AM Best Request for Comment Response: Application of Best's Credit Rating Methodology to IFRS 17-Reporting Companies

On February 26, 2024, AM Best requested comments from market participants in the insurance industry and other interested parties on the application of Best's Credit Rating Methodology (BCRM) and related criteria procedures to IFRS 17-reporting companies. Related criteria procedures are "Available Capital and Insurance Holding Company Analysis," "Understanding Global BCAR," "Understanding BCAR for Canadian Property/Casualty Insurers" and "Understanding BCAR for US and Canadian Life/Health Insurers."

The request for comment (RFC) period ended on March 27, 2024. AM Best did not respond individually to comments submitted during the RFC period. A total of eight (8) comments were received. For respondents who chose to remain anonymous, best efforts have been made to shield the identity of both author and company by redacting any text that could be used to identify the commenter. AM Best greatly appreciates the responses received during the public consultation period. The following commentary addresses key themes resulting from public feedback and internal review.

BCRM, associated criteria procedures and Best's Capital Adequacy Ratio (BCAR) focus on the underlying economics of (re)insurers and are not specific to accounting standards, nor are key rating assumptions, variables and drivers in BCRM and related criteria procedures. This approach ensures global consistency and comparability across AM Best's credit ratings and does not change upon the introduction of IFRS 17. However, clarifications related to IFRS 17 have been provided, as referenced in a Best's Commentary of January 4, 2024, titled "Frequently Asked Questions: IFRS 17" on page 3 under the methodology heading.

After considering comments received, AM Best is not making changes to BCRM and associated criteria procedures for IFRS 17. AM Best notes that its methodology and criteria procedures evolve over time as improvements are identified and as changes become desirable to reflect developments in the underlying operations of insurers.

1. Financial leverage

Several of the comments received referred to financial leverage. Comments centred on whether the financial leverage ratio used in AM Best's rating process should include the available capital from the BCAR and a suggestion that it should include 100% of the (taxed) contractual service margin (CSM).

AM Best's financial leverage ratio has not normally used the available capital from the BCAR model.

AM Best considers financial leverage in the rating process as outlined in its criteria. For IFRS 17 reporters, AM Best will also take into consideration a financial leverage calculation that includes 100% of the life segment CSM. AM Best will continue to consider interest coverage ratios, cash flows over time, their variability and relationship to debt maturities, and how capital markets may view debt levels.

2. Pricing risk, insurance revenue and premiums

Commentary on this topic was focused primarily on whether risk charges in BCAR would be increased for reinsurers reporting under IFRS 17, given IFRS 17's accounting for ceding commissions and the resulting reduction in insurance revenue.

AM Best considers that IFRS 17 insurance revenue, and the treatment of reinsurance ceding commissions, provide an appropriate measure of exposure to pricing risk for use in the BCAR. Additionally, the measure of exposure may on occasions be influenced by analytical judgement. The present value of cash inflows on contracts initially recognised in the year will be used for life segment business not measured under the Premium Allocation Approach (PAA).

Although the BCAR remains a key component of the balance sheet strength assessment, other factors are also evaluated. The emphasis on quantitative and qualitative factors involved in assessing balance sheet strength is likely to evolve to some degree.

3. CSM for life business

Comments on the treatment of the CSM covered both AM Best's approach to the life segment, as well as suggestions for comparable treatment in the non-life segment and for contracts not recognised as insurance under IFRS 17. We respond here on the treatment in the life segment and respond on the CSM and other activities in point 4 of this document.

A view that 100% of the CSM (net of tax and reinsurance held) should be treated as available capital in the BCAR was expressed in several comments. This was supported by arguments that (a) the CSM is an economic measure; (b) reporting under IFRS 17 is audited; (c) counting 100% would be consistent with some regulatory measures; (d) varying treatments over the transition to IFRS 17 can affect the CSM; and (e) the amount is a discounted figure and is a residual, so it is not subject to incremental risk.

AM Best expects considerable volatility may arise in life CSM that is additional to volatility considered elsewhere in BCAR.

The CSM reported under IFRS 17 is part of the Net Economic Value due to Long-term Business (NEVLtB). AM Best's approach in typically granting only partial equity credit for NEVLtB is to allow for volatility and for fungibility constraints. Comments received also noted that the treatment of the CSM as a liability on initial recognition under IFRS 17, and its gradual amortisation into profit, is a response to expected volatility.

Global consistency and comparability of credit ratings strongly support maintaining our existing approach of granting partial equity credit for NEVLtB.

AM Best notes the comments relating to the auditing of CSM reporting in accounts prepared under IFRS 17. However, audited measures typically attract wide ranges of both credit in available capital and charges for required capital looking across the many measures that are audited. Similarly, the loss-absorbing nature of the CSM would not, in and of itself, affect how its incremental volatility is reflected in equity credit.

