IFRS 17 Highlights How Low Interest Rates Hurt Insurers

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Key Takeaways

- We welcome the latest amendments to International Financial Reporting Standards (IFRS) 17, which we consider is more realistic and consistent than IFRS 4.
- The new standard will give a more realistic, economic view of the balance sheet and more clearly represent the economics underlying the insurance industry.
- However, comparability between insurers reporting under IFRS 17 and those reporting under local or U.S. generally accepted accounting principles could diminish.
- The proposed changes to the balance sheet could also reduce transparency by removing information on credit risk.

On June 26, 2019, the International Accounting Standards Board (IASB) published its exposure draft amendments to IFRS 17. These are the latest in a series of amendments published to address concerns raised by the insurance industry and stakeholders since IFRS 17 was first published in 2017.

The most-recent amendments addressed some issues raised by primary insurers in regard to their purchase of reinsurance. For example, the mismatches in recognition of claims and gains from reinsurance have been removed. S&P Global Ratings views the amended draft as more realistic and consistent than IFRS 4, and considers that the IASB is safeguarding the representation of the economics that underpin insurance markets.

When it comes into effect in 2022, IFRS 17 will remove some of the material weaknesses of the current standard, IFRS 4 (see "Credit FAQ: How Will IFRS 17 Affect The Credit Quality Of Insurers?", published on June 5, 2018). However, we are concerned that the new information that is being added could crowd out information relevant to assessing credit risk.

Clarity At A Cost

For some life insurers in particular, the more realistic, economic view of the balance sheet under IFRS 17 will mean a dip in reported shareholders' equity. In our view, this is a faithful representation of the challenge life insurers face when yields are low. We expect it to encourage a move toward short-term products, and policies that carry lower or no guarantees.

External stakeholders may appreciate details such as profitability by year of contracts written (known as annual cohorts). However, while these details will enhance insurers' annual reports under IFRS 17, we could lose other information currently included in the balance sheet, unless insurers choose to display it in the appendix. Reliance on issuer-specific discount assumptions will also make it more difficult to compare insurers.

It is also likely to be harder to compare insurers that report under IFRS 17 and those that report under local or U.S. generally accepted accounting principles (GAAP). Insurers will need to ensure that their external communications to investors and other stakeholders clarify under what basis they are reporting.

Life Insurers Forced To Face Reality

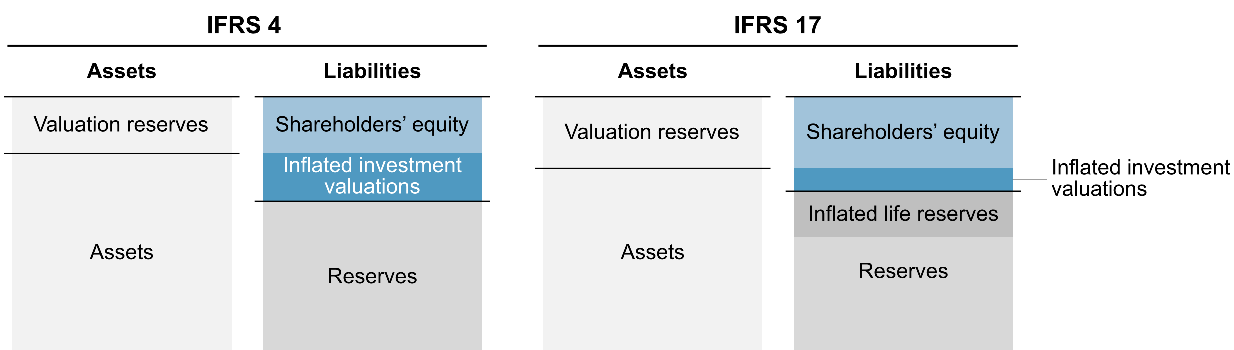
In our opinion, life insurers suffer more than non-life insurers when interest rates are low. Although we capture how persistently low interest rates affect balance sheets in our ratings, under IFRS 4, we found the issue was not as clearly displayed on the actual balance sheet as it is under IFRS 17 (see "Credit FAQ: How Interest Rate Risk Is Captured In Our Insurance Ratings, published on Feb. 25, 2016).

IFRS 4 Phase I included an accounting basis mismatch between market value assets and book value liabilities; IFRS 17 removes this. The effect of the mismatch, in many cases, was to overstate shareholders' equity by matching valuation reserves to bond investments, a problem exacerbated by persistently low interest rates in many regions around the globe (see chart 1).

IFRS 17 will make it easier to see how low yields put life insurers under pressure.

Chart 1

IFRS 17 Removes Low Interest Rate Distortion



Source: S&P Global Ratings.

At the same time, IFRS 4 does not include elements of life embedded value. Therefore, the current shareholder value of life contracts in an insurer's book of business is not earned before those contracts expire. We anticipate that, in response, life insurers may focus on short-term contracts, or stop offering long-term guarantees. That said, this might be a crucial step in managing low interest rates.

