IFRS 17 Benchmarking Survey

Q3

2022

insight | life solutions

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1.

Executive Summary

1. Executive Summary

Insight Life Solutions conducted a series of five surveys in Q3 2022 to seek South African life insurers' views on specific IFRS 17 topics. The surveys aimed to summarise the progress made to date on IFRS 17 implementation and industry thinking on topics where the Standard allows discretion.

A total of 11 entities, mostly life insurers and bancassurers, participated in the series, with between 6 and 10 respondents responding to each survey.

It is hoped that readers will use the results to benchmark their approach against the rest of the market, as well as against their own future decisions as implementation draws nearer, discussion around these topics settles, and industry consensus is reached.

This report sets out the survey responses. In summary:

Progress

For most topics, respondents were generally between considering an approach/ producing indicative numbers and finalising an approach internally. All respondents had made a start on each of the topics, with transition being the only area where some respondents were still discussing an approach internally. These respondents generally have a June financial year-end, which means that their implementation date is 6 months later than those with a December year-end, potentially explaining the slower progress.

The reinsurance survey had fewer respondents than other surveys, which is a reflection of the uncertainty still felt in this regard. Those who did respond tend to be relatively advanced compared to the rest of the market, so the apparent good progress reflected in the survey responses may not necessarily be representative of the market as a whole.

Transition (10 respondents)

Progress appears slower regarding transition than for other topics, with 60% of respondents not having finalised an approach internally or completed a dry run. Progress tends to be correlated with financial year end: those with a December year-end (i.e. transitioning on 31 December 2023) are further ahead than those transitioning later. Most respondents are using a combination of all three transition approaches, with internal consistency around the earliest year of application of the full retrospective approach across product lines, usually indicating a model or system change that makes acquiring historic information beyond that point impracticable.

Risk Adjustment (8 respondents)

A combination of approaches is likely to be implemented across the industry, with value at risk, margins for adverse deviations and cost of capital approaches all being popular. These selections were largely informed either by their ease of calculation or their similarity of existing processes, which indicates a desire for pragmatism in this regard. The most popular targeted confidence level is 85%, with some respondents going as low as 75% and others as high as 96%.

Discount Rates (8 respondents)

The bottom-up approach is more popular than the top-down approach to calculating discount rates, with most respondents assuming illiquidity premiums of zero. Interestingly, most respondents plan to use the start of period yield curves as their locked in yield curves rather than a weighted average. Operational simplicity seems to be the driving factor for this decision. Most respondents plan to lock in inflation rates, even those that may not be directly linked to an observable index (e.g. expense inflation).

Grouping and Level of Aggregation (9 respondents)

All respondents plan to use annual cohorts for most of their product lines and all respondents indicated that their IFRS 17 cohorts align with their financial year. Most respondents plan to have three profitability groups per cohort, with stress and scenario testing being the most popular method for determining which contracts have no significant possibility of becoming onerous.

Reinsurance (6 respondents)

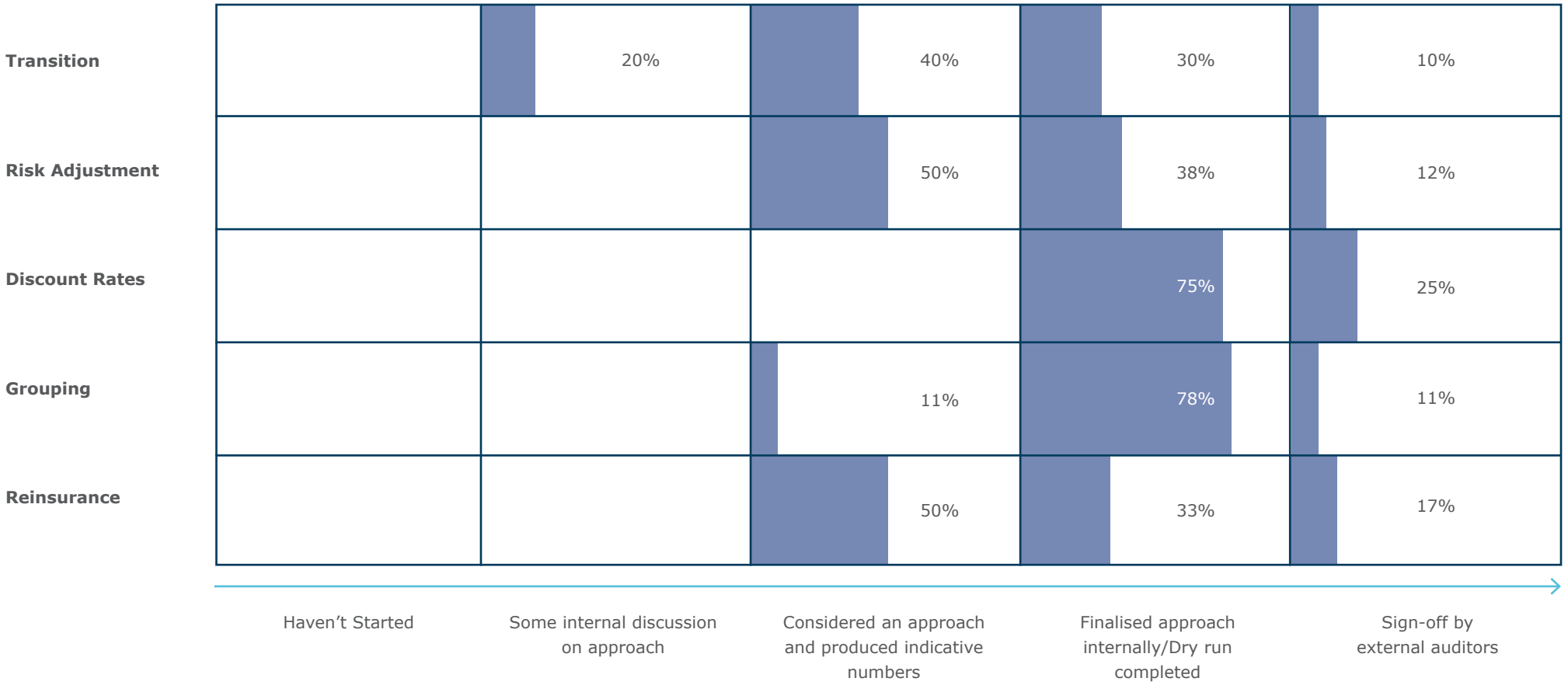
The number of respondents to this survey was lower than for the other surveys (6 respondents). Conversations with industry players revealed that the reason for this was the uncertainty still felt by many insurers regarding this topic. Those who responded, therefore, probably represent the segment of the market that is more advanced in its progress relating to reinsurance. Of the insurers who did respond, none expect major changes to their reinsurance arrangements. Where changes are foreseen, they are relatively minor, and relate to the updating of treaty terms to better align the grouping and contract boundaries of insurance and reinsurance contracts. All respondents are calculating the risk adjustment for reinsurance as the difference between the gross and net risk adjustments. Most respondents are experiencing modelling challenges in relation to measuring the loss-recovery component.

