The Impact of IFRS 17 on Key Performance Indicators

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Foreword

IFRS 17 is bringing a fundamental change in the accounting of re/insurance contracts for over 1,000 insurance entities around the world. As a result, insurance companies have been facing significant operational and technical challenges, with implementation costs for IFRS 17 anticipated to largely exceed those experienced for the Solvency II directive when it was applied across Europe in 2016.

Despite an air of uncertainty around the date that IFRS 17 will become effective and pending final guidance from the International Accounting Standards Board (IASB), insurance companies around the world are progressing with implementation activities. This includes monitoring developments in the standard, reviewing reinsurance treaties and optimising transition balance sheets with risk management solutions involving financial hedges and reinsurance covers.

With challenges relating to reinsurance accounting now somewhat resolved following amendments by the IASB, the attention of insurance company Chief Financial Officers (CFOs) has turned to finalising their preliminary views of their financial position and financial performance upon transition to IFRS 17.

Ultimately, insurance companies will now focus their efforts on producing key performance indicators (KPIs) that will be meaningful in IFRS 17 annual financial reports. Having solved the fundamental questions pertaining to methodology, and continuing with investments in data and systems, insurance companies will question which existing KPIs will remain to be meaningful after IFRS 17 implementation, and which new KPIs will emerge as a result.

While analysts await the first set of IFRS 17 annual reports to properly assess the impact of the accounting changes, CFOs are looking to analysts for their perspective on what kind of data sets can be discarded and what new metrics they would like to see produced. Some CFOs are concerned that they will hear inconsistent messages from analysts depending on differing perspectives on the importance of certain reporting categories, such as solvency versus performance.

This report focuses on the KPIs that readers of financial statements use to assess the present and future performance of companies. Some of the most common KPIs used in the insurance industry are:

- **Gross Premiums Written**
- **Return on Equity**
- **Operating Profit**
- **Combined Ratio, together with Loss Ratio and Expense Ratio**
- **New Business Value or Value of Business Acquired**
- **Annual Premium Equivalent**
- **Return on Assets**

Leadership Round Table to Assess the Future of KPIs in IFRS 17 Financial Reports

Having identified an impasse in discussions over the last several months, Aon hosted a round table meeting on 29 January 2020 with participants from rating agencies, investment banks and audit firms. The objective of the round table was to achieve high-level consensus on the shape of future KPIs within an insurance company’s financial statements. The findings of this report are drawn from discussions at this round table and are intended to help insurance companies to plan their implementation work. Aon is grateful to the rating agency, investment bank and accounting firm analysts who participated in the round table, and whose perspectives are cited throughout this report.

The various opinions expressed in this publication summarise the respective views of the individuals participating in the round table. However, they do not purport to reflect the opinions or views of the institutions to which the participants are professionally associated. Participants of the round table are listed within the appendix to this report.
The current KPIs used within financial statements will be affected by the measurement and presentation requirements of IFRS 17. Questions about the impact of IFRS 17 on insurance KPIs, and addressed within this report include:

1. What should users of insurance company financial statements learn about the upcoming changes to KPIs to properly assess creditworthiness and performance of re/insurance companies?
2. What should the re/insurance industry know about changed or new KPIs to understand an insurance companies’ performance today and future earnings potential?
3. Will the impact of IFRS 17 on KPIs result in better transparency and accountability regardless of whether they are subject to audit or not?

When seeking to answer these questions, the round table participants found that IFRS 17 is an ideal opportunity for insurance companies to improve the presentation of their data within financial reports. This regulatory change can also address existing challenges that analysts encounter when appraising financial metrics today, for example, market-consistent embedded value and new business value.

Participants noted that certain information not available in today’s financial reports may be produced as a result of IFRS 17. For example, disclosures of movements in the contractual service margins of groups of contracts (but excluding back-book business) will improve transparency and understandability of insurance financial statements. Furthermore, volume-based metrics, such as gross premiums written, even if not audited, will be valuable to analysts.

