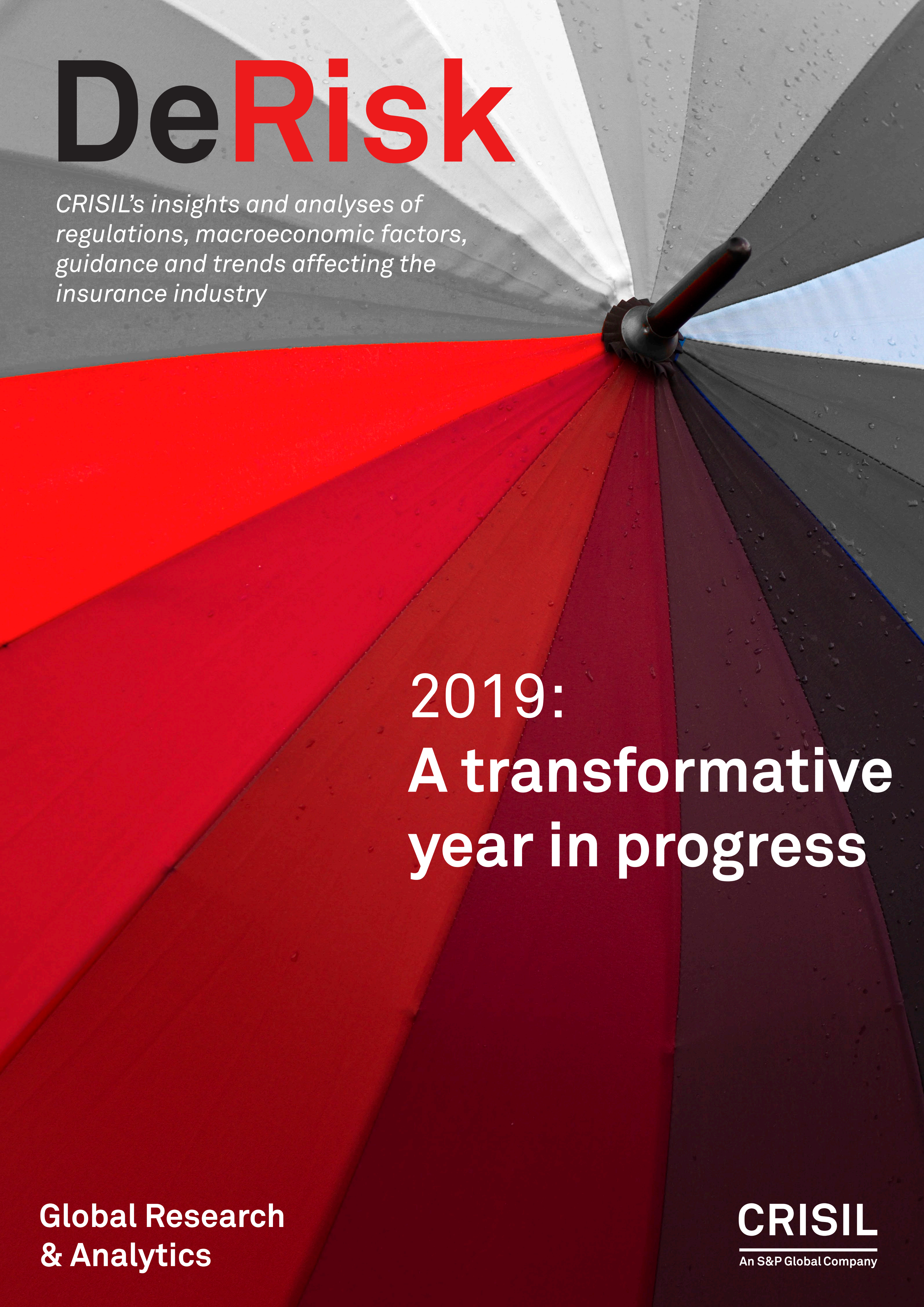

DeRisk

CRISIL's insights and analyses of regulations, macroeconomic factors, guidance and trends affecting the insurance industry

2019:
A transformative year in progress

Global Research
& Analytics

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2019: **A transformative year in progress**

All signs are that 2019 will be another challenging year for the insurance industry, especially given the recent accounting standard updates (ASUs) and regulatory trends. Globally, regulators are paying more attention to the original objectives of Solvency II and identifying areas for improvement in accounting and risk management.

The ongoing implementation of the International Accounting Standards Board's (IASB) IFRS 17 standard has given multinational insurers the opportunity to make structural changes to improve risk aggregation and integration across business functions, including actuarial and finance. The main operational issues with IFRS 17 implementation revolve around adopting an appropriate measurement methodology to calculate reserves, while aggregating risk and deploying data from different functions.

