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Analytical Considerations for IFRS 17 Reporters: Frequently Asked Questions

Following more than a year of (re)insurers reporting under the new standard, and with the benefit provided by a full annual cycle of rating analysis, this FAQ provides clarifications on AM Best's analytical approach for IFRS 17 reporters.

In particular, this FAQ provides clarification on how IFRS 17 information is used in AM Best's proprietary capital model, Best's Capital Adequacy Ratio (BCAR).

AM Best expects to continue to refine its analytical approach as disclosures and market practices evolve.

How does AM Best treat the Contractual Service Margin (CSM) and Risk Adjustment (RA) in the BCAR?

Under various reporting standards, AM Best adjusts reported equity when assessing a (re)insurer's available capital in the BCAR. This includes granting partial equity credit for Net Economic Value due to Long-term Business (NEVLTB).

For IFRS 17 reporters, the life Contractual Service Margin (CSM) and Risk Adjustment (RA), which are on-balance sheet components of the insurance liabilities, form the basis of this calculation.

For a number of IFRS 17 reporters, AM Best expects to grant 75% equity credit for life CSM and RA in BCAR available capital. The reason for not granting full equity credit reflects the sensitivity of economic values to market conditions, potential volatility in reported amounts and fungibility limitations.

Partial equity credit in the BCAR may also be granted for unearned profits for life-like business accounted for under the premium allocation approach (PAA) or under IFRS 9 as investment contracts, for which no CSM is calculated. Alternative off-balance sheet metrics, such as Value of In-Force (VIF) under embedded value reporting, could then be used to estimate the NEVLTB and would typically receive 50% equity credit in the BCAR.

Partial equity credit in the BCAR may also be granted to country specific unallocated surpluses in participating funds for life business, such as German free RfB (freie Rückstellung für Beitragsrückerstattung).

NEVLTB, whether represented by life CSM, RA, VIF or unallocated surpluses, is considered soft capital. AM Best considers the quality of capital in its ratings analysis, and a high reliance

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on such soft capital to support risk-adjusted capitalisation would be considered a partially offsetting balance sheet strength factor.

AM Best does not typically give equity credit in BCAR for CSM related to non-life business. This is consistent with current practice under other accounting standards.

How does AM Best treat CSM and RA in its financial leverage calculation?

When relevant in assessing financial leverage, AM Best considers the equity credit granted for certain life segment amounts, including NEVLTB. However, AM Best publishes financial leverage without credit for these elements in its credit reports.

Coverage ratios, the amount and timing of cash flows, their variability and relationship to debt maturities, and a rating unit's financial flexibility continue to play important roles in AM Best's rating analysis.

How does AM Best consider discounting and RA under IFRS 17, when calculating non-life reserving risk in BCAR?

In the BCAR, reported reserves are adjusted to an economic basis that accounts for AM Best's view of a rating unit's ultimate reserves, which are discounted to their present value, recognising the time value of money and adjusted for AM Best's view of any reserve deficiency.

To maintain a consistent treatment of the time value of money, discounting booked by a rating unit is typically treated as reserve deficiency and credit for the time value of money is given through the discount factors in the model, which are based on industry payout patterns by line of business and a 4% annual discount rate.

AM Best's criteria allows for adjustments to the discount factors, where appropriate. The discount factors may incorporate a rating unit's payout pattern when AM Best assesses it to be materially different from the industry payout pattern.

In practice, for a number of IFRS 17 reporters in certain markets, AM Best may elect to use a rating unit's reported discounted reserves without treating this discounting as a reserve deficiency. This approach enables AM Best to factor into its analysis the difference in payout patterns.

The RA relating to non-life business is typically given credit as reserve equity and non-life reserving risk is charged on claims reserves net of the RA.

How does AM Best contend with financial items that are no longer available from published financial statements, such as deferred acquisition costs (DAC)?

Typically, IFRS 17 alternatives have been identified when financial items previously used in the analysis are no longer available under the new standard.

DAC for life and non-life business is an input to the BCAR model for IFRS 4 and US GAAP reporters. However, in-coverage DAC is not an audited figure available from published financial statements under IFRS 17.

AM Best has requested this information through its supplemental rating questionnaire (SRQ). However, the quality and completeness of data returned have been limited.

Therefore, AM Best in practice has typically not used this SRQ data for IFRS 17 reporters, instead relying on items available in published audited financial statements.

In contrast to in-coverage DAC, pre-coverage acquisition costs, that is acquisition costs that are incurred before the group of contracts they relate to is recognised, are available from published IFRS 17 financial statements. AM Best typically makes a deduction from available capital to reflect the risk of non-recoverability that is associated with these acquisition costs.

How is pricing risk captured for IFRS 17 reporters?

Net written premiums are no longer part of the income statement under IFRS 17.

For IFRS 17 reporters, AM Best typically uses net insurance services revenue to derive the exposure base for pricing risk in BCAR. The present value of cash inflows on contracts initially recognised in the year is also used for life business not measured under the PAA.

Adjustments may be made to these reported measures based on analytical judgement.

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