Given the magnitude of the change, it was noted that parallel reporting will be almost impossible to avoid during the first few years after adopting IFRS 17.

Returns on equity will likely be distorted because of the impact of the transition on equity balances. During this time, disclosures on regulatory capital will be valuable to analysts. In Europe, this is placing even greater importance on the impacts of Solvency II review.

Rating agency analysts agreed that it is unlikely that IFRS 17 will have an immediate impact on the methodologies used by rating agencies to determine insurance ratings criteria.

After financial impact assessments, and once the two bases of numbers are configured, it is important to calculate the KPIs under both regimes and understand the impacts on specific KPIs at different levels of aggregation. This exercise has to be done to equal extent for internal management information reporting and external reporting to investors and regulators. The IFRS 17 impact on KPIs should not be underestimated, nor its analysis left until the last minute.
The Impact of IFRS 17 on Key Performance Indicators

For now, analysts at the rating agencies do not see IFRS 17 as having an immediate impact on the criteria methodology used for insurance ratings. Although the analysts indicated that numbers, ratios and thresholds might change, and guidelines for certain KPIs (e.g. Return on Equity) may need further consideration, an analysts’ approach to ratings will not change in the short-term because of IFRS 17. However, certain second-order implications cannot be excluded in the long-term. Some analysts at the rating agencies indicated that they expect that the move to IFRS 17 may impact the metrics they use in their scorecards. This will depend on the materiality of business lines expected to be most affected (e.g. Life business). Although the standard introduces costs and complexity, analysts at the rating agencies agreed that it is an improvement from current insurance accounting.

From the perspective of equity analysts, deficiencies in current reporting were also emphasised but IFRS 17 was noted as having the potential to bring comparable and useful measures of shareholder value and sensitivity to market risks, particularly in the context of M&A and hedging. This will increase the complexity of financial statements but is likely to provide a better economic view of the insurance company.

Insurance companies are likely to run parallel reporting during transition years. With the potential for several years of accounting volatility arising from the run-off of the back book under the new regime, it will be important for analysts to see an analysis of what the numbers would have looked like under the previous accounting standards for two to three years. This will depend on the magnitude of the differences.

In conclusion, although the requirements are complex, analysts consider IFRS 17 a major improvement to financial reporting in the insurance industry. Given the magnitude of the change, parallel reporting is unavoidable in the first years after adoption. Nonetheless, rating agencies anticipate that transition to IFRS 17 will have no immediate impact on ratings of insurance companies.

Gross Premiums Written

With the arrival of IFRS 17, Gross Premiums Written (GPW) will no longer be presented in financial statements. Instead, Insurance Contracts Revenue will be the new top line item in an income statement. This revenue figure will be comparable to GPW for short-duration contracts but not for long-duration contracts. Preparers can choose to continue producing those numbers as a volume metric for internal reporting and management information. They also have an option, but not a requirement, to disclose GPW in the notes to financial statements under the Alternative Performance Indicators sections. Those sections can be subject to audit, but at the preparer’s discretion. If not audited, GPW data will still be of value to analysts, similarly to regulatory numbers that were not subject to audit or subject to ‘lighter’ audit as is the case for Solvency II reports in some European Union member states.

The analysts agree that under IFRS 17 volume information is still needed. IFRS 4 Life premiums have long been viewed as problematic in this respect and, in Life insurance, Annual Premium Equivalent (APE), or other conceptually similar measures, will likely remain the most meaningful volume-metric for new business that will help inform market share. Looking outside of business measured using Premium Allocation Approach (PAA) and the Life segment, non-Life reinsurance looks to have the strongest incentive to report new supplementary volume data.

With information on onerous contracts on day one becoming easily available, it will be important to assess the weight of those groups in the volume of total business written that year. Analysts will want to use it to formulate a view on whether the company is overstretching its operations or understand its market share positions. The ability of analysts to do this would depend heavily on the depth and richness of an insurance companies’ disclosures.