Although these regulatory and accounting changes have emanated from Europe, they are having an impact in other geographies, too, including the US.

In the US, the new ASU 2018-12 standard on long-duration contracts announced by the Financial and Accounting Standard Board (FASB) adopts a similar framework to IFRS 17 for measurement and modelling of deferred acquisition costs. This will spawn challenges, including of new processes, calculations, and analytics for finance and actuarial models, along with the inevitable issues around statutory reporting.

Finally, the trend in the insurance industry to move towards less liquid assets such as private equity, debt and alternative investments has necessitated more robust controls and frameworks to manage liquidity risk.

In that spirit, in March 2019, the UK's Prudential Regulation Authority (PRA) published consultation paper CP4/19 on liquidity risk management for insurers.

We expect this trend of sharper focus on liquidity risk to continue.

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IFRS 17

Concerns over underlying cost burden...

One of the most important objectives of IFRS 17, which replaced IFRS 4 in May 2017, is to include provisions for risk in a way that liabilities for future policyholder benefits are reported. The new effective adoption date for IFRS 17 implementation is January 1, 2022, which represents a one-year delay from the original date.

Given the scale and complexity of the changes required, the urgency to start implementation has been a topic of conversation worldwide, fuelled by concerns over the underlying cost of implementation for insurers.

We examine three of the major challenges below:

Data aggregation

IFRS 17 will have a major impact on the way data is collected, stored and analysed. It requires insurers to analyse data with sufficient granularity to identify and consistently segregate groups of contracts at the time of inception. The level of granularity of data will have a major impact on actuarial modelling and financial reporting systems. For example, historical interest rate data needs to be available for calculating the Contractual Service Margin.

Contract scrutiny

Based on our industry experience, we expect IFRS 17 implementation will be more complex for life insurance and reinsurance companies than for non-life insurers. That is because non-life companies will typically be able to apply the premium-allocation approach more widely than others. To understand the impact, insurers will need to review all existing contracts, their terms and conditions, and economic substance. For example, some with-profit contracts may fall under the variable fee approach, but others may be classified as indirect participating contracts and so require a building block approach.

Results communication

IFRS 17 introduces a number of changes to the language of insurance accounting. Companies will have to invest substantial time to educate and prepare their stakeholders for these changes. In particular, the income statement under IFRS 17 may be very different from what stakeholders are used to. For example, revenue will include items such as changes in the Contractual Service Margin and this will make comparisons with historical accounts difficult.

ASU 2018-12

...and US insurers will have to review cash flow assumptions

The ASU 2018-12 (on 'Targeted improvements to the accounting for long-duration contracts') is similar in spirit to IFRS 17, although it focusses only on long-duration contracts. It will significantly change how US insurers account for long-duration contracts, including how they measure, recognise and report their insurance liabilities and deferred acquisition costs.

The new standard applies to US insurance entities issuing long-duration contracts such as life insurance, long-term care, disability income, and annuities. The FASB has made these changes to provide timely and useful information to financial statement users. The intention is to simplify how insurers apply certain aspects of the accounting model for long-duration contracts. The effective adoption date is December 15, 2020, with early adoption permitted.

Under ASU 2018-12, insurers will need to make quarterly updates to the discount rate assumptions they use to measure liabilities for future policyholder benefits. They will also need to review cash flow assumptions (e.g, number of lapsed policies) at least annually and update where necessary.

The new standard will also affect how US insurers recognise and measure deferred acquisition costs (DAC) and requires embedded guarantees that meet the definition of market risk benefits to be measured at fair value. It applies to several products such as guaranteed minimum accumulation benefit and guaranteed minimum income benefit. Insurers will be required to make new disclosures including liability roll-forward and information about significant inputs, assumptions and methods used in measurement.

In our view, ASU 2018-12 introduces new reporting complexities and its effective implementation will require more integration between finance and actuarial processes, and data systems. Over the multi-year implementation process, insurers will need to integrate finance, risk, and actuarial systems to prepare for the new accounting standard. We list several specific challenges below.