The "dual look" nature of IFRS 17, whereby an ultimate profit is assessed and then credited into earnings over the duration of policies, is an innovation of the standard. Some comments noted that certain regulatory regimes similarly assess ultimate profit but credit it to capital on day one. Such regulatory regimes typically incorporate required capital that is consistent with their purpose and the available capital used. For example, a calibration (as in the case of the EU's Solvency II) to a chosen confidence level incorporates the volatility described above into required capital. AM Best's treatment of the CSM is consistent with such a framework.

Equity credit granted in BCAR for life CSM is expected to typically range between 40% and 65%. The level of equity credit granted, however, is subject to analytical judgement and may vary depending on case-specific considerations. An important consideration in assessing higher levels of credit is whether amortisation of the CSM occurs late in the in-force period of policies in the context of the risk profile over the same period.

4. CSM for non-life business, contracts reported under IFRS 9

Comments on these subjects centred on views that (a) non-life CSM should receive available capital credit in BCAR; (b) value in non-life contracts emerges over a generally shorter timeframe than for life, which

limits uncertainty; and (c) similar value to that in unit-linked business accounted for under IFRS 17 also exists in IFRS 9-accounted products.

The different activities of an insurer are considered in the rating assessment in many ways. In addition to available and required capital in BCAR, AM Best considers other factors in the balance sheet strength assessment and other building blocks, and includes qualitative aspects at various stages of a ratings assessment.

Non-life insurance activities with short policy durations in AM Best's ratings universe do not normally receive equity credit in BCAR for an estimate of expected profit from in-force policies as they run off. Comparability and continuity across the credit ratings universe strongly support maintaining our existing approach in considering non-life CSM under IFRS 17 and it therefore does not, in general, receive equity credit.

In principle, comparability and continuity for unit-linked life insurance and investment activities reported under IFRS 9 might be targeted by removing the CSM for unit-linked, extending the CSM using an estimation technique to all investment management activities, or applying existing treatments to values as reported. We are continuing our existing practice for IFRS 17 reporters.

5. Risk adjustment

Comments on risk adjustment questioned how AM Best would allow for the varying ways in which insurers set their risk adjustments and suggested that 100% of the risk adjustment should be incorporated into available capital and that 100% would be consistent with some regulatory regimes.

In the life segment, AM Best expects to typically treat the risk adjustment in the same way as the CSM, in that the two are aggregated as part of the NEVLtB calculation.

In the non-life segment, consistent with existing practice for the treatment of risk margins in incurred claims reserves, the risk adjustment in the liability for incurred claims (LIC) of IFRS 17 reporters receives equity credit in the loss reserve equity calculation.

6. Supplemental Rating Questionnaire (SRQ)

Several comments noted that the resources and judgement required to complete AM Best's SRQ for the by-line breakdown of risk adjustment, requirements on deferred acquisition costs (DAC), and the effect of discounting for non-life incurred claims and data on receivables and payables are too onerous.

AM Best's SRQ obtains data not usually available directly from a company's financial statements. This will remain the case for companies reporting under IFRS 17. The information is typically used in BCAR or other quantitative elements of AM Best's ratings analysis. AM Best is sensitive to the demands of completing its SRQ. When a rated entity is unable to provide a requested disclosure, AM Best has been and remains willing to work within the context of what can reasonably be provided or to use alternatives where necessary. In these instances, rated entities should consult their rating analyst/reviewer.

7. Deferred acquisition costs

The comments on DAC centred on various observations that DAC is not a required disclosure under IFRS 17; there were suggestions that DAC is not a relevant concept under IFRS 17 but rather is a legacy metric.

AM Best's treatment of DAC under IFRS 17 is unchanged. AM Best refers to the portion of DAC under IFRS 17 that is allocated to in-force contracts as in-force DAC, whilst the portion allocated to future new business is referred to as IFRS 17 DAC.

IFRS 17 does not require disclosure of in-force DAC but does require reporting of IFRS 17 DAC. This is a new asset that has not previously been reported, and AM Best expects to typically deduct it from available capital in BCAR. The AM Best rating process affords flexibility based on analytical judgement, to ensure economic treatment of specific insurance contracts and product features. AM Best envisages that there may be product-specific features that create exceptions to the deduction of 100% of IFRS 17 DAC in the assessment of available capital in BCAR.

8. Future discretionary benefits (FDB), participating funds

There were comments related to propositions that (a) 100% of the FDB liability should receive equity credit in BCAR available capital; (b) it is available to absorb losses and shocks; and (c) provisions for FDB should be part of the denominator of financial leverage ratios.

AM Best notes that the allowance for FDB takes place primarily in the credit to the risk factors for participating business in the required capital for investment risk in BCAR. Additionally, available capital can be adjusted as provided for in the section titled "Surpluses in Funds with Discretionary Participation Features" in AM Best's Available Capital and Insurance Holding Company Analysis criteria procedure.

AM Best does not envisage that capital in participating funds, other than amounts included in reported equity, would normally impact financial leverage ratios.