In conclusion, even if not audited, the volume-based metrics about new business written will be still valuable for analysts and should be reported.
Return on Equity
Both numerator (NIAT) and denominator (Equity) will change substantially upon IFRS 17 implementation. Many insurance companies are concerned that the accounting change will suppress equity figures, and, at least in principle and in exceptional circumstances, possibly to negative values. For some companies, particularly in the Life segment, Return on Equity (RoE) indicators may be viewed as distorted if the Contractual Service Margin (CSM) is wholly excluded from the denominator. In Europe, a potential solution is to have more and better disclosures of Solvency II capital to prove solvency.

Changes to RoE will have a knock-on effect on measuring executive performance and thus on executive compensation. The analysts will continue to perform peer group and sensitivity analyses. The analysis of net capital generation and how it links to IFRS 17 should be viewed as a basis to the assessment of executive compensation programmes.

Rating agencies are not concerned with executive compensation schemes unless they have behavioural effects on the company’s operating performance. They factor in insurance companies’ “seasonal” behaviour. To understand volatility in return on equity and return on assets, rating agencies would most likely prefer to see explanations of the volatility and alternative measures rather than adjustments in the actual ratios. Some analysts noted that within the Life segment, RoEs reported under IFRS 4 have not been particularly meaningful.

To obtain a useful RoE, it may make sense to increase the denominator by the CSM (and use a consistent numerator), particularly in the Life segment. Analysis of changes in the CSM would also be a useful indicator of the strength of underwriting, risk appetite of the insurer and of performance of claims and expenses.

In conclusion, during the transition to IFRS 17, when RoEs will be distorted, some analysts may increasingly look at disclosures on regulatory capital along perhaps with RoEs adjusted for the CSM.

Return on Assets
Return on Assets will experience similar impacts as Return on Equity, to the extent that its numerator is also NIAT. These two fundamental KPIs will change and analysts will need to understand the drivers behind the change and whether it is a result of an accounting mismatch (whether under IFRS 4 and/or IFRS 17), which might be from the mechanics of the CSM, or an economic mismatch, or a mix of both. In some instances these ratios may however move in different directions. In cases where the values of insurance liabilities increase because of the CSM, equity might be depressed and the RoE correspondingly inflated.

The difference between the yield on investment assets and the discount rate applied to the insurance liabilities may become an important performance metric. The new IFRS 17 income statement may more transparently tell if the investment function is adding real value as it will compare investment income with the amount required to meet the unwind of the discount rate on insurance liabilities. This metric has not previously been available.

In conclusion, the difference between investment income and the unwinding of the liability discount rate should provide new and valuable insights into the quality of the investment function.

Financial Leverage
Some analysts expect that material equity hits as a result of IFRS 17 transition may have an immediate and significant impact on the financial leverage of insurance companies. Financial leverage metrics could be distorted when reported equity becomes negative and equally significant changes to financial leverage ratios can follow for many years after implementation because insurance companies will be looking to optimise their reported equity balances. As a result, analysts expect to see the industry
looking also at other KPIs, such leverage on a Solvency II capital basis (in Europe). Analysts see a potential solution in factoring the CSM balance into the equity figure in the denominator.

**In conclusion, financial leverage indicators are anticipated to be impacted by IFRS 17 and analysts are likely to place greater importance on alternative metrics.**

**Operating Result**

The IASB is currently working on clarifying disclosure requirements for composition of profit or loss statements across all sectors. As a result, the overall meaning of an insurance company’s operating result should become clearer in future IFRS 17 annual statements.

The key information from the insurance operating result (the sum of insurance service result and insurance investment result) is the indication of the extent to which it is driven by recurring business, new business and run-off business. Although this is not a disclosure requirement, it would be of great value to analysts because it gives a clear picture of where the business is headed.

**In conclusion, it would be useful for disclosures to include tables showing how much operating profit is generated by recurring business, new business and run-off business.**

**General Insurance: Loss Ratio**

Today, a loss ratio is calculated as the claims incurred divided by net premiums earned. It may not always be easily translated to new IFRS 17 line items such as insurance service expense divided by insurance service revenue. This is because new IFRS 17 line items are derived by various adjustments, for example, for variance in cash flows or for time value of money.

