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Credit FAQ:

Credit FAQ: How Will IFRS 17 Affect The Credit Quality Of Insurers?

June 5, 2018

The world's insurance companies face the biggest change in accounting standards in perhaps 20 years--International Financial Reporting Standards 17, which comes into force in 2021. For those companies moving to IFRS 17 from IFRS 4, S&P Global Ratings believes the rule's complex and costly changes to the reporting of profits and losses as well as balance sheet presentation can increase financial transparency, though with potential for great volatility in results. However, we think insurers should probably start now to manage the transition through increased external communication to ensure broad acceptance among investors and other stakeholders. We see IFRS 17 as a potential change for the better, for example, through the retrospective approach that calls for a deep-dive analysis of the life insurance back book. Yet we have also spotted a couple of risks to implementation and to the level of dependency on company-specific assumptions.

Key Takeaways

- We welcome IFRS 17 as moving the balance sheet for insurers to a market-consistent basis and removing the mismatch of market values for assets and book value for liabilities, therefore providing a chance to improve comparability and consistency. However, comparability with non-IFRS reporting insurers might become lost.
- Development of the rule's KPIs, and transparent disclosure and communication is in our view a significant and expensive challenge for insurers.
- We do not expect the accounting and reporting change to solely trigger any rating changes for insurers that make the switch, but we cannot rule them out over time if, for example, the KPIs lead to a change in steering for insurance companies.
- Due to full market valuation of liabilities under IFRS 17, we expect some insurers to preemptively add to their capital buffers toward 2021 to prevent capitalization from weakening.

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As a result of IFRS 17 implementation, will you change your ratings on insurers?

We anticipate limited rating changes from IFRS 17 itself, as an accounting change should all else being equal not necessarily reshape the fundamental risk of insurance operations nor our view of central aspects in our rating assessment on insurers, such as risk-based capital adequacy and relative operating performance in the competitive landscape.

The change in reported shareholder's equity should not fundamentally alter our view of risk-based capital adequacy. We continue to maintain an economic view of insurers' balance sheets in our current analysis of risk-based capital adequacy. For example, in our analysis of capital, we don't allow for unrealized gains between market value and book value on bond investments if the invested funds are coming from life insurance, as liabilities are on a book value basis only under the current IFRS 4 phase I. IFRS 17 is removing this mismatch between assets and liabilities and moving them both to a market basis.

Our view of operating performance relative to competitors or peers plays an important factor in our rating assessment, as we regard it as an indicator of competitive strength or weakness. Existing operating performance metrics like return on equity (RoE) might deliver results that run in different directions from Jan. 1, 2021. Consequently, we see the need for insurers to develop a new set of operating performance metrics to ensure consistent comparability. Such measures could include margin (versus volume) measure for profitability for the contractual service margin (CSM) insurance liabilities or CSM insurance revenues. The accounting change will also lead to a new set of KPIs in insurance management. However, some existing performance measures like return on assets (RoA) for life insurers and return on revenues (RoR) for non-life insurers might just need an adjustment in the calculation.

We expect some insurers' capitalization to weaken due to full market valuation of liabilities under IFRS 17. That said, the insurers will likely manage their portfolios and pre-emptively build more of a capital buffer toward 2021. In that way, we think the market-consistent view of liabilities under Solvency II puts insurers in the European Economic Area (EEA) ahead of the curve.

What is your view about the impact of IFRS 17 on the timing of realization of profits over the lifetime of insurance contracts?

When applying IFRS 17 the first time, insurers will have to make many decisions about how they classify their books of business for the purposes of reporting capital and CSM, among other things. For example insurers, particularly life companies, will have to classify contracts within their back book as either onerous, not onerous, or potentially onerous for the purposes of reporting their ongoing profit. This opens the door for considerable variability in how different companies classify and report potentially similar books of business. We expect transparent disclosure of underlying assumptions and expected earnings paths. We understand that underlying capital strength and a product portfolio's profitability do not fundamentally change overnight. Provided insurers offer timely and transparent communication before first-time application, we would not expect any change to our prospective view on operating performance and capital as such, unless prospective quality of capital deteriorates materially.

Any lack of transparency might result in prudent estimates from external stakeholders. What's more, the new KPIs as well as the capital and operating performance metrics require timely, detailed, transparent disclosure that external stakeholders will accept, in our view. We hope that

over time, a consensus will emerge about exactly what is needed. Regardless, given a sufficient amount of detail and granularity of disclosure, we believe our prospective rating assessment of insurers will remain largely unchanged.

How do you address some losses to comparability and consistency that IFRS 17 might introduce?

We believe IFRS 17 could potentially increase the transparency and comparability of insurance reporting overall. Of note, on the life insurance side, for the first time the rule calls for a market-consistent presentation of assets and liabilities.

However, with the removal of some well-known balance sheet and profit and loss account items, such as premium income and technical expenses, comparability between insurers reporting under IFRS and those reporting under U.S.-GAAP or local, statutory GAAP will suffer.

That shouldn't be an issue for S&P Global Ratings because in our ratings analysis we already ensure consistency between companies reporting under different accounting systems. In using our risk-based capital model globally, for insurers reporting under IFRS, local, statutory GAAP, and U.S. GAAP, we adjust reported numbers to ensure a consistent view of risk-based capital adequacy. For example, we allow up to 50% of life value-in-force in our view of total adjusted capital (TAC) and allow for policyholder bonus reserves available to absorb losses in some jurisdictions.