A New Viewpoint Could Help

IFRS 17 will provide an economic view of insurers' balance sheets. This could help insurers flag the economic risks associated with low interest rates, and to manage and counteract them. That said, until users have experience of reading annual reports under IFRS 17, it is difficult to see how insurance reporting might develop. One area that could need explaining is prospective shareholders' equity--specifically, how the insurer incorporates the unearned profits from contracts and whether it include the contractual service margin (CSM).

We see a risk that if the underlying assumptions on which insurers base their valuation of liabilities become inconsistent, it could be difficult to compare insurance companies. For example, IFRS 17 makes the choice of interest rate curves fully flexible. By contrast, in regulatory regimes such as Solvency II, regulators indicate which curve to use for each region.

IFRS 17 also assumes that insurers may take one of two different approaches to determining the discount rate: the top-down approach and the bottom-up approach. In theory, these approaches could lead to in the same discount rate, but in our experience they generally give different results. Actuarial assumptions may also vary by region--an issue that already affects reporting under IFRS 4. Given how all these issuer-specific assumptions will combine, we expect stakeholders to find it harder to compare insurance companies.

Swings And Roundabouts On Transparency

Although underwriting transparency will increase under IFRS 17, we are concerned about the loss of clarity regarding gross receivables and payables. The introduction of annual cohorts--a major change being introduced in the new standard--will enable external stakeholders to analyze the performance of each underwriting year. The change will make it easier to manage life insurance product lines and to analyze life insurers' back-books, side by side. However, questions regarding the attractiveness of some multiple-year contracts might arise.

Annual cohorts are being introduced to enable external stakeholders to analyze insurers' underwriting performance from year to year.

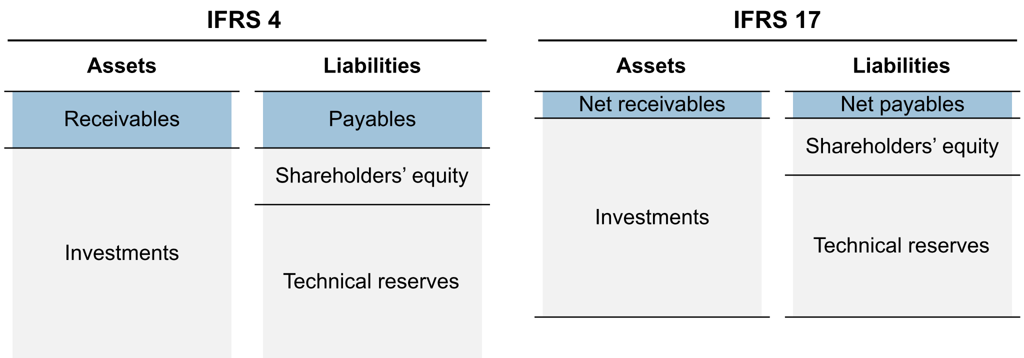
Although we welcome the greater granularity of information offered by the disclosure of annual cohort results, we also consider that it may not reflect the underlying nature of insurance businesses, which are based on the mutualization and diversification of risk. Insurance depends on large numbers and a diversified portfolio of risks spread over time. The accounting view implied by the annual approach could also deviate from the economic view that insurers use to managing insurance risk.

Life insurers expect that producing this data will cause them to incur material IT implementation costs. In our view, it may be expensive to produce the additional data, but it won't cost enough to influence our ratings (see "Credit FAQ: How Will IFRS 17 Affect The Credit Quality Of Insurers?", published on June 5, 2018).

IFRS also shortens the balance sheet by allowing insurers to stop disclosing gross positions for payables and receivables in the statement of financial position. The proposal will effectively shorten the balance sheet by reducing the number of line items. Information on credit risk on those "netted" balance sheet positions will be lost, unless it is fully reflected in the appendix (see chart 2).

The shortening of the balance sheet under IFRS 17 could lead to a loss of relevant information.

IFRS 17 Balance Sheet Drops Information On Receivables



Source: S&P Global Ratings.

We consider that despite the short-term nature of the cash flows affected, the change could mean a loss of potentially relevant information and could reduce transparency. Ideally, we would prefer to see it made a mandatory part of the appendix, so that this relevant information is still available to insurers and external stakeholders.

The IASB Has Moved To Reduce Mismatches

IASB has addressed many, but not all, of the insurance industry's concerns, which were raised through organizations such as the European Financial Reporting Advisory Group and the European Insurance CFO Forum. In particular, it moved to reduce the potential unintended effects of the previous draft on insurers that use reinsurance. It now permits a risk mitigation option and the mitigation of financial risks by using either derivatives or reinsurance. This limits accounting mismatches in the earnings statements of insurers that use reinsurance to cover financial risks. For example, some insurers use reinsurance to offset the risks stemming from contracts that have direct participation features.

One of its amendments addresses another mismatch--gains on proportionate reinsurance contracts now can be recognized at the same time as claims from the underlying insurance contract have to be reported. In effect, this means that insurance acquisition costs will be included as cash flows in the policy reserve. That said, we consider the focus on "proportionate" reinsurance, rather than the much wider range of "proportional" reinsurance, might lead to a loss of relevance. However, in cases where insurance contracts are renewed annually and categorized as onerous contracts, insurance acquisition costs might be deferred and booked as assets on the balance sheet. This is an important feature for multiple-year contracts. Under IFRS 4, they were displayed as having deferred acquisition costs (DAC) that amortized over the life span of the contract.