2.

Progress

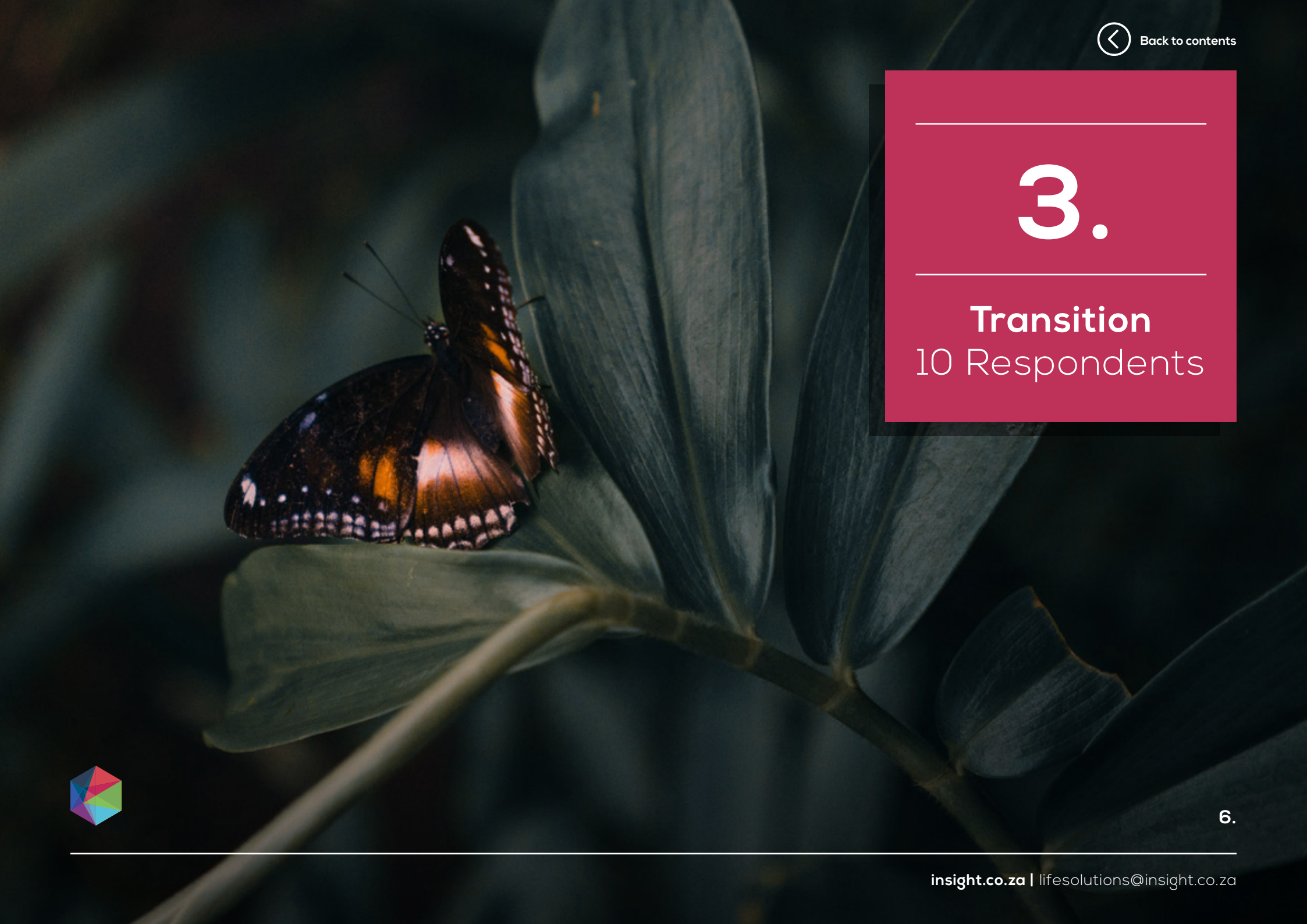
2. Progress

In every survey, respondents were asked to describe their progress regarding that topic.
The blocks in each row below represent the proportion of respondents at the various stages of maturity.



3.

Transition
10 Respondents

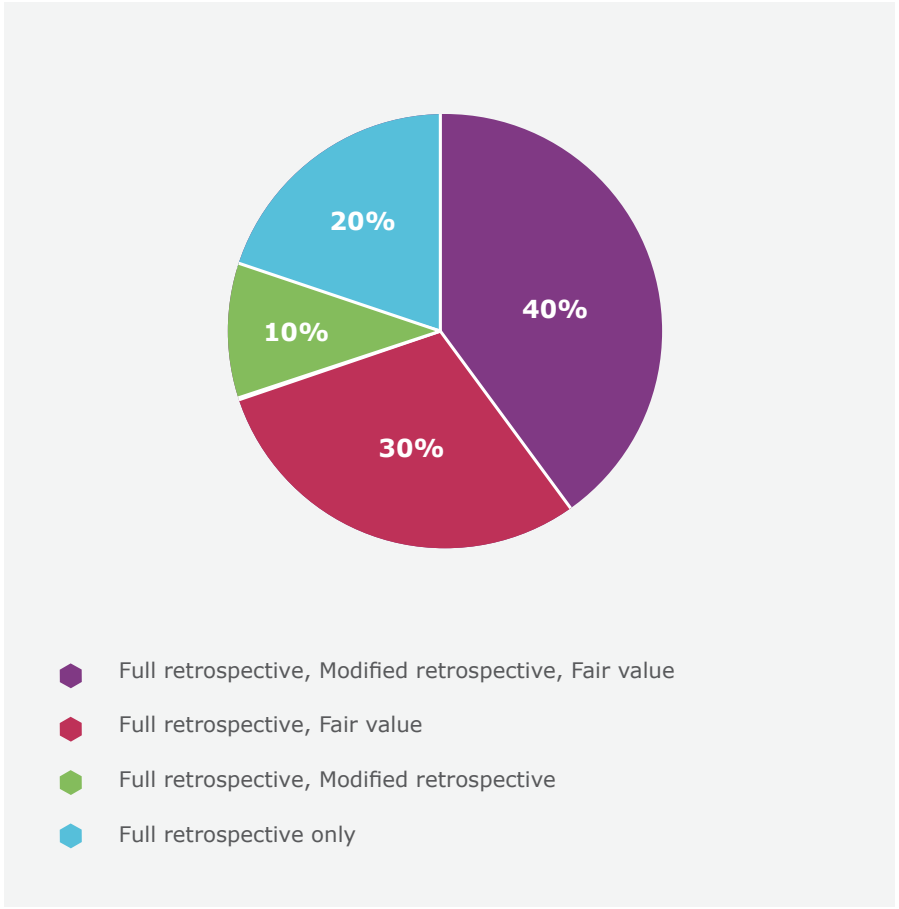


3. Transition

Application of Approaches

Most respondents are using a combination of approaches, with 40% using all three (full retrospective, modified retrospective and fair value), 30% using full retrospective and fair value and 10% using full retrospective and modified retrospective.