Losses incurred will stay the same regardless of accounting. Complexity will be driven by the new IFRS 17 requirement to discount those losses and the insurance contract revenue (from inception), thus sensitivity to discount rates, as well as by coverage unit methodology.

Net loss ratios for short-duration contracts measured under PAA may deviate if those contracts are covered by multi-year reinsurance treaties and valued under the general measurement model (GMM). Stability of loss ratios is a base for sliding scale commissions in reinsurance contracts. Risk adjustment may not absorb all the volatility from the contracts and little practical guidance exists on the risk adjustment more generally. As a result, much is left to the discretion of the management of the insurance company.

Analysts expect that over time combined ratio and loss ratio will evolve to be composed of purely IFRS 17 line items. Until the “new combined ratio” emerges, parallel reporting will be necessary.

During the years after first adopting IFRS 17, analysts would find waterfall charts with reconciliations between IFRS 17 equity and Solvency II capital helpful because capital remains the most relevant measure. Participants noted that IFRS 17 may result in loss ratios becoming more meaningful as discounting will make general insurance liabilities of different duration more comparable.

**In conclusion, discounting is one of the drivers of volatility in loss ratios at transition to IFRS 17. Analysts will be interested in disclosures of interest rate sensitivities and explanation of calculations of loss ratios.**

**General Insurance: Expense Ratio**

Underlying expense ratios are unlikely to be significantly impacted by IFRS 17, even with the recent IASB changes in requirements for deferred acquisition costs (DAC). However, the recent changes to guidance on DAC agreed at the
December 2019 IASB meeting will inflate equity data compared to current reporting and it is yet to be decided how financial statement readers will treat disclosed IFRS 17 DAC.

In conclusion, regardless of recent amendments to accounting for acquisition costs, the analysts expect the impact on expense ratio to be smaller than on loss ratio.

**Reinsurance**

IFRS 17 requires separate measurement of reinsurance covers. As such, analysts agree that reinsurance KPIs will become increasingly important. However, as of today there is little clarity of what those KPIs might be. Today’s attempts at measuring ceded RoE and gross or net loss ratios encounter significant limitations and data challenges. Insurance companies often produce internal reports from the actuarial function about the effectiveness of reinsurance, but they have no equivalents reported externally. It has emerged that analysts would welcome such information as they believe that disclosures about loss recovery components could be an interesting KPI to consider.

In conclusion, the analysts do not have a clear view on which IFRS 17 KPIs would best indicate the effectiveness of reinsurance programmes.

**Life Insurance: Market Consistent Embedded Value**

Analysts recognised that only a few insurance companies still externally disclose market consistent embedded value (MCEV). The majority in the industry has limited its reporting to internal purposes or stopped producing the embedded value (EV) data altogether. EV is not always a completely audited number and IFRS 17 is likely, at least to some degree, to supersede remaining EV disclosure, thus further reducing separate EV reporting.

In conclusion, MCEV is likely to become even less important as a result of IFRS 17.

**Life Insurance: Value of New Business**

Some analysts acknowledge that the CSM and New Business Value (NBV) are conceptually similar yet the CSM is a more comparable measure than NBV moving forward. Other analysts took the view that there could still be significant differences in methodologies relating to discount rates, grouping of contracts, expenses and risk adjustment that suggested comparability may not increase by as much as initially thought.

The analysts agree that at first look of financial statements some portfolios of Life business (e.g. UK bulk annuities) may appear less attractive because of significant delay in profit recognition, but the profit still exists. The delay in recognition may have a positive impact on management behaviour and approach to executive compensation because it would enforce long-term view on performance assessments.

Some analysts were of the view that an NBV-like metric would be useful for non-insurance contracts but there was lack of clarity on how comparability could be ensured. Some suggested looking for inspiration from the investment management industry.