The latest amendments support a more economic view of reinsurance use and no longer discourage the purchase of reinsurance.

We consider that the amendments allow for a more economic view of mitigating risk by buying reinsurance (and the effects on costs of that choice) than the previous IFRS 17 standard. Insurers may only be allowed to apply this retrospectively in certain circumstances. However, the IASB's amendments have removed the potential caveats to buying reinsurance under IFRS 17.

IFRS And GAAP Will No Longer Be Roughly Comparable

IFRS 17 has made a radical shift to a new set of metrics. This will diminish comparability between IFRS and other GAAPs. Almost all insurance reporting globally has, up until now, included metrics such as gross premium, net premium, technical expenses, and claims expenses. Although these differ in detail between the different accounting regimes--IFRS 4, U.S. GAAP and local GAAP--it was possible to make a rough comparison, especially on common industry metrics like premiums or the net profit number. For non-life insurers, there has been sufficient information on claims and expenses to calculate a combined ratio.

IFRS 17 will bring in new metrics like the contractual service margin, which will allow the development of completely new key performance indicators (KPIs). U.S. GAAP is also due to see some changes in accounting for long-duration contracts.

The challenge for stakeholders like S&P Global Ratings is that the two standards no longer aim to converge. Most of the traditional earnings statement and balance sheet metrics are likely to vanish with IFRS 17. This will make it difficult to compare historical earnings and balance sheet data of the insurers reporting under IFRS, and so complicate the analysis of insurers for investment or ratings purposes.

Stakeholders will lose the ability to compare insurers reporting under IFRS and GAAP.

Communication Is Key

In addition to IASB's efforts to strengthen and widen the market's understanding of the upcoming IFRS 17 standard, we consider it vital that insurers that report under IFRS communicate with their internal and external stakeholders early. The process should begin well before 2022 and statements should be very transparent, to lessen the risk of misunderstanding. A lack of transparency could lead to a higher cost of capital.

As IFRS is principles-based, we expect to see a range of application approaches, some prudent, some realistic, and some less prudent. To allow external stakeholders to judge the approach, IFRS foresees that underlying assumptions will be disclosed. For example, insurers should publish the yield curves used for discounting.

Users of financial reporting would likely also appreciate an industrywide agreed set of legacy accounting metrics to support the transition. Given the widespread use of issuer-specific assumptions--for example, around discounting--will make it harder for market participants to compare and contrast insurers' balance sheets and earnings statements. A potential unintended consequence is that market participants will need to invest more capacity in analysis to make good comparisons.

In rating terms, the loss of the historical track record will prove challenging.

Impact On Ratings Is Likely To Be Indirect

Simply introducing IFRS 17 is unlikely to directly affect our ratings. However, the change is likely to be accompanied by the use of new KPIs, and we expect economic balance sheets to be more transparent. This could mean insurers' management teams make changes which we would consider either positive or negative to the ratings. This could, in turn, lead to rating actions.

In our analysis of insurance companies, we work hard to ensure consistency across regions and accounting regimes. For example, we use a global, risk-based capital model. Generally, our rating analysis is intended to be accounting neutral. As a result, where insurers move to IFRS 17 from IFRS 4 and their reported shareholders' equity changes as a result, we do not expect the change to have a meaningful impact on our leverage and coverage calculations, and thus to affect ratings.

In South Korea, insurers are already preparing for adoption of IFRS 17. This demonstrates that hybrid debt issues by life insurers can bolster their capital position. We can also imagine situations in which IFRS 17 gives more or less leeway for dividend payments and a change in dividend payout policy. This would alter our analysis of prospective capital adequacy.

As explained above, low interest rates have always been testing for life insurers. The move to IFRS 17 does not create the issue. On the contrary, it provides a more realistic view of the underlying economics. In our view, this will help insurers to manage their companies in the low interest rate environment.

Some smaller insurers may struggle to adopt and the accounting change might encourage consolidation among smaller insurers.

Some of the insurers we rate are already far more prepared than others, and are likely to remain more forward in their planning. Some of the early adopters are therefore well prepared for the 2022 deadline. By contrast, we expect some small insurers could struggle with it (see "IFRS 17 Proposed Delay Will Allow Insurers More Time To Prepare", published Nov. 9, 2018). If an insurer is not prepared to fully comply with IFRS 17 by Jan. 1 2022, it could suggest that its governance is less strong. That said, some smaller insurers may combine forces to overcome this challenge.

Related Research

- Credit FAQ: How Will IFRS 17 Affect The Credit Quality Of Insurers?, June 5, 2018
- IFRS 17 Proposed Delay Will Allow Insurers More Time To Prepare, Nov. 19, 2018
- Credit FAQ: How Interest Rate Risk Is Captured In Our Insurance Ratings, Feb. 25, 2016

This report does not constitute a rating action.

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