Twenty per cent (20%) of respondents are applying the full retrospective approach only.



Earliest Years of Application of Each Approach

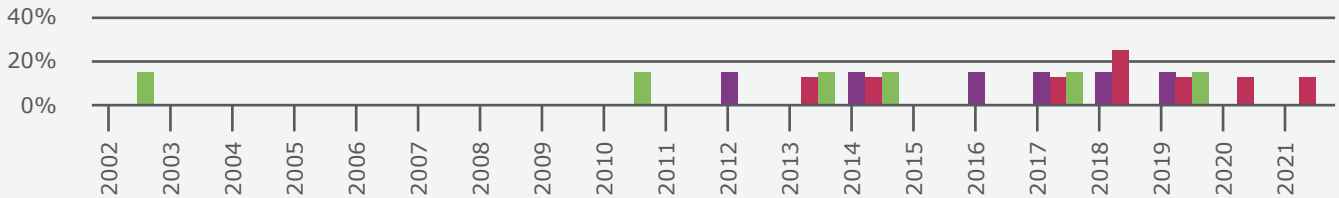
Q What is the earliest year from which you are applying each transition approach?

The graphs show the earliest year of initial recognition of the most common product types (credit life, funeral and whole of life) at which each transition approach applies.

Almost all respondents showed internal consistency across their product types in terms of the earliest year of inception to which the full retrospective approach is being applied. For a given insurer, for example, full retrospective may be applied for credit life, whole of life, funeral and other product types for IFRS 17 groups recognised from 2017 onwards. This may indicate a change in models, systems or processes in that year that have enabled access to historic data and assumptions from that year onwards.

There was more variability in the starting dates of the modified retrospective and fair value approaches.

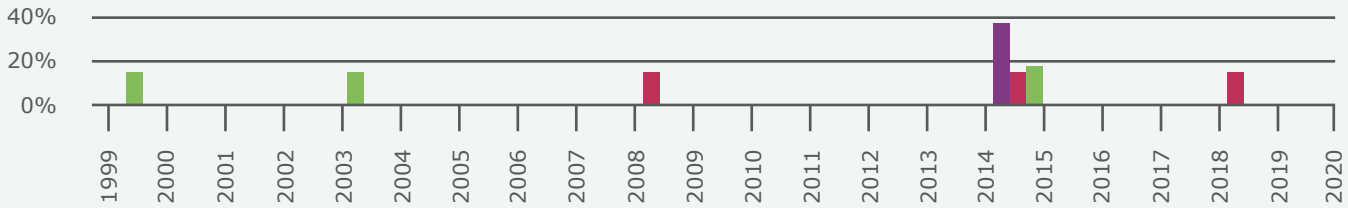
EARLIEST YEAR APPLIED: FULL RETROSPECTIVE



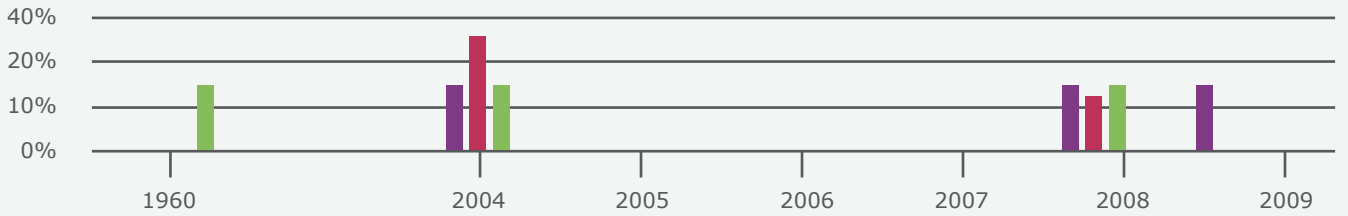
Credit Life Funeral Whole of Life

EARLIEST YEAR APPLIED: MODIFIED RETROSPECTIVE

Credit Life Funeral Whole of Life



EARLIEST YEAR APPLIED: FAIR VALUE



The values in these graphs are expressed as a percentage of those respondents that offer the respective products:

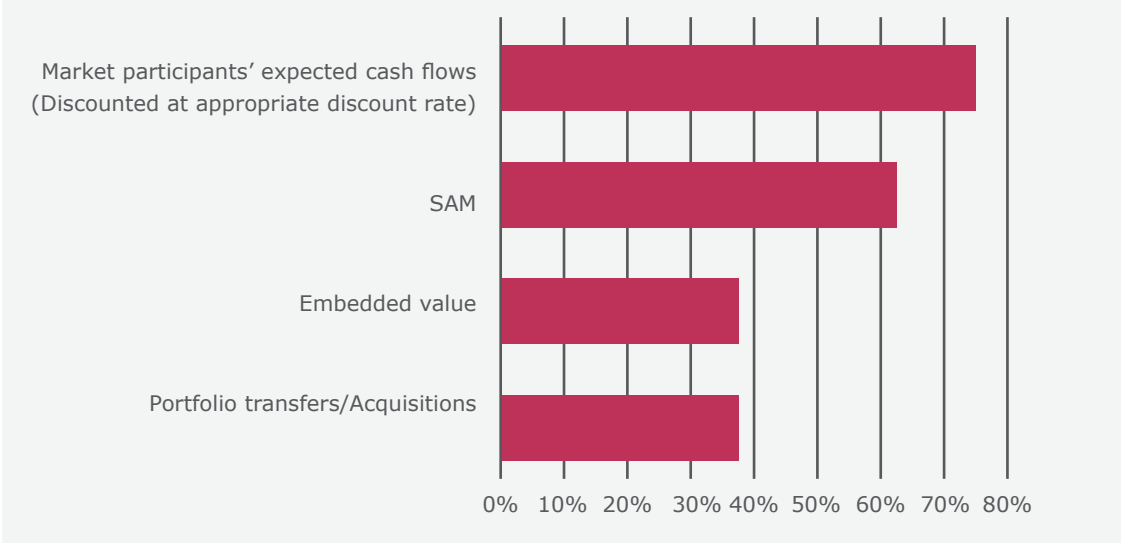
Credit Life: 7
Funeral: 8
Whole of Life: 7

Fair Value Methodology

Q **For those liabilities to which you are applying the fair value approach, which methodology are you using to calculate the fair value?**

The respondents employing the fair value approach tend to prefer a methodology that leverages existing measures of economic value (i.e. SAM and Embedded Value) or is based on present value techniques (market participants' expected cash flows). Some are able to use observable market data to arrive at a fair value (portfolio transfers/acquisitions).

