Trend Review
August 27, 2024

IFRS 17 — Economic View Adds Complexity to Reinsurers' Financial Statements

When using IFRS 17 data, comparisons across accounting standards require a high level of interpretation

Principal Takeaways

- A key difference between IFRS 17 and IFRS 4 is the focus of IFRS 17 on recognition of an insurance contract's profit over the duration of the insurance coverage. Early recognition of losses on onerous contracts is mandatory under IFRS 17. This is a considerably more significant change from previous practice for the life segment than for non-life.
- Under IFRS 17, discounting is now normally required for all insurance contract liabilities. Although this is offset by the requirement for an explicit risk margin, the impact may be seen in lower liability levels on the balance sheet as well as in reported combined ratios. Under IFRS 17, reinsurers have typically seen a greater overall impact on combined ratios than the direct market has. The impact on profitability is further dampened by a lower investment result than previously (due to the investment expense from unwinding the discounting).
- IFRS 17 introduced new elements to account for the liability components of insurance contracts: risk adjustment and contractual service margins for longer duration policies.
- Insurance service revenue replaces premium written as the revenue line in income statements.
- Traditional profitability metrics such as loss and expense ratios may change significantly under IFRS 17, particularly for reinsurers; and the combined ratio can be based on net/net or net/gross.

In the midst of one of the hardest reinsurance markets in decades, reporting under the long-discussed International Financial Reporting Standards (IFRS) 17 has finally started. The broader insurance industry has debated the potential impact and challenges related to the move from IFRS 4 for years, but many still struggle to understand the new standard. IFRS 4, for all of its limitations, allowed analysts to use metrics common in the analysis of reinsurers' financial statements under US GAAP. The consistent message from analysts, regulators, and AM Best was that a change in accounting standard should not have an impact on a company's financial strength. Nevertheless, the new standard has brought about considerable challenges.

The move from IFRS 4 to IFRS 17 is a significant change for those in the insurance industry adopting the new accounting standard. Although the transition brings about changes to metrics for all types of (re)insurers, it is a far more radical change for life and composite (re)insurers. For the life business specifically, the standard allows for a more meaningful and accurate representation of earnings. The move will also impact some longer-tailed lines of property and casualty business, albeit to a smaller extent.

IFRS 17 became effective on January 1, 2023, although some European and Asian reinsurers are adopting it over the next three years. It completely overhauled prior approaches for measuring and reporting insurance results and introduced new nomenclature, creating challenges for insurance companies as they prepare financial statements. It alters the way users of financial

Analytical Contacts:
Antonietta Iachetta, Oldwick
+1 (908) 882-1901
Antonietta.Iachetta@ambest.com

Dan Hofmeister, Oldwick
+1 (908) 882-1893
Dan.Hofmeister@ambest.com

Contributors:
Jessica Botelho-Young, London
Mathilde Jakobsen, Amsterdam
Christie Lee, Hong Kong
Anthony Silverman, London
Carlos Wong-Fupuy, Oldwick

2024-093.9

Copyright © 2024 A.M. Best Company, Inc. and/or its affiliates. ALL RIGHTS RESERVED. No portion of the content may be reproduced, distributed, or stored in a database or retrieval system, or transmitted, or uploaded into any external applications, bots or websites, including those using artificial intelligence technologies such as large language models and generative AI in any form or by any means without the prior written permission of AM Best. AM Best does not warrant the accuracy, completeness, or timeliness of the AM Best content. While the content was obtained from sources believed to be reliable, its accuracy is not guaranteed. You specifically acknowledge that neither AM Best nor the content gives any investment, financial, tax, insurance, or legal advice. You are solely responsible for seeking competent professional advice before making any investment, financial, tax or insurance decision. For additional details, refer to our Terms of Use available at the AM Best website: www.ambest.com/terms.

statements—whether policyholders or investors—understand, interpret, and compare these new statements. Although IFRS 17 allows for more detailed disclosures about specific insurance contracts, users of the new standard, from all stakeholder constituencies, will need to become acquainted with the new components used to assess a company.

The reinsurance market and the broader insurance industry are adjusting to these changes, which has necessitated some segmentation of performance analysis in the reinsurance market. Many of the largest reinsurers are domiciled in Europe and Asia and have moved to IFRS 17. However, most of the Bermuda-domiciled reinsurers, which have become substantial capacity providers in recent years, will continue to report according to US GAAP. Furthermore, the large European and Asian reinsurers typically write substantial life business, the line of business most impacted by the new standard. Understanding the relative performance among various segments and standards under IFRS 17 is challenging and requires considerably more interpretation than previously.

