The IFRS 17 Income Statement and how this is affected by the Discount Rate Methodology

For IFRS 17 reporting, there is a completely new income statement which splits profits between "insurance profits" and "investment profits". This is different to the current IFRS 4 income statement, where there is no such split.

For insurance business that is sensitive to the discount rate, such as annuities, the choice of discount rate methodology will change the way the profits are reported, in particular whether profits are recognised as "insurance profits" or "investment profits". The IFRS 17 income statement is complicated, so a short explanation is shown below of the new items:

	£m	What is this?
Insurance Revenue		Under IFRS 17 premium income is spread over time. The revenue recognised during the period is the sum of: • Cash flows released from the best estimate liabilities ("Present Value of Future Cash Flows" in the standard). This is net of any investment components or refund of premium • Reduction in risk adjustment[1] The cash flows released from the best estimate liability and the release of risk adjustment are adjusted for any historic losses recognised on business which has become loss-making ("loss components" in the standard). • **Release of Contractual Service Margin** • Amortisation of acquisition expenses (this is offset within Insurance service expense below)
Insurance service expense		The Insurance service expense is the sum of: • Benefit and expenses paid that are attributable to insurance business (net of investment components and refunds of premium) • Amortisation of acquisition expenses • Any losses recognised at inception for new business, or changes in losses previously recognised (the other side of "loss components" adjusted in insurance revenue)
Reinsurance result		These are the same elements recognised in insurance revenue and expenses, but for reinsurance ceded
Insurance Result		This is the sum of the items above
Net investment income		This is the change in value of any assets held and any investment income. There is an option under IFRS 9 to split the return on investments between P&L and OCI ("Other Comprehensive Income").
Insurance Finance Income / Expense		**Any changes in insurance liabilities due to changes in financial assumptions (including any interest accretion**) must be shown within the insurance finance income/expense item. There is an option under IFRS 17 to split this item between P&L and OCI. Where an assumption change for non-financial assumptions is made, there will normally be a difference between the impact on the Best Estimate Liability and the Contractual Service Margin since they use different discount rates. This difference is allocated to this line.
Other		Any item which does not fit into either the insurance result or the investment result will be shown in this section. This will include, for example, expenses that are outside the contract boundary, debt interest and any non-insurance profits (such as profits from asset managers).
Profit before tax		This sums the insurance result, the individual investment result, and "other" results

*Items shown in **bold** are affected by the discount rate methodology, discussed overleaf. The release of CSM will be higher if CSM recognised when contracts are sold is higher. This is affected by discount rate methodology.*

[1] IFRS 17 allows either the entire change in the risk adjustment to be recognised through insurance revenue, or for the result to be disaggregated between insurance revenue and insurance finance expense.

The IFRS 17 discount rate can be set using a "top down" or "bottom up" approach.

For a "top down" approach is used, the yield on a reference portfolio of assets is adjusted to remove the impact of credit risk (or "default adjustment"). A high default adjustment will reduce the discount rate, whilst a low default adjustment will increase the discount rate.

The "bottom up" approach uses a risk-free asset and an illiquidity premium. A low illiquidity premium will lead to a low discount rate and has the same effect a high default adjustment for a "top down" approach.

Contractual Service Margin (CSM)

The initial CSM is the amount required to ensure no profit is made at point of sale. For single premium contracts that are not loss-making (or "onerous"), this means the initial liability is set equal to the premium received[2], or:

$$Initial\ CSM = Premium - BEL - Risk\ Adjustment - Acquisition\ Expenses$$

BEL is the Best Estimate Liability (or "Present Value of Future Cash Flows" in the standard)

For single premium contracts such as annuities, the BEL is heavily dependent on the discount rate. A high default adjustment, and a low discount rate, will normally lead to a higher BEL and a lower CSM, but this may not be the case for other lines of business. For example, for term assurances with a negative BEL, a higher default adjustment would lead to a more negative BEL, and where business with stochastically modelled options and guarantees, default allowances may behave differently.

Once the contract has been sold, the CSM will then be released into Insurance Revenue over future accounting periods. If the starting CSM is low due to a high default adjustment, then this will lead to lower Insurance Revenue, and a lower Insurance Result.

Insurance Finance Income/Expense

The BEL will increase over time due to the initial discount rate unwinding. For contracts with a positive BEL (such as annuities), this is will be a cost, and is recognised in Insurance Finance Expense.

A higher default assumption will lead to a lower discount rate and a lower cost recognised in Insurance Finance Expense.

Net Impact

The choice of default adjustment (or lower illiquidity premiums for a bottom up discount rate) broadly means:

	Insurance Result	Investment Result
Low default allowance *Higher discount rate* *Lower BEL / Higher CSM*	⇧	⇩
High default allowance *Lower discount rate* *Higher BEL / Lower CSM*	⇩	⇧

[2] Net assets will increase by the premium received, but will reduce by the increase in BEL, Risk Adjustment and Acquisition costs incurred. Setting up a Contractual Service Margin equal to the balance between these items results in no profit when an annuity is sold.

While these relationships will hold over time, any default adjustment might not be released into profit at the same rate as the CSM, meaning there is also an impact on the timing of profit from year to year (over many years the total profit will still be the same however).

This relationship could break down where default allowances (or illiquidity premiums) are changed due to changes in the assessment of liquidity. Where such a change is made, it will be recognised immediately through the investment return line, rather than over time.

Further, the first balance sheet set under IFRS 17 will be complex. IFRS 17 requires the first balance sheet to be set, as far as possible, on the basis that IFRS 17 had always been used for reporting. The decisions made for illiquidity premiums and default allowances will impact the opening equity and level of CSM recognised at outset.

The choice of discount rate methodology may have implications for the way external analysts view an insurer's results. It'll only become clear how much value external analysts place on the different components of IFRS 17 profits once results start to be published, but actuaries setting default assumptions may want to consider how analysts will view the different parts of the income statement:

- A high default adjustment will generally lead to a higher BEL and a lower CSM. The CSM might be viewed as deferred profit, and external analysts may place a value on this. Whilst they might also place a value on any allowance for the future release of default adjustment, this will not be an obvious part of the profit emerging on the income statement.
- As well as the impact on the balance sheet, the amount of CSM being released into profit may be more stable than the investment result. Its possible external analysts put a higher value on the "insurance profit" as it may be seen as a "normal" level of profit that will be repeatable in future years.

When advising Boards and Audit Committees, actuaries may wish to consider the impact on the behaviour of the income statement, and advise stakeholders, when setting default assumptions, as well as the impact on the level of the Best Estimate Liability (BEL).