FAIR VALUE METHODOLOGY CHOICE

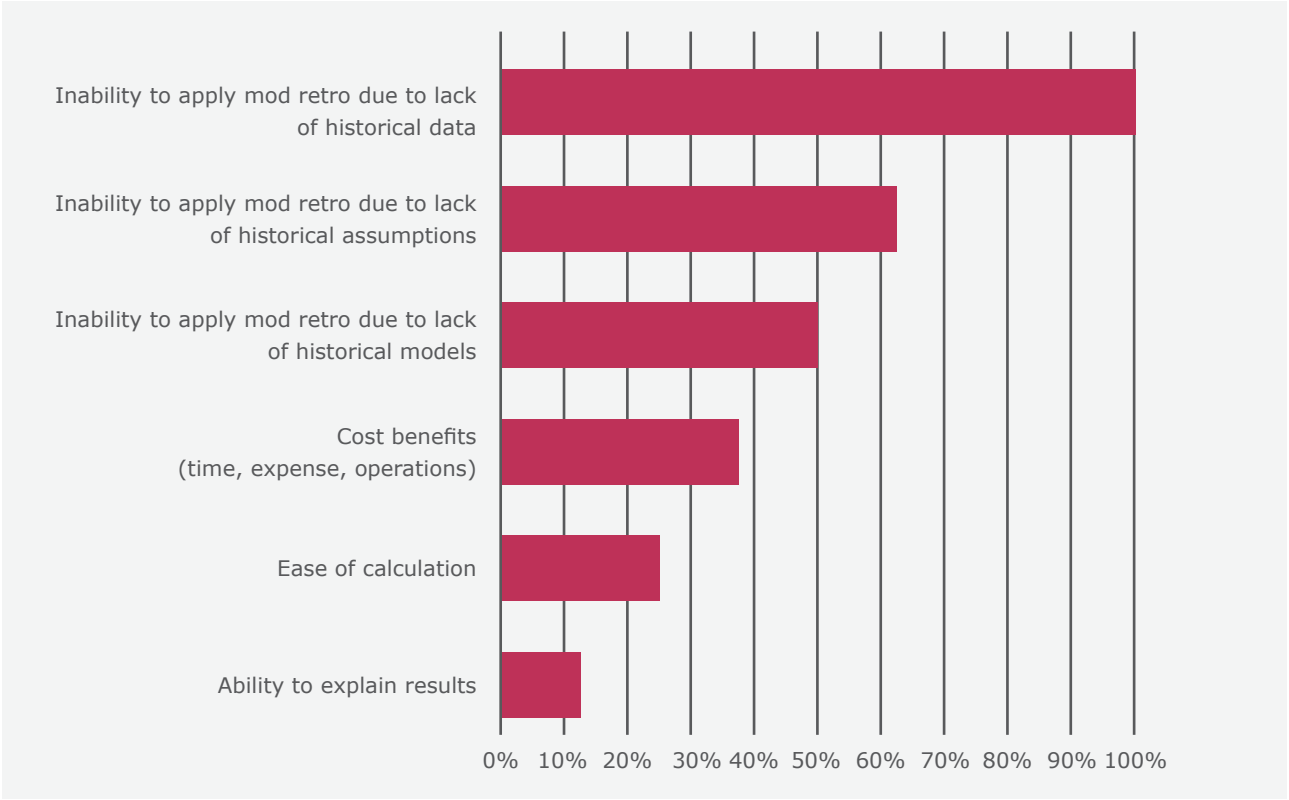


The values in this graph are expressed as a percentage of those respondents (8 in total) applying the fair value approach to at least one of their portfolios.

Fair Value Rationale

Q **For those liabilities to which you are applying the fair value approach, which factors determined your decision to use fair value rather than modified retrospective?**

REASONS FOR APPLYING THE FAIR VALUE APPROACH



All respondents cite either lack of historical data or assumptions (or both) as reasons for applying the fair value approach, which indicates that this approach will mostly likely be used by default rather than by choice.

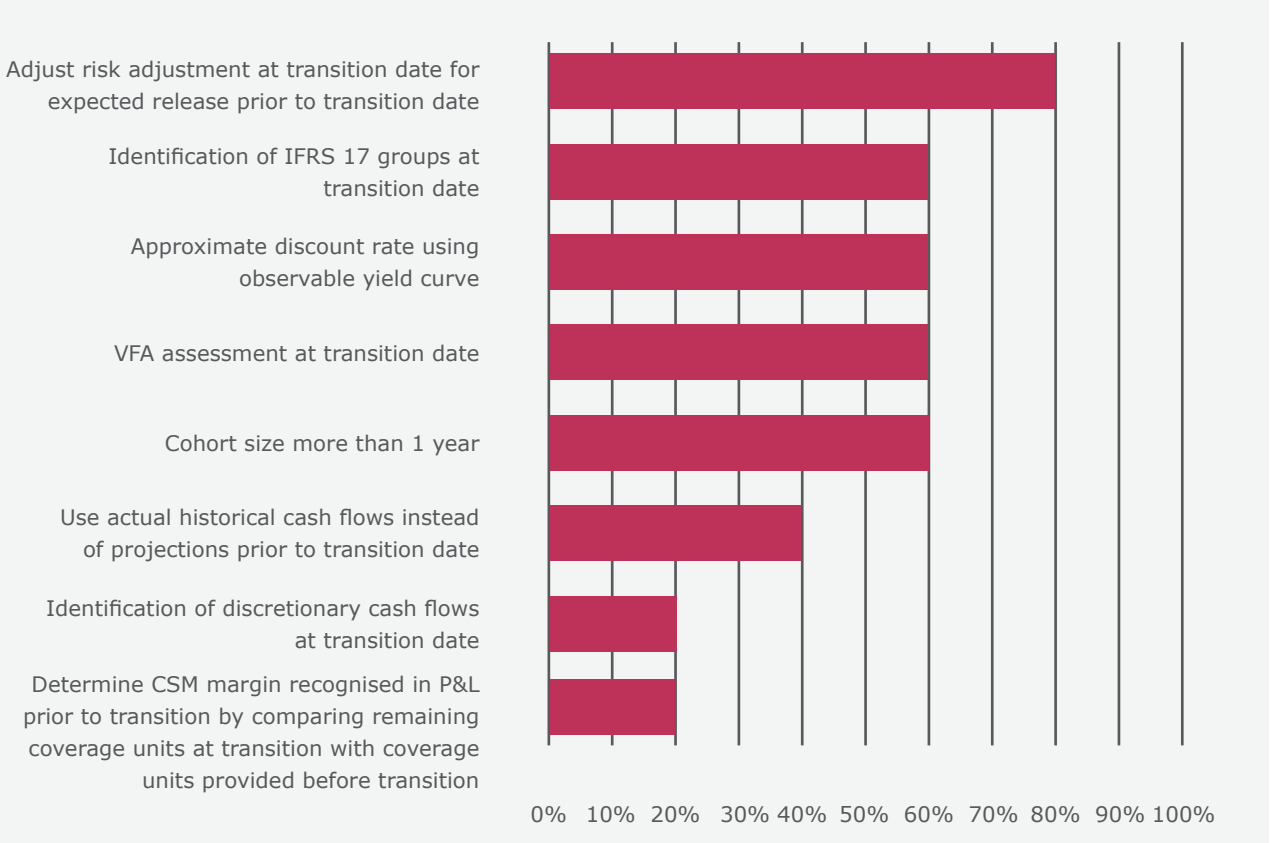
Some respondents, however, are realising other benefits from using this method, e.g. lower costs, ease of calculation and ability to explain results.

