IFRS 17 Insurance Contracts
Potential impact on the insurance market

Objective

1 The objective is for the EFRAG TEG to discuss and provide comments regarding the impact of IFRS 17 *Insurance Contracts* on the insurance market.

Introduction

2 The EFRAG Secretariat's assessment of the potential impact of IFRS 17 on the insurance market in Europe was based on an early draft of the economic study commissioned by EFRAG, EFRAG's extensive case study and EFRAG's simplified case study. The paper will be updated for the final version of the economic study.

3 The EFRAG Secretariat focusses on the following aspects:

(a) Potential impact on pricing; and

(b) Potential impact on products offered to policyholders.

Question for EFRAG TEG

4 Does EFRAG TEG have any comments regarding this paper?

Potential impact on pricing

How pricing changed in the past

5 The economic study commissioned by EFRAG indicated that generally, the insurance price increases occurred during two sub-periods, namely from 2008 to 2011 and from 2013 to 2017. During the other two periods, 2005 to 2008 and 2011 to 2013, prices actually fell or increased only very moderately. The exception is insurance related to health which showed an accelerating rate of growth of its price over these periods.

6 Online aggregators have put pressure on prices for non-life retail products, especially motor insurance as per the economic study commissioned by EFRAG. Aggregators will continue to significantly change the distribution economics of the insurance industry:

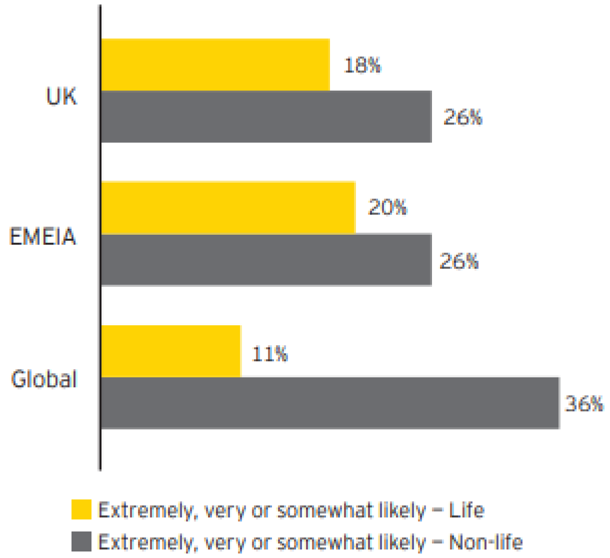
(a) For players with established brands, this represents a competitive dilemma as, in selling through aggregators, they may cannibalise their higher-profit lines;

(b) Exclusive, captive and independent agents find themselves providing at least the same value and personalised services for a lower level of commissions after paying the aggregator; and

(c) Customers find it easier to choose insurance products based exclusively on price. This erodes customer loyalty, decreasing retention rates and making switching more prevalent.

7 In their customer survey of 2014[1], Ernst and Young details 20 considered trends on switching insurance providers on a global basis as well as for the UK and EMEIA (Europe, Middle East, India and Africa).

Likelihood to switch in the next 12 months



Potential impact of IFRS 17

8 In terms of any potential impact on pricing due to IFRS 17, the [draft] economic study commissioned by EFRAG indicated that IFRS 17 is not expected to have a noticeable impact on pricing and product mix in most insurance product areas. However, a majority of insurance undertakings participating in the [draft] economic study indicated that they expected a negative impact in the Life and Credit Suretyship product areas. The negative expected impact was attributed to these contracts being long duration contracts and IFRS 17 introduces a valuation of such contracts which differs significantly from current practices.

9 From EFRAG's extensive case study, a majority of respondents indicated that IFRS 17 is not expected to affect their current pricing methodology. Most respondents from EFRAG's extensive case study expected no impact on pricing from the use of cohorts or groups under IFRS 17. Few respondents clarified that the use of cohorts or groups would affect pricing and this was because of the attention of investors to the disclosures or the use of mutualisation.

10 The EFRAG Secretariat notes that currently insurers use a wide range of approaches to manage/share risks (this is commonly referred to as mutualisation). Risks shared could be insurance risk (e.g. death occurring), financial risk (e.g. the investments produce insufficient return to pay out the minimum guaranteed return) or expense risk (e.g. costs related to the insurance contract other than those related to the insurance or financial risk). For example, a claim as a result of a fire destroying

[1] The *Reimagining customer relationships Key findings from the EY Global Consumer Insurance Survey 2014 EMEIA* report can be accessed at: https://www.ey.com/Publication/vwLUAssets/ey-2014-global-customer-insurance-survey-emeia/$FILE/ey-global-customer-insurance-survey-emeia.pdf

a house is paid for out of the premiums collected from a large number of policyholders. The insurer thus spreads its risks among a large group of policyholders. The EFRAG Secretariat does not expect the introduction of IFRS 17 to change this practice, therefore not affecting current pricing methodologies.