Today, users of financial statements mostly interpret NBV as only an estimate of expected profits at issue because it doesn’t provide insight as to whether a company ever delivered on those estimates. The analysts see the cohort requirement as a potential answer to that problem. Most of them believe that insurance companies should not be exempt from this cohorting requirement, particularly for the business measured under the variable fee approach (VFA). Cohorting introduces audited accountability and the profitability of business is not being lost as a single EV number. Reported cohorts may be on an entity-wide basis, as often is the case for the non-Life sector, with further granularity as insurance companies choose.
The analysts strongly support the disclosure of CSM by year-of-issue for future new business reporting, if not the value of business in force at transition, even though they appreciate that annual values for CSM are a sum of many moving parts and thus are far from perfect. Such disclosures would bring reporting in the Life sector closer to non-Life sector as general insurance companies provide this information for, although, as anticipated for Life business, often without product splits. Such disclosures will give users a better grasp of Life profit development and how it contributes to the overall profitability of companies. This should improve users’ confidence in insurance financial statements.

In conclusion, disclosures of CSMs by issue-year, with optional disclosures of back-book business on transition are an ideal opportunity to improve users’ trust in the financial information prepared by insurance companies. These disclosures could bring auditable accountability and by this address previous challenges around the NBV as a standalone metric.

Life Insurance: VFA Cohorts
For participating business such as with-profits, the lack of clarity on what is profitable business and what is not is a key reason why such business has fallen out of favour as a product that shareholders could reasonably support management in writing new business, even with favourable economics. It was noted that the profitability of participating business is connected to its bonus paying capacity: having clear disclosures by cohort will also tell policyholders whether they are being subsidised by/are subsidising others. Insurance companies may not be keen to disclose this information, but it would improve transparency.

The analysts felt strongly that financial stakeholders need to understand what the performance of a cohort looks like before any subsidies between cohorts, as for any other business that may incur losses on a year’s sales. As such, there is a clear need for annual cohorted information. For mutualised products management may often adopt a policyholder focus and not view the business on a cohorted basis. However, financial accounts are concerned with reporting to financial stakeholders in general, rather than to policyholders.

In conclusion, not applying annual cohorting would severely limit transparency and leave management, as now, barely able to justify new participating business to (non-policyholder) financial stakeholders even if the economics are favourable.

Life Insurance: Analysis of Changes in CSM
The analysts believe that the analysis of change in the CSM would be an important disclosure because it helps in understanding evolution of the business. It shows trends in performance by making it clearer how expenses, claims, strength of underwriting interact with the profitability of groups.

In conclusion, the analysis of changes in CSM is expected to become a key KPI within the Life insurance sector.
Appendix

About IFRS 17
IFRS 17 Insurance Contracts is a global accounting standard issued by the IASB in May 2017. While its guidance is under review, it is currently scheduled to become effective on 1 January 2022. Its objectives are to:

• Replace IFRS 4 issued by the IASB in 2004
• Increase comparability and transparency of financial statements produced by companies that issue re/insurance contracts
• Introduce current measurement of insurance liabilities and reinsurance assets, deferral of profits and immediate recognition of losses

List of Round Table Participants
The following individuals attended a round table on 29 January 2020 in London.

Rating Agencies:
• A.M. Best – Anthony Silverman, Associate Director - Analytics
• Fitch Ratings – Stephan Kalb, Senior Director
• Fitch Ratings – Fedor Smolyakov, Director
• Moody’s Investors Service – Simon Harris, Managing Director
• Moody’s Investors Service – Antonello Aquino, Associate Managing Director
• Moody’s Investors Service – Helena Kingsley-Tomkins, Assistant Vice President
• Standard & Poor’s – Mark Nicholson, Director

Investors:
• Berenberg – Michael Huttner

Auditors:
• BDO – Mark Spencer, FS Accounting Advisory Leader
• Deloitte – Peter Plat, Senior Manager, Risk Advisory

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About Aon

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