The values in this graph are expressed as a percentage of those respondents (8 in total) applying the fair value approach to at least one of their portfolios.

Modified Retrospective Approach: Modifications Used

Q **For those liabilities to which you are applying the modified retrospective approach, which modification(s) are you using most extensively?**

MODIFICATIONS USED



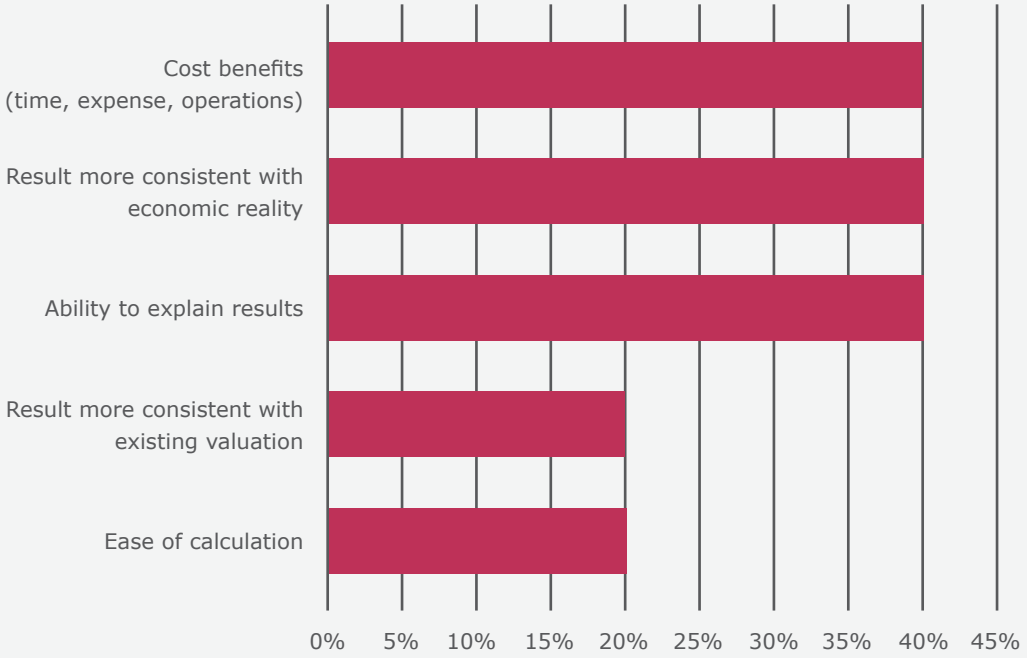
Respondents are mostly making use of modifications which allow assessments that would have been made at the date of inception or initial recognition to be determined instead at the transition date.

The values in this graph are expressed as a percentage of those respondents (5 in total) applying the modified retrospective value approach to at least one of their portfolios.

Modified Retrospective Approach Rationale

Q **For those liabilities to which you are applying the modified retrospective approach, which factors determined your decision to use modified retrospective rather than fair value?**

REASONS FOR ADOPTING A MODIFIED RETROSPECTIVE APPROACH



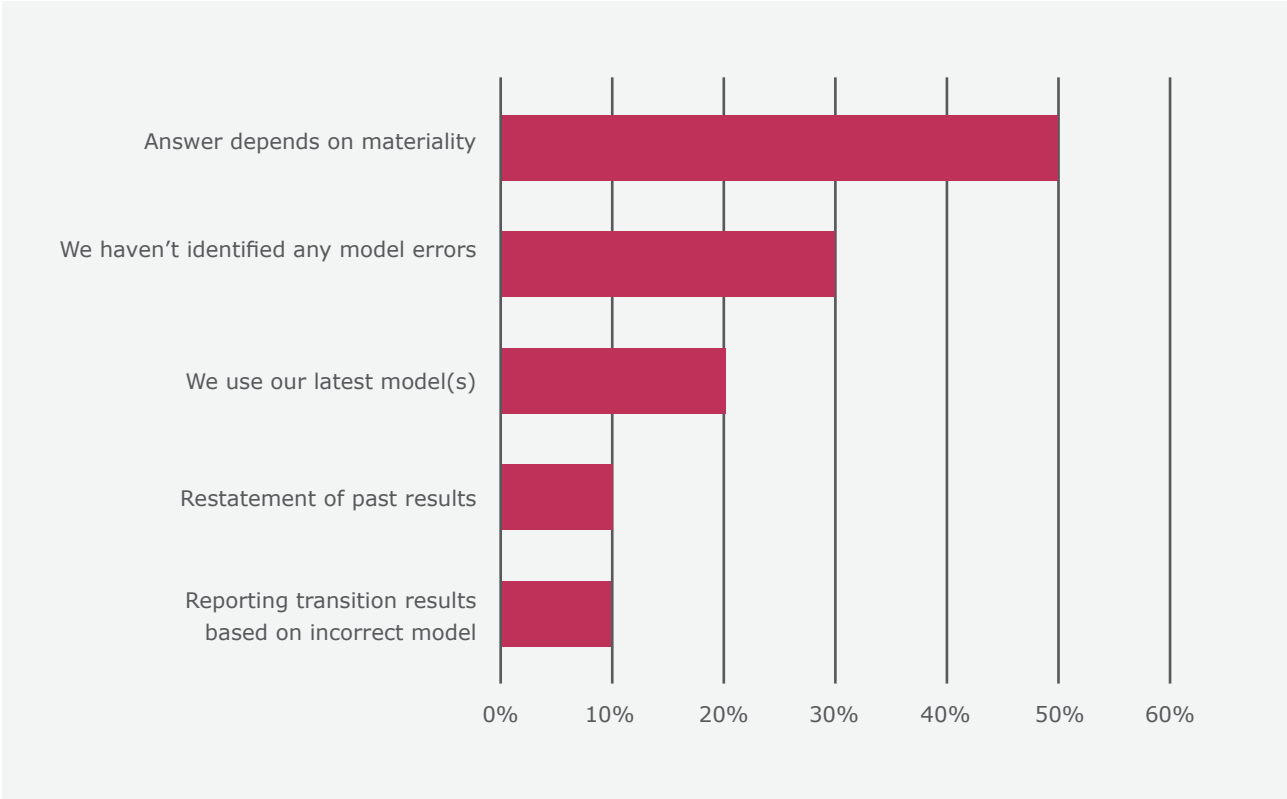
Those respondents who have selected the modified retrospective approach for certain portfolios mostly cite lower costs, consistency with economic reality and ability to explain results as the reasons for their selection.