11 Under IFRS 17, sharing of risks applies when policyholders bear a reduction in their share of returns from a pool of underlying items because of payments to policyholders of other contracts that share in that pool or vice versa. These sharing of risks cash flows are allocated to groups under IFRS 17. Sharing of risks includes intergenerational transfers, i.e., sharing of cash flows between current policyholders and future generations of policyholders and some of these cash flows are allocated to cohorts and the remaining cash flows are measured as a separate liability and are not required to be allocated to cohorts. The EFRAG Secretariat considers that in applying IFRS 17, any gains/losses may become more visible and this may affect the prices of some insurance products.

12 Some respondents from EFRAG's extensive case study stated that they would avoid pricing methodologies leading to recognition of onerous contracts at inception and over time they may need to consider the IFRS 17 effects on the set of metrics used for assessing product pricing. The EFRAG Secretariat notes that if entities voluntarily write insurance contracts that are onerous at inception, the losses would be recognised upfront in profit or loss under IFRS 17.

13 From the responses to EFRAG's simplified case study, most of the respondents either did not expect that IFRS 17 will change their current pricing methodology or did not know. A few respondents expected a change in their current pricing methodology. These respondents indicated that IFRS 17 is expected to influence the decision on introduction of new products, with the focus on profitability and type of product, guarantees and options, duration of policies, etc. Similar to the response from the extensive case study, these respondents indicated that avoiding losses may be an additional factor in the pricing of insurance contracts.

14 Furthermore, the majority of stakeholders who provided input into the [draft] economic study commissioned by EFRAG expressed concern about the treatment of reinsurance contracts under IFRS 17 and that it could add a non-economic pricing constraint to mitigate perceived losses in the financial reporting due to accounting mismatches. Further, any implications to the pricing of reinsurance which can be acquired will also impact on the pricing of the underlying contract to the policyholder.

Potential impact on products offered to policyholders

How products changed in the past

15 The economic study commissioned by EFRAG indicated that the key fact to note in terms of the evolution of the product mix in the EU insurance market from 2005 to 2008 is the decline of the market share of life-insurance in the total insurance market (measured by gross premiums) and the increase in the market share of non-life products. Life insurance, however, remains still by far the largest insurance segment.

16 In the past years, life insurance has been impacted by three main factors affecting the product mix as per the economic study commissioned by EFRAG:

(a) Life insurers have been adapting their product mix to **low interest rates**. Some insurers who provided input to the economic study commented that traditional life products (i.e. offering a guaranteed return) are not attractive anymore. Companies have been moving towards products with no or a lower guarantee, shifting both interest rate risk and market risk to policyholders and reduced profit sharing (e.g. unit-linked products). It is believed that the weight of unit-linked products will continue to increase as smaller insurers join their larger peers.

(b) **Demographic change** - more health insurance products and retirement solutions are sold due to Europe's ageing population; and

(c) **Regulatory changes** - there are two main regulatory trends that have severely impacted the life insurance industry in the last 10 years: diminishing of tax advantages of insurance products and the introduction of Solvency II. According to most of the life insurance undertakings interviewed for the economic study commissioned by EFRAG, Solvency II had brought about a shift to products that are less capital intensive, more fee driven and with lowered/simplified guarantees. As consequence, Solvency II incentivised life insurers to shift more risks to policyholders and third-party asset managers.

Potential impact of IFRS 17

17 A majority of industry participants in the [draft] economic study commissioned by EFRAG indicated that the new external reporting requirements might have an impact on some features of the products offered. For instance, because IFRS 17 is expected to make the performance of insurance products more transparent, some entities might decide not to continue offering specific product lines.

18 As stated in paragraph 8 above, industry input to the [draft] economic study commissioned by EFRAG indicated that IFRS 17 is not expected to have a noticeable impact on the product mix except for the Life and Credit Suretyship product areas:

(a) Life insurers are expected to be the most affected by IFRS 17. This is due to the fact that there exist significant differences between the methods used currently to account for such long-term contracts and the requirements of IFRS 17. According to life insurance undertakings interviewed for the economic study commissioned by EFRAG, there were two critical points that might have an impact on the product mix:

(i) **Fair value vs. historic rate** - Considering the long-term nature of life insurance contracts, it is believed that the IFRS 17 requirements to reflect economic changes in the measurement of insurance contracts in a timely way would result in volatility in their performance that most of the life insurance undertakings see as "artificial". This may induce insurance undertakings to offer less long-term insurance contracts; and

(ii) **Level of granularity and annual cohort requirement** - Following the implementation of IFRS 17, losses cannot be diluted in a large pool and must be made explicit. According to some life insurance undertakings, this may lead them to increase the premium in contracts where the risk is perceived to be higher and/or change the product offering. Furthermore, according to most of the industry stakeholders interviewed, granularity that is too detailed (i.e. the annual cohort requirement) may introduce noise and increase complexity in terms of data volumes.

(b) For "Credit Suretyship" the reason provided is that IFRS 17 will require insurance undertakings to adopt fair value accounting practices, which implies that the volatility of the market will be reflected in profit or loss and this volatility might be even greater for corporate segments where the frequency of claims is already high. Participants suggested that, as a result, insurance undertakings may focus more on products/line of business where the volatility is lower, and this may act as a disincentive for providing certain products that policyholders might desire. The EFRAG Secretariat notes that IFRS 17 provides an accounting policy choice whereby this 'volatility' can be recognised either in profit or loss or other comprehensive income.