New Look Liabilities

IFRS 17 requires discounting of future cash flows for all insurance contracts, including non-life, and establishing a "risk adjustment" portion of the reserve, which differ significantly from the rules established in US GAAP accounting. In many cases, this discounting has led to significantly lower loss reserves (now called insurance contract liabilities) and, as a result, has driven equity positions up and leverage ratios down. The impact of the discounting could be partly dampened with a Risk Adjustment (RA), an adjustment for the level of uncertainty about the timing and amount of cash flows.

The effect of the time value of money (unwinding the discount) and the effect of *changes* in the time value of money (effect of changes in discounting assumptions/yield curve change) are presented in the insurance finance result, separately from insurance service result. This component can be significant. The separate presentation allows users to better compare the sources of income.

In a new approach, IFRS 17 combines a current view of the value of insurance contracts on the balance sheet, with a simultaneous recognition of profit over the period insurance services are provided to policyholders. The gains or losses earned from underwriting are reported separately, with detailed disclosures that explain financial statement lines such as new business written, experience for the year, claims and payments, and changes in assumptions that impact the value of the insurance contracts.

CSM, the new component, represents the present value of unearned profit on a contract expected to be earned as insurance services are provided. CSM is set up as a liability on the balance sheet but adds a level of complexity relative to traditional best estimate reserves seen in the property/casualty segment. Nonetheless, the CSM is similar to value of in-force (VIF) in embedded value reporting, which has historically been one of the key performance indicators (KPIs) life insurers use to measure the long-term value creation in their business.

The CSM may not be substantial for many non-life reinsurers' capital, but it is substantial for a life reinsurer's capital. Some debate exists on how to treat CSM in performance metrics and capital structures. It has economic value for balance sheets but isn't necessarily tangible capital an insurer can immediately pay claims with.

For general measurement model (GMM) reported business, part of the RA is a component of the "Liability for Remaining Coverage" (LRC), which is similar to unearned premium reserves, with the remaining part being a component of the "Liability for Incurred Claims" (i.e., claims reserves estimates). In other words, the RA functions as a reserve margin. IFRS 17, however, does not prescribe

a specific method to calibrate risk adjustment. Margins in reserves also vary for non-IFRS 17 reporters, but the advantage of IFRS 17 is explicit reporting of the margin.

The final model is the VFA, which is a modification of the GMM for contracts with direct participation features. It allows insurers to pass the insurer's share of the investment result through the CSM, instead of taking what can be a volatile item directly to the income statement.

Although discounting liabilities is meant to more adequately support reinsurers' asset-liability matching (ALM)—which in the past wasn't aligned due to assets being carried at fair value and liabilities at amortized cost—there is a clear cost in terms of complexity. However, the advantage of discounting is that economic capital is more transparent.

Profitability Trends Under IFRS 17

Overall profitability isn't expected to change materially under IFRS 17 for non-life (re)insurers; however, the timing of profit recognition can differ significantly under the new approach, particularly for life reinsurers. Previously, we would often see a trend of higher earnings at the beginning of a policy period and slower earnings later in the life of the contract.

Under the new standard, the expectation is that, as the insurance service is provided over time, earnings will be recognized in the income statement, which is expected to produce a more stable earnings trend that is more representative of an underlying run rate. For example, if we looked at a company writing a new life policy with a ten-year time horizon, we would see that at time zero, the profits under IFRS 17 would be zero (assuming the contract is not onerous), due to setting up a CSM reserve to capture the expected future profits. Under the prior standard, the difference between premiums paid and setting up reserves would be recognized as profit. In this respect, IFRS 17 moves life reporting onto a more similar basis to non-life than was previously the case.

Same Names, Different Metrics

Historically, the reinsurance industry has relied on a variety of measures to compare the performance of market participants, such as combined ratios, return on revenue, and return on equity (ROE). Although these metrics are still used under IFRS 17, they differ from the past, and in most cases are not directly comparable to local GAAP reporters.

For IFRS 17 reporters, the standard brings about the sunset of gross premium written and the introduction of insurance service revenue in income statements. As such, the ability to comparably measure premium leverage based on claims and expenses is diminished—and considerably more so for reinsurers than for the direct market. Insurance carriers are no longer required to report premium written; instead, the top line is now captured in insurance service revenue. As is currently the case for non-life earned premiums, insurance revenue comprises the amortisation into revenue of provisions that, at inception, sums to premiums. For GMM business, these provisions comprise expected claims, the risk adjustment, the CSM and deferred acquisition costs (DAC). The CSM may be viewed as a balancing item at inception. Perhaps surprisingly, the DAC provision is not a required disclosure and is not part of the LRC (except for the any part allocated to future new business). A split of revenue among these four components is required disclosure for GMM business. For PAA, there is a single revenue figure that comprises amortisation of the LRC and DAC.

