some lines of business.

Insurers may also wish to understand how IFRS results and the CSM would change under different sensitivities, such as economic and demographic sensitivities, and methodology choices, such as the choice of run-off method.

Insurers may be interested to understand the extent to which loss components exists within the business, for example by amount, duration and line of business. Understanding to what extent the loss components would change under various sensitivities may be of interest especially as favourable changes to assumptions may flow through to profit and loss in the current year.

3. Other measures

Solvency capital measures and embedded value are not expected to be significantly impacted by the introduction of the CSM initially, although there may be changes to future product design that affect capital and embedded value in the future. The CSM may be viewed from this perspective as an artificial liability and does not occur in for example the Solvency II Best Estimate Liabilities or measures of embedded value. There will be an economic impact from changes in the timing of tax cash-flows due to the delayed release of profits.

4. Conclusion

IFRS 17 should allow more consistent and more granular comparisons of profitability across insurers. For those insurers and analysts who like to consider a market consistent approach to assessing value, the inclusion of the CSM may mean that the IFRS profit in the current reporting period may, by itself, be a less informative indicator of the performance of insurers. Those insurers may therefore seek to develop and communicate KPIs which benefit from the improvements brought in by IFRS 17 and which also convey further information relating to the underlying performance of the insurer from a market consistent perspective.

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