The values in this graph are expressed as a percentage of those respondents (5 in total) applying the modified retrospective value approach to at least one of their portfolios.

Treatment of Model Errors

Q How are you dealing with model errors identified when applying the full retrospective approach?

TREATMENT OF MODEL ERRORS



Par 42 IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors requires that, to the extent that it is practicable, "an entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by… restating the comparative amounts for the prior period(s) presented in which the error occurred."

Responses to this question suggest that past results of all affected prior periods will only be restated in cases where material errors are found.

Some respondents are using their latest models to perform their historic calculations, which would imply that no model errors would be identified for these entities and, hence, no need for restatement.

4.

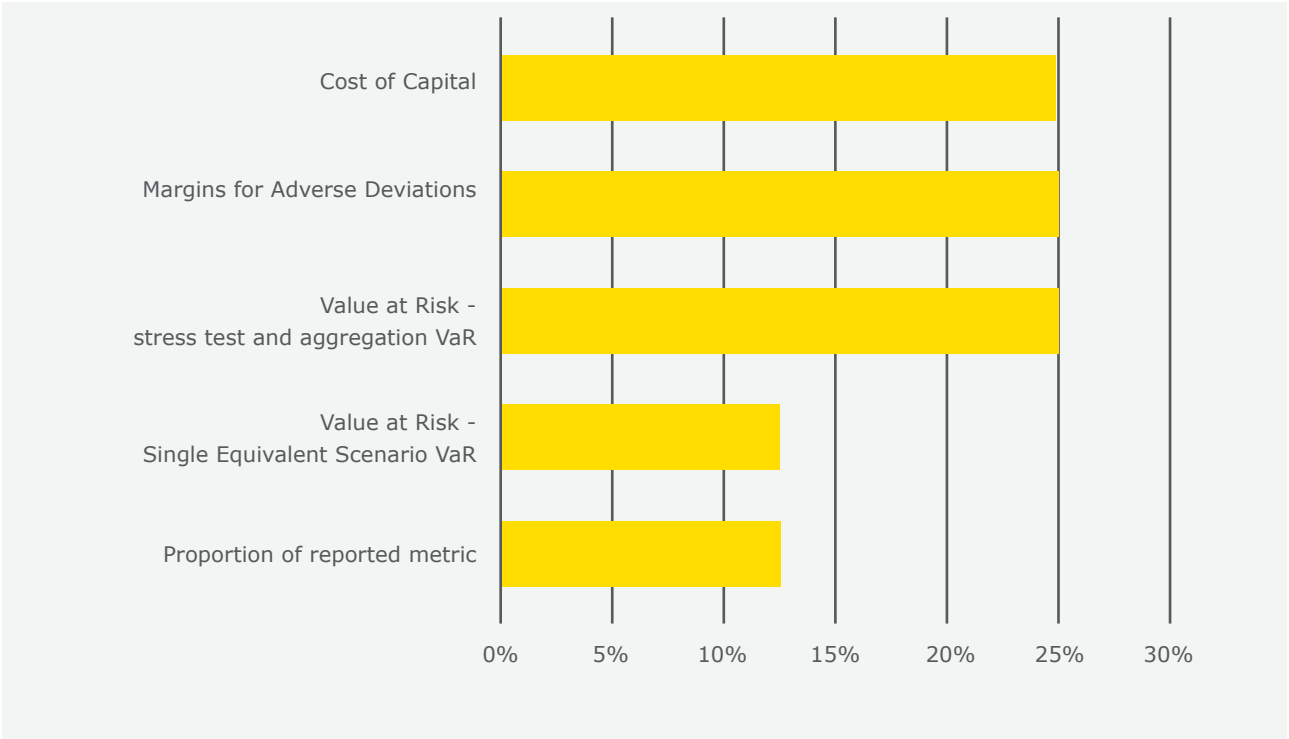
Risk Adjustment
8 Respondents

4. Risk Adjustment

Methodology

Q **Which methodology do you plan to use for the risk adjustment calculation?**

RISK ADJUSTMENT CALCULATION METHODOLOGY



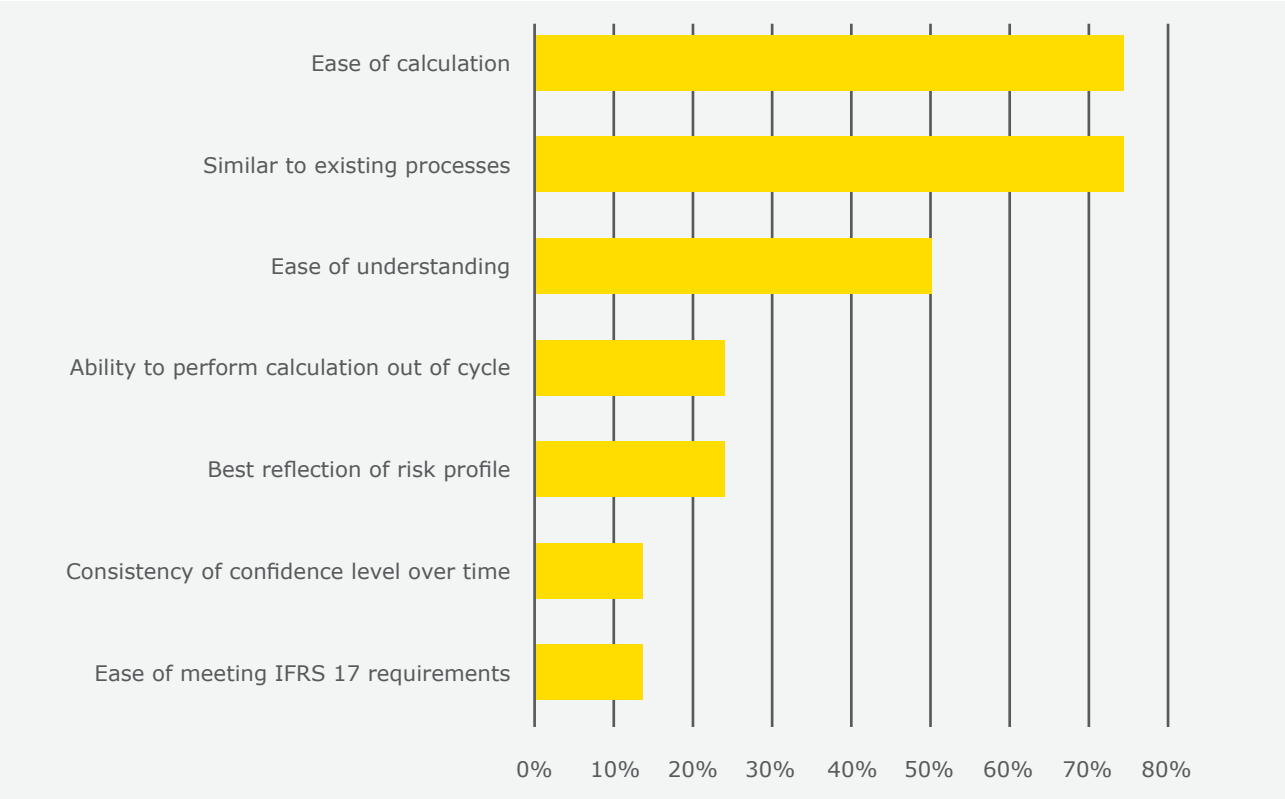
Responses were fairly evenly spread amongst respondents, with cost of capital, margins for adverse deviations and value at risk all being popular methodology choices.