Combined ratios had typically been divided into loss and expense ratios when examining underlying profitability metrics. However, under IFRS 17, expenses are not required to be allocated to the insurance/underwriting activity in a manner consistent with IFRS 4/local GAAP reporting,

significantly hindering comparative analysis. Users are dependent on voluntary disclosure of non-operating cost splits among life and non-life and other expenses. Additionally, the definition of expenses in IFRS 17-incurred claims may differ from previous practice for loss adjustment expenses.

AM Best notes that identifying a consistent allocation of group expenses to non-life expense ratios has always been an exercise with some challenges. Nevertheless, at the current stage of development for reporting under IFRS 17, separate loss ratios and expense ratios are losing relevance and there is a greater reliance on the combined ratio, which remains the primary measure of underwriting performance for non-life reinsurers under IFRS 17. However, the combined ratio is not the same as under IFRS 4 or US GAAP. The new view takes into account the time value of money and the uncertainty of future cash flows, which is considered useful in assessing economic profitability. However, challenges lie in interpreting and understanding what the new inputs in the calculation mean when comparing companies and historical trends using different accounting regimes.

A greater level of understanding is needed, not just for discounting, but also for the two different ways of calculating combined ratios—the net/gross and net/net bases. Although we've found that net/net combined ratios track more closely with IFRS 4/US GAAP computations of combined ratio, some companies have elected to report on one basis, while others use the other. Whether a reinsurer will pick one or the other will typically depend on its business strategy. When comparing combined ratios under IFRS 17 to those under IFRS 4 and US GAAP, the impact of the change will be directly tied to the duration of liabilities, the scale of reinsurance held assets and expenses, the reinsurance held result and the impact of reinsurance ceding commissions (**Exhibit 1**).

Although the combined ratio historically has been the primary measure for non-life underwriting profitability, the overall operating performance of all types of reinsurers has historically been measured by the ROE. The basic calculation for ROE remains consistent with previous practice; however, it's important to note how much variability can emerge under IFRS 17 if assets are not matched to liabilities by duration or if credit spreads move. The numerator component (net income) of ROE now recognizes earnings in a different pattern under IFRS 17, while the impact on the denominator (shareholders' equity) varies depending on the companies' transition approach.

Some companies have reported ROE measures that add the value of the CSM to the equity value in the denominator. A consistent numerator is also required for these ratios. For non-life reinsurers, the discounting of loss reserves can cause slight increases in overall equity positions, thereby slightly lowering ROEs, although they are still generally more comparable to IFRS 4 measures than for life companies.

Exhibit 1
Claims and Expense Ratios Under IFRS 17

1. Net/Gross	
Net Claims Ratio	**Net Expense Ratio**
Gross Claims + Reinsurance Held Loss (Profit) / *(Re)insurance Services Revenue*	*Expenses* / *(Re)insurance Services Revenue*
Note: The net expense ratio is the same as the gross expense ratio.	
2. Net/Net	
Net Claims Ratio	**Net Expense Ratio**
Gross Claims – Reinsurance Held Recoveries / *(Re)insurance Services Revenue – Reinsurance Held Expenses*	*Expenses* / *(Re)insurance Services Revenue – Reinsurance Held Expenses*

Source: AM Best data and research

For life companies, the identification of run-rate profitability means the ROE is more akin to an achieved return on investment in a manner similar to ROEs in other economic sectors. AM Best's analysis is that this ratio should become more important, mostly at the expense of the estimated internal rate of return for new business. The newly matched revenue and claims, which both relate to the reporting period for life companies under IFRS 17, should increase the importance of profit to revenue ratios.

Composite reinsurers present a level of complexity that leads to being heavily dependent on segment disclosure. In AM Best's view, this is an aspect of reporting that will naturally evolve over the next few years.

Additional Analysis Needed

The adoption of IFRS 17 has provided benefits in terms of comparability of profit with other industries, smoother earnings, and greater alignment with economic value. However, users of financial statements need to be mindful of the characteristics of IFRS 17 and make sure they fully understand how and why the financial data has changed. In past years, IFRS 4 and US GAAP had been compared against one another and even consolidated into composites. Many in the market might attempt to consolidate and compare IFRS 17 and US GAAP financial statements, but doing so will very likely result in distorting what the numbers are really telling us. For example, two companies might report a 90.0 combined ratio, but those may be very different under IFRS 17 and GAAP now. That's not to say that companies under various standards can't be compared, but that their results require careful interpretation.

We are still in the early days of reporting under IFRS 17, as only one year has been reported. AM Best expects that disclosures will continue to evolve over the near to medium term—we will continue to monitor how results and comparability across sectors evolve over time.

For additional details about the IFRS 17 changes, please see Frequently Asked Questions: IFRS 17 (January 4, 2024).