Modelling challenges

- Creation of new processes, calculations and analytics for assumptions set at the time of policy inception, including modifications to existing libraries for actuarial models
- Creation of new actuarial valuation platforms for fair value calculations and updated DAC amortisation methods

Reporting challenges

- Enhancement of reporting systems to ensure additional data volume for increased disclosure and presentation requirements. For example, entities operating in multiple business lines will need to ensure that they have appropriate systems, internal controls, policies and procedures in place to collect and disclose the required information
- Reassessment of tax reporting in order to update tax control framework and governance strategy as a response to the wider finance function changes. The aim should be to have an accurate reporting period that includes deferred tax liabilities and tax-adjusted assets

- Updated account mapping of financial reports to new measurement models, including significantly increased disclosure requirements

IFRS 17 and ASU 2018-12

Global convergence of accounting standards begins

Our observations on FASB and IASB lead us to believe that an era of global convergence of accounting standards has started. Both boards are committed to increasing accounting transparency for insurers, specifically around treatment of contracts. As discussed above, the US FASB has taken the initiative to enforce consistency with some of the aspects of IFRS 17 in their ASU 2018-12 standard for long-duration contracts. We take a closer look at differences and similarities.

Diverging practices

In practice, ASU 2018-12 and IFRS 17 differ in several respects.

- ASU 2018-12 focuses on research and is rule-based, while IFRS 17 looks at overall patterns and is based on principles.
- ASU 2018-12 uses an entity based model, while IFRS 17 uses a contract-based model. For example, IFRS 17 standards apply to any entity that writes a contract that meets the definition of 'insurance' under IFRS 17.
- Under ASU 2018-12, no revaluation of fixed assets or intangible assets is permitted. By contrast, IFRS 17 allows use of a revaluation model for these assets.
- The classification of debts under ASU 2018-12 is divided into current liabilities and non-current liabilities. With IFRS 17, there is no such differentiation of liabilities as all debts are considered non-current on the balance sheet.
- Under ASU 2018-12, insurance contracts such as term-life or whole-life products do not need to be measured using updated assumptions about parameters such as the applicable discount rate, whereas updated assumptions are mandatory under IFRS 17.

Converging goals

Although no formal joint FASB-IASB projects are currently planned, the focus of both boards is to enhance communication between companies and users of financial statements such as investors and analysts. For example, both ASU 2018-12 and IFRS 17 share the following requirements:

- Enhanced and more granular disclosure requirements, compared to pre-existing disclosure requirements
- Income taxation based upon an estimated average annual effective tax rate
- Amortisation of intangible assets over their estimated useful lives
- Presentation of changes in shareholders' equity
- No requirements to present interim financial information
- Preparation of financial statements on the accrual basis of accounting, except in rare circumstances

Solvency II

Long reach set for beyond Europe...

Even while Solvency II was being drafted, European regulators and the insurance industry were advocating that many of its principles could be adopted by other regulatory bodies outside Europe. For example, global insurance standards can be seen within the Insurance Core Principles of the International Association of Insurance Supervisors.

Ongoing global trend

Many countries outside the EU, including Australia, Bermuda, Brazil, Canada, Japan, Mexico, Singapore and the US, are planning to adopt, or have already adopted, a risk capital requirement similar to Solvency II.

For example, the US-based National Association of Insurance Commissioners is specifically planning to ensure that the US regulatory framework is deemed 'equivalent' to Solvency II in Europe. Equivalence is important to the competitiveness of US insurers doing business in the EU. In particular, it is hoped to use this to avoid capital or collateral add-ons being imposed on US insurers as a result of them being domiciled outside Europe and regulated by a non-EU regulator.

Three areas of Solvency II require this evaluation of equivalence: solvency calculation, group supervision and reinsurance. The implementation of Solvency II and similar regulations such as Own Risk and Solvency Assessment (ORSA) globally will require a significant amount of work to bring about changes in management and organisational culture within insurers.

Equivalence avoids duplication and promotes open, international markets, while ensuring that policyholders are protected globally. The advantages are that EU insurers with business in a country with equivalence may use local rules to report on operations in that country, while an insurer from outside the EU may operate in the EU despite not being in full compliance with Solvency II.

Possible Brexit impact

The UK's pending exit from the EU (Brexit) will likely have an impact on the UK's relationship to Solvency II. A soft Brexit (i.e. the UK bound by EU regulations and tariffs) could involve the UK accepting Solvency II. By contrast, a hard Brexit (i.e. UK not bound by EU regulations and tariffs) would place the UK outside of Solvency II. If the UK stays within Solvency II, then, because they would not be consulted, there is the risk that it could be changed in a way that is unfavorable to the UK. For example, EU member-states could resolve to remove the matching adjustment within Solvency II.

A key goal of a soft Brexit would be to retain both passporting and equivalence. Passporting allows insurance business to be written by an insurer in another member-state and mostly benefits reinsurers and non-life companies. For life insurance groups, the normal practice is to operate a life company within the state where the business is written. Hence, UK insurers will typically already have an EU registered presence that enables them to write European business.