We might need to adjust operating metrics in a few cases. As our assessment of competitive position is built around our view of relative operating performance versus peers, we would expect most peer groups to comprise those reporting under similar accounting principles. However, where a peer group consists of companies reporting under different accounting regimes, or using different assumptions in their application of the principles, we would expect to adjust for these to the extent possible to carry out our assessment.

Do you expect funding costs for insurers change materially?

Although we are not entirely clear, with the switch to IFRS 17 we believe funding costs could possibly rise—but presumably not enough to materially affect our ratings on insurers.

While the aim of IFRS 17 appears to be a higher degree of comparability of insurers' accounts with those of corporates, some comparability with insurers not reporting under IFRS might become lost. In our view, the insurance sector's complexity will not necessarily vanish with the new accounting standard. Generalist investors might continue to rely on financial analysts who specialize in insurance. Then too, specialist investors will have to get used a new set of metrics and potentially update their databases and valuation tools.

How could IFRS 17 trigger changes to insurers' ratings?

As we have explained, we consider it unlikely that the accounting change in itself would trigger any rating changes. However, there could be second-order effects that result in S&P Global Ratings changing views about prospective capitalization. Should that occur, we many need to review the rating.

Adjustments to existing and the development of new KPIs might influence management to enter or exit lines of business or change their risk profiles. The impact of legacy mismatches between

assets and liabilities profiles will be more pronounced under IFRS 17. Insurers in the EEA, with Solvency II, have already embraced a market-consistent view of liabilities and might face less of a change in this respect. To mitigate the impact, insurers are likely to undertake a more disciplined investment strategy to manage their asset and liability mismatches better. As a consequence, targeted profitability or capital adequacy, or a company's strategy might change materially.

We view the impact of IFRS 17 implementation to be relatively more significant for Korean insurers. This reflects insurers' negative spread stemming from legacy high-yield guarantee policies (especially for life insurers). To prepare for IFRS 17, some South Korean insurers have raised new capital as part of their proactive capital management policy to ensure sustainable capital buffers. This comes on the back of their refinement of product strategies to focus on insurance protection policies with limited interest rate guarantees.

Is the cost of IFRS 17 implementation potentially rating negative?

As the standard seems to be most complex for life insurers, we would assume a considerably higher cost than for non-life insurers. The retrospective approach, requiring an in-depth analysis of existing contracts in the back book by cohort of new business--sometimes over many decades--might be one of the most complex parts of the new standard. Although some market rumors cite costs of IRFS 17 implementation in line with those for Solvency II in the EEA, we believe they will not be material relative to risk capital. In addition, the temporary burden to earnings generation over 2018-2021 is not likely to affect our view about operating performance, as we focus on a prospective view of underlying performance.

For Asia-Pacific, the implementation of IFRS 17 could prove daunting for all insurers, but especially for small and midsize companies. The operational burden of incorporating new accounting infrastructure changes, alongside updates in regulatory frameworks, will further weigh on compliance expenses.

Do you expect any change to the Jan. 1, 2021, implementation date?

Provided that the IFRS 17 announcement of IASB came in 2017, without any previous quantitative impact studies, the time to implementation on Jan. 1, 2021, appears quite short. Unlike the first attempt to update the IFRS 4 phase I exposure draft for IFRS 4 phase II in 2010, we do not expect any change to the timeline. Although the exposure draft in 2010 has been pushed back by the insurance industry and investors, the standard, in the meantime renamed IFRS 17 instead of IFRS 4 phase II, has already been accepted to be adopted in several countries. In Asia-Pacific, Korea, Australia, Hong Kong, New Zealand, and Singapore have announced the adoption of IFRS 17 from 2021. India's planned implementation of Ind AS, which we anticipate to largely converge with IFRS, will be effective from April 1, 2020.

IFRS 17 is to be adopted by insurers globally, except those reporting under U.S. GAAP and those solely reporting under local, statutory GAAP. Listed insurance groups in most jurisdictions are required to report under IFRS. While the EU endorsement process potentially might allow for additional time to adopt, we expect other regions and EU-based global multiline insurance and reinsurance groups to adopt in time and start much earlier with educating the market about the change. It also appears important that insurance associations and other forums discuss communication and disclosure to avoid inconsistent messaging from the industry.

Why do you believe that transparency of disclosures is so important?

A prerequisite for the comparability of insurance accounts under IFRS 17 will be consistent application of the standard as well as the transparency of underlying assumptions, including discounting factors. IFRS 17 is based on many underlying assumptions, including clustering in the retrospective approach. To familiarize internal and external stakeholders with the new KIPs and potentially materially different absolute numbers for capital and earnings, early communication internally and externally seems key. We would expect insurers to greatly increase their communication to the market and granularity of disclosure over the course of 2019 and 2020.

An object lesson is market-consistent embedded value, which was introduced with high hopes regarding consistency. However, that goal has not been fully achieved and the investor community hasn't to date embraced the metric. We hope insurers will do a better job regarding IFRS 17.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

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