

IFRS 17 – impact on UK annuity business

This article from the IFRS 17: Transversal working party introduces some key issues insurers may face when implementing IFRS 17 for annuity business. The working party intends to explore some of these issues more deeply over the coming months and would be happy to receive feedback from members on topics of particular interest.

Requirements of the standard

Annuities provide a good illustration of the aims of IFRS 17. Under the current reporting framework in the UK, any part of the premium not considered necessary to support the fulfilment of the contract is reported as profit at the date of sale. IFRS 17 prohibits this approach, instead requiring the profit to be recognised in line with the service provided under the contract. This profit deferral is achieved by establishing a Contractual Service Margin (“CSM”) for each group of contracts.

There are several technical and operational questions introduced by the standard regarding its application to annuity business. A few of the key issues are discussed in more detail below:

Day 1 profit

The profit to be deferred through the establishment of the CSM is calculated based on best estimate cash flows, discounted based on the nature of the liability cash flows (not necessarily related to the assets held), and an explicit Risk Adjustment. The discount rate methodology chosen will have a significant impact on the CSM and therefore the reported profitability of annuities. As the discounting is, in theory, independent of the assets held, investment expenses are not always included in the assessment of the fulfilment cash flows. This potentially increases the disclosed profitability of new business but with some of the “profit” being required to fund these investment costs as they become due.

The determination of the Risk Adjustment is principles based, and heavily influenced by the level of confidence that the insurance company elects to use. On initial recognition, the size of the Risk Adjustment will affect the size of the CSM, though both components are expected to be released into profit over time. Setting a particularly large Risk Adjustment could result in groups of contracts being reported as onerous, with zero CSM.

Changes in expectations of profit over time

During the term of the contract, changes in expected future profits due to non-economic experience and assumptions require the CSM to be recalculated. This is effectively a restatement of the calculation at inception (excluding coverage already provided), including the use of discount rates applied at the initial measurement. Changes due to changes in economic assumptions and experience do not adjust the CSM and therefore impact profits directly in the current reporting period. This will include changes in future payments due to inflation-linked benefits increasing at a higher or lower rate than expected.

Pattern of service provided

Annuity claims (discounted or undiscounted) have been presented as a possible measure of the coverage provided under an annuity contract. This may not give a sensible pattern of profit release for annuities with guarantee periods and deferred annuities. This is a particular issue for bulk purchase annuity writers, where some approaches would result in very limited revenue recognition in the initial years. The June 2019 IASB Exposure Draft on changes to IFRS 17 includes proposed changes to coverage units which may impact annuities so developments will need to be monitored.

Reinsurance

The liability calculations (which includes the CSM) need to be performed and disclosed gross of reinsurance, with reinsurance contracts being measured separately. This separation leads to the possibility of mismatches due to different discount rates and different granularity in the calculations.

Transition

A CSM needs to be set up for existing business on transition to IFRS 17 in 2022, effectively establishing a liability for profits that have already been reported and possibly distributed under IFRS 4. If deemed practical, the business must be valued at the date of transition assuming that IFRS17 has applied throughout the lifetime of that business. Otherwise, a fair value measure may be taken at the point of transition, or certain modifications may be applied to the retrospective calculation. This requirement could significantly alter the profit emerging from the back book when compared to IFRS4 and is likely to lead to a strain on shareholder equity for annuity companies at transition, offset by higher reported profits in future years.

Operational complexities

There are many additional requirements from compliance with IFRS 17 that cause operational complexities for an insurer across all products, such as:

- the granularity of the analysis is more detailed,
- the disclosures required are far more comprehensive, and
- there are new components such as the CSM and RA that need to be valued.

These complexities will have impacts on the systems and processes that companies use, as well as an impact on the people who produce the required disclosures.

Summary

In summary, UK insurers with annuity business will have complex decisions to make (including discount rate methodology and transition approach) and implementation issues to resolve as part of their transition to IFRS 17. The IFRS profit profile for annuity business will change drastically and disclosures are increased. It is also noted that as Solvency II Technical Provisions do not include a CSM, IFRS 17 profits are expected to emerge more slowly than the emergence of surplus under Solvency II. Investor education will be important to ensure the impact on annuity business from the change in accounting standards is well understood.

Further articles from the IFRS 17 Transversal Working Party will discuss these and other annuity issues further. See <https://www.actuaries.org.uk/practice-areas/life/research-working-parties/ifrs-17-transversal> for details.