Published by AM Best

BEST'S SPECIAL REPORT

A.M. Best Company, Inc.
Oldwick, NJ
CHAIRMAN, PRESIDENT & CEO **Arthur Snyder III**
SENIOR VICE PRESIDENT & TREASURER **Cynthia Young**
SENIOR VICE PRESIDENT **Lee McDonald**

A.M. Best Rating Services, Inc.
Oldwick, NJ
PRESIDENT & CEO **Matthew C. Mosher**
EXECUTIVE VICE PRESIDENT & COO **James Gillard**
EXECUTIVE VICE PRESIDENT & CSO **Andrea Keenan**
SENIOR MANAGING DIRECTORS **Edward H. Easop, Stefan W. Holzberger, James F. Snee**

AMERICAS
WORLD HEADQUARTERS
A.M. Best Company, Inc.
A.M. Best Rating Services, Inc.
1 Ambest Road, Oldwick, NJ 08858
Phone: +1 908 439 2200

MEXICO CITY
A.M. Best América Latina, S.A. de C.V.
Av. Paseo de la Reforma 412, Piso 23,
Col. Juárez, Alcadía Cuauhtémoc, C.P. 06600, México, D.F.
Phone: +52 55 1102 2720

EUROPE, MIDDLE EAST & AFRICA (EMEA)
LONDON
A.M. Best Europe - Information Services Ltd.
A.M. Best Europe - Rating Services Ltd.
12 Arthur Street, 8th Floor, London, UK EC4R 9AB
Phone: +44 20 7626 6264

AMSTERDAM
A.M. Best (EU) Rating Services B.V.
NoMA House, Gustav Mahlerlaan 1212, 1081 LA Amsterdam, Netherlands
Phone: +31 20 308 5420

DUBAI*
A.M. Best Europe - Rating Services Ltd. - DIFC Branch*
Office 102, Tower 2, Currency House, DIFC
P.O. Box 506617, Dubai, UAE
Phone: +971 4375 2780
*Regulated by the DFSA as a Credit Rating Agency

ASIA-PACIFIC
HONG KONG
A.M. Best Asia-Pacific Ltd
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827 3400

SINGAPORE
A.M. Best Asia-Pacific (Singapore) Pte. Ltd
6 Battery Road, #39-04, Singapore
Phone: +65 6303 5000

Best's Financial Strength Rating (FSR): an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. An FSR is not assigned to specific insurance policies or contracts.

Best's Issuer Credit Rating (ICR): an independent opinion of an entity's ability to meet its ongoing financial obligations and can be issued on either a long- or short-term basis.

Best's Issue Credit Rating (IR): an independent opinion of credit quality assigned to issues that gauges the ability to meet the terms of the obligation and can be issued on a long- or short-term basis (obligations with original maturities generally less than one year).

Best's National Scale Rating (NSR): a relative measure of creditworthiness in a specific local jurisdiction that is issued on a long-term basis and derived exclusively by mapping the NSR from a corresponding global ICR using a transition chart.

Rating Disclosure: Use and Limitations

A Best's Credit Rating (BCR) is a forward-looking independent and objective opinion regarding an insurer's, issuer's or financial obligation's relative creditworthiness. The opinion represents a comprehensive analysis consisting of a quantitative and qualitative evaluation of balance sheet strength, operating performance, business profile, and enterprise risk management or, where appropriate, the specific nature and details of a security. Because a BCR is a forward-looking opinion as of the date it is released, it cannot be considered as a fact or guarantee of future credit quality and therefore cannot be described as accurate or inaccurate. A BCR is a relative measure of risk that implies credit quality and is assigned using a scale with a defined population of categories and notches. Entities or obligations assigned the same BCR symbol developed using the same scale, should not be viewed as completely identical in terms of credit quality. Alternatively, they are alike in category (or notches within a category), but given there is a prescribed progression of categories (and notches) used in assigning the ratings of a much larger population of entities or obligations, the categories (notches) cannot mirror the precise subtleties of risk that are inherent within similarly rated entities or obligations. While a BCR reflects the opinion of A.M. Best Rating Services, Inc. (AM Best) of relative creditworthiness, it is not an indicator or predictor of defined impairment or default probability with respect to any specific insurer, issuer or financial obligation. A BCR is not investment advice, nor should it be construed as a consulting or advisory service, as such; it is not intended to be utilized as a recommendation to purchase, hold or terminate any insurance policy, contract, security or any other financial obligation, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser. Users of a BCR should not rely on it in making any investment decision; however, if used, the BCR must be considered as only one factor. Users must make their own evaluation of each investment decision. A BCR opinion is provided on an "as is" basis without any expressed or implied warranty. In addition, a BCR may be changed, suspended or withdrawn at any time for any reason at the sole discretion of AM Best.

Version 011624