19 Most of the respondents who provided input to the [draft] economic study commissioned by EFRAG agreed that IFRS 17 will have a neutral impact on the property and casualty segment – which are typically contracts providing insurance coverage over a relatively short period of time, such as one year. The main changes for short-term insurance contracts will depend upon entities' existing insurance accounting practices.

20 In addition, the [draft] economic study commissioned by EFRAG stated that following the adoption of IFRS 17, products with high volatility exposure (such as participating contracts) may be redesigned, replaced or offered at a higher premium.

21 Respondents from EFRAG's extensive case study were split regarding the impact of products due to IFRS 17, with half expecting there would be an impact on their range of products offered to policyholders and the other half expecting there would be no or not a significant impact.

22 Of those respondents from EFRAG's extensive case study that expected an impact, the reasons included:

(a) Potential excessive granularity in the level of aggregation for the valuation may lead to a reconsideration of the strategic positioning in some lines of business, e.g., increase in prices or dropping out from certain lines of business, which show a considerable volatility in results over time;

(b) Impact mainly on long-term products offered and in the role of insurers as institutional long-term investors due to volatility and complexity under IFRS 17; and

(c) For life business, current measurement of insurance liabilities will make the cost of long-term guarantees transparent and this will require more discipline in product design and pricing and may drive management action on onerous legacy books.

23 Furthermore, the EFRAG Secretariat notes that currently some entities may underwrite insurance contracts with a particular risk which are cross-subsidised with other insurance contracts. For example, insuring young drivers who are considered to be statistically riskier on the road compared to older drivers and so are more likely to make a claim. Under IFRS 17, entities are required to separate portfolios into onerous contract groups, groups of contracts that have no significant possibility of becoming onerous and a group of any remaining contracts. As a result, any gains/losses that may not have been apparent from the cross-subsidisation may become more visible and this may impact the products being offered to the policyholders.

24 For reinsurance, the following potential impacts due to IFRS 17 were raised by participants in EFRAG's extensive case study:

(a) For reinsurance held, since IFRS 17 measures the reinsurance contract held independently from the underlying contracts, primary insurers would not be able to demonstrate that they have reduced their risks on the statement of financial position. Therefore, these primary insurers might not see an economic benefit of reinsuring the business any longer and may use other risk mitigation methods instead in order to reduce their risk exposure;

(b) There may be a tendency to eliminate certain features from reinsurance contracts, e.g., fixed minimum compensation payments made by the reinsurer to the cedant. This commission is provided by the reinsurer to the cedant in exchange for a participation in all future profits and losses generated from the underlying portfolio. However, under IFRS 17, the reinsurer's share may shrink substantially due to the participation being based on expected premium volume less the fixed commission. As a consequence, the risk exposure of ceding enterprises may tend to increase.

25 Respondents from EFRAG's simplified case study were split as to whether IFRS 17 would affect product types being offered with slightly more respondents expecting this would not be the case. Respondents that expected a change noted, amongst others, there could be changes to the product design including changes to contractual conditions. Also, some types of contracts may be reduced or no longer be sold, e.g., products with discretionary participation features for savings and annuities and insurance cover to less favourable risk profiles.

26 Those respondents from EFRAG's simplified case study who stated that their product types are expected to change due to IFRS 17 provided reasons that include:

(a) the specific treatment of reinsurance held compared to assumed business and the mismatch between reinsurance contracts held and insurance contracts issued;

(b) the level of aggregation and identification of onerous contracts;

(c) product features would have to consider the contractual service margin and risk adjustment figures; and

(d) the significant operational impact and costs of IFRS 17.

27 Furthermore, some supervisory authorities that provided input to the [draft] economic study commissioned by EFRAG commented that most likely, new products with mixed features (e.g. insurance or service features) may be introduced and there may be more transparency in the way tariffs are calculated. This greater transparency may eliminate a number of redundancies in terms of reporting and costs associated with it (that could also lead to the shut-down of legacy systems) and probably lead to a more efficient way to run the business which eventually will absorb the short-term costs.

28 The above feedback indicates that entities may re-consider both their pricing methodologies and product offerings due to entities applying IFRS 17, the latter to a greater extent compared to the former. However, EFRAG does not have any quantification of the extent of changes to pricing or product design that would result. The EFRAG Secretariat also notes that decisions around product pricing and product design are driven by a range of economic, commercial and regulatory factors among which external financial reporting requirements appear to be play only a small part. Accordingly, while IFRS 17 could to some degree change or create accounting-related incentives to amend pricing in order to reduce the deliberate under-pricing of risks, and more generally to review product features that lead to higher accounting complexity, the EFRAG Secretariat does not expect any such changes to be pervasive or systemic.

29 Finally, as regards pricing, the EFRAG Secretariat also notes that any additional implementation costs arising from IFRS 17 will ultimately be borne by customers or shareholders.