There were not any obvious trends linking methodology choice to progress to date, so final methodology choices may be rather varied at implementation date.

Methodology Rationale

Q **Why did you select this method?**

RISK ADJUSTMENT METHODOLOGY RATIONALE



Almost all respondents cited either ease of calculation or similarity to existing processes (or both) as reasons for selecting their respective methodologies. This was followed by "ease of understanding", all of which indicate the desire for pragmatism in implementing IFRS 17.

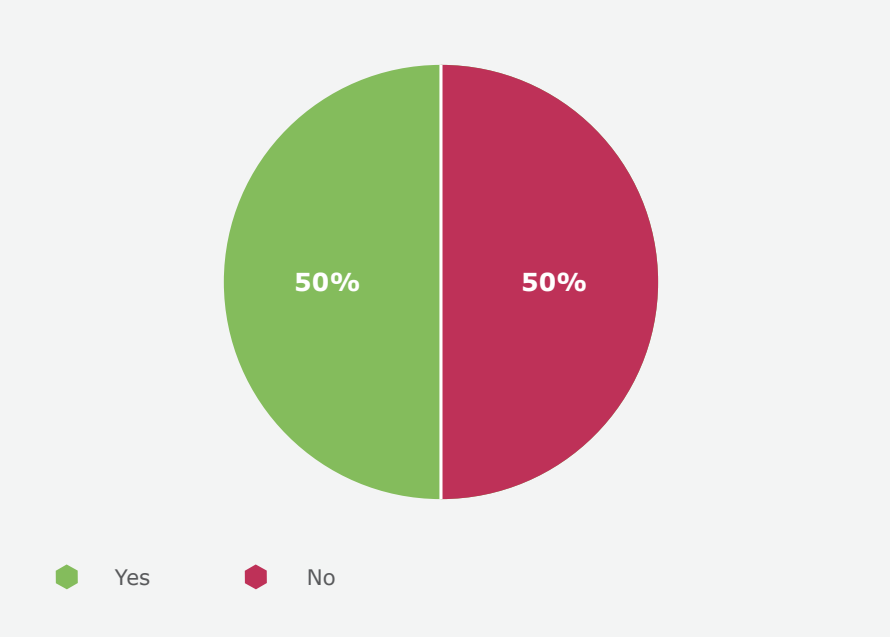
Implementation versus Calibration

Q **Is your implementation the same as your calibration method?**

This could refer, for example, to insurers calibrating their risk adjustment using a cost of capital approach but then using a simpler proxy (which provides similar results) to implement and report on it.

Half of the respondents are implementing their risk adjustment using a different method from their calibration method, e.g. calibrating margins for adverse deviation so as to approximate a stressed and aggregated VaR.

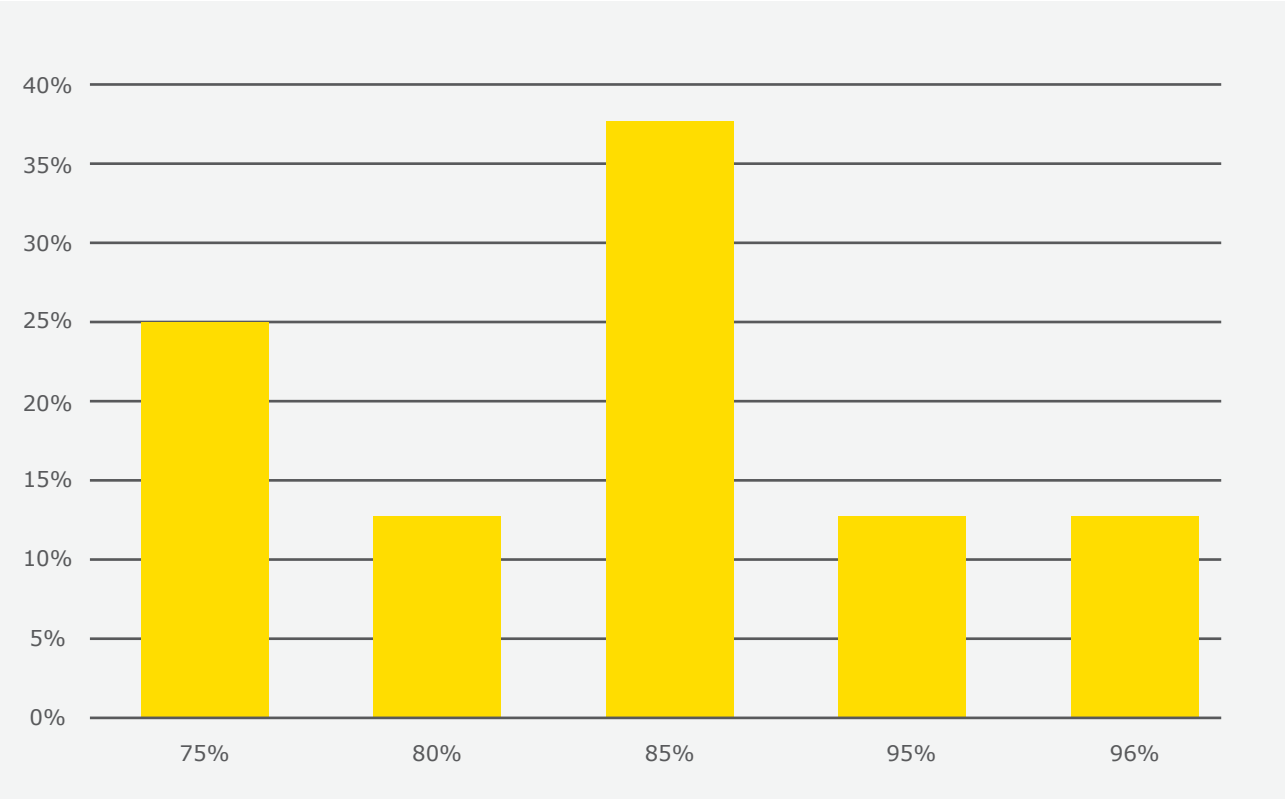
IMPLEMENTATION SAME AS CALIBRATION?