Liquidity risk

...and focus on liquidity risk to increase

Over the past five years, there has been minimal development in terms of how insurers identify and mitigate liquidity risk. However, there is evidence of increasing liquidity risk in the industry with no corresponding methodological approach to mitigate it. This situation stands in contrast with the banking industry, in which we have observed strong development of methods, limits and holistic policies to help understand and mitigate exposures. However, traditional liquidity risk appetite in insurance is likely to change and adapt in line with demanding requirements from new regulations.

Many sources of liquidity risk for insurers

We have observed an increased tendency by the insurance industry to invest in alternative assets such as private equity, debt, solar, wind and infrastructure due to a prolonged low interest rate environment. These investments are a potential source of liquidity risk, along with other risks such as liability, concentration, off-balance-sheet, funding, cross-currency, intra-day and franchise risks. Typically, such risks arise for investments in alternative assets due to the reduced ability to monetise or collateralise these less tangible investments. In our view, liquidity risk often receives lower attention from insurers than banks because, unlike banks, insurers receive cash flows in the form of premiums that precede cash flow payments upon the occurrence of an insured event. This is often termed as the 'inverted production cycle'.

Due to this inverted productive cycle, greater financial control is necessary for insurers. Supervisory authorities are now sharply focused on financial solvency of insurance companies, to protect policyholders and other stakeholders. The PRA's consultation paper CP4/19 requested insurers to provide an opinion on diverse practices related to liquidity risk. This move has been made because, in PRA's view, regular inflow of liquidity through premiums may cause insurers to consider liquidity risk as a 'second order concern and to potentially underestimate, or fail to recognise, the risks to a positive liquidity position in times of market stress'.

The PRA is concerned about liquidity insufficiency in the context of safety and soundness objectives. While insurers benefit from an inverted production cycle, they are not immune to liquidity risk. Insurers have experienced financial distress or failed in other jurisdictions because of liquidity concerns, during times when access to wholesale funding became reduced. One of the most notable examples was AIG, the US insurer that required a 2-year, $85 billion bailout during the 2008 Global Financial Crisis because of liquidity issues.

We anticipate the focus on liquidity risk by regulators will increase further. In addition, structural changes appear to have reduced liquidity in some markets. This may potentially exacerbate market volatility if certain assets are downgraded during broader market stress. Increased numbers of insurers holding material derivatives positions may also generate systemic liquidity risk. Even insurers using derivative contracts to hedge market risk in their insurance assets may face unexpected liquidity demands, if the value of the derivative moves unfavourably.

In our view, insurers should proactively review their ORSA reports along with their liquidity risk management framework, material sources of liquidity risk, liquidity risk stress-testing results, liquidity buffers, liquidity risk monitoring, and liquidity contingency plans.

Where do you stand?

Navigating your transformation

We are active insurance industry participants in industry research and thought leadership and produce regular reports highlighting topical issues within the insurance industry. Our teams of market risk experts, actuaries, quantitative analysts and SMEs are engaging with insurers to provide them with the best possible regulatory and insurance-related solutions, including actuarial modelling and statutory reporting.

...CRISIL can provide comprehensive support to you

Our offerings to Insurance firms

- Business Transformation
- MRM
- Fraud and Analytics
- Insurance Operations

Our key services include:

- Model Risk Management
- Actuarial modelling
- Data management and analytics services
- Implementation of new regulations
- Asset allocation and strategy research
- Fixed-income research
- Counterparty Risk
- Portfolio analytics
- Insurance operations and operational risk
- Statutory & tax, reporting & analytics
- Fraud reporting and analytics
- Financial crime and compliance

Insurers have a long road ahead to transform themselves by riding the current wave and CRISIL is well-poised to become a vital partner in the journey.

We at CRISIL have been proactive in collaborating with financial institutions to help them create successful analytics and technology strategies. We are strategically placed to work closely with the insurance industry in the transformation which lies ahead.

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It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.
It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

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CRISIL Global Research & Analytics (GR&A) is the world's largest and top-ranked provider of high-end research, risk and analytics services. We are the world's largest provider of equity and fixed-income research support to banks and buy-side firms. We are also the foremost provider of end-to-end risk and analytics services that include quantitative support, front and middle office support, and regulatory and business process change management support to trading, risk management, regulatory and CFO functions at world's leading financial institutions. We also provide extensive support to banks in financial crime and compliance analytics. We are leaders in research support, and risk and analytics support, providing it to more than 75 global banks, 50 buy-side firms covering hedge funds, private equity, and asset management firms. Our research support enables coverage of over 3,300 stocks and 3,400 corporates and financial institutions globally. We support more than 15 bank holding companies in their regulatory requirements and submissions. We operate from 7 research centers in Argentina, China, India, and Poland, and across several time zones and languages.

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