Targeted Confidence Level

Q **At what confidence level does you company expect to set the risk adjustment? If you are not using VaR, what is the equivalent confidence level that will be disclosed?**

TARGETED CONFIDENCE LEVEL



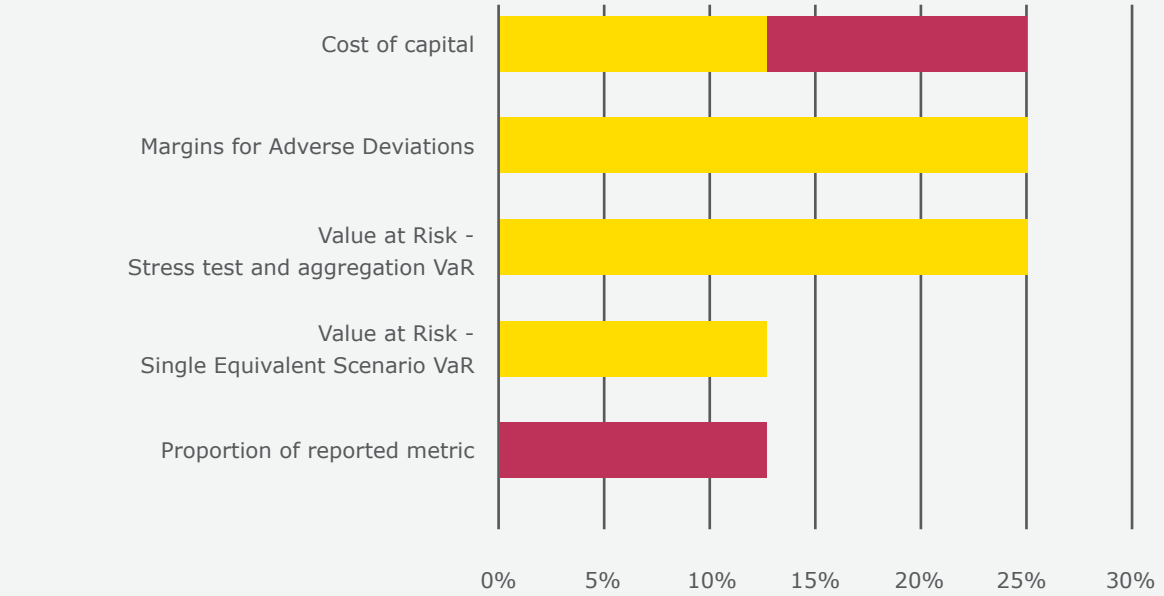
All respondents are disclosing confidence levels at an entity level rather than differentiating by line of business or type of reserve. Just under 40% of the respondents (three of the eight) are targeting an 85% confidence level, with the remainder spread from 75% to 96%.

All but two respondents plan to disclose the same confidence level at group- and entity-level. One will target a range at group level (80-90% rather than the 85% point estimate) and one is undecided.

Order of Calculation

Q **In your risk margin calculation, are you setting a confidence level and then calculating a risk adjustment at that level of confidence, or are you first calculating the risk adjustment and then deriving the implied confidence level?**

ORDER OF CONFIDENCE LEVEL SETTING AND RISK ADJUSTMENT CALCULATION



Unsurprisingly, the order of calculation mostly corresponded to the methodology selected, with respondents using a VaR or MfAD approach first setting a confidence level and then calculating their risk adjustment accordingly.

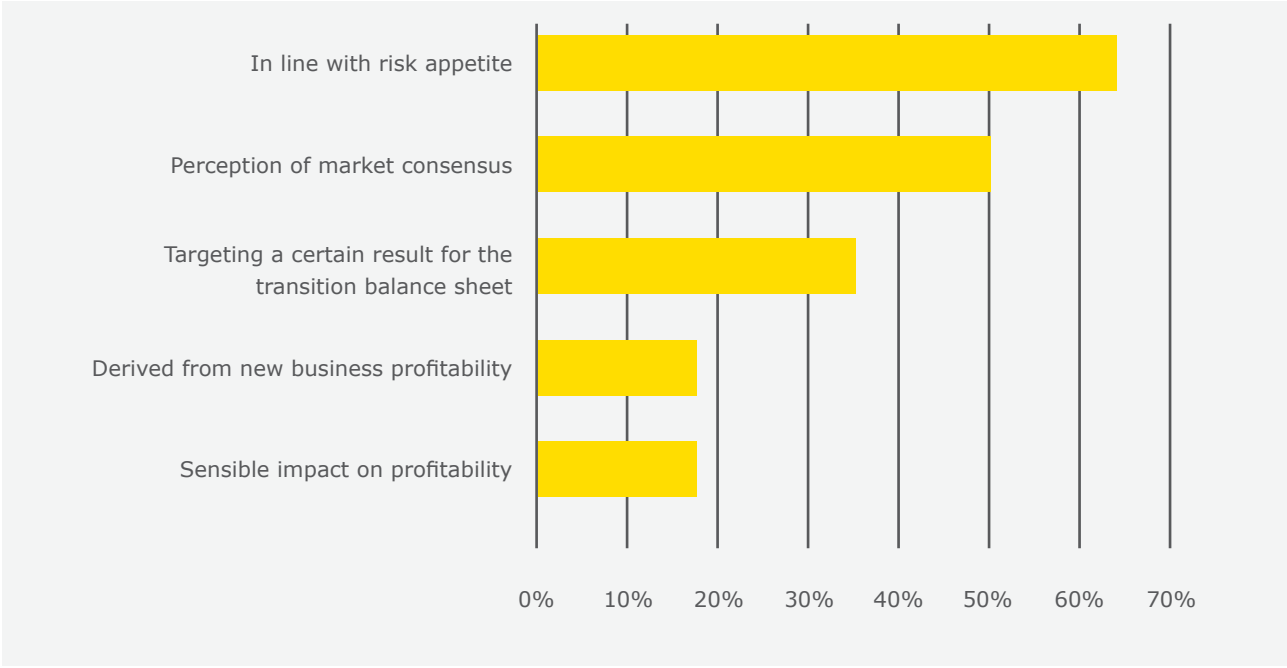
Those respondents using a cost of capital or proportional approach generally calculate the risk adjustment first and then determine the implied confidence level.

The respondent who is doing CoC but setting confidence level first is back-solving for the required margins.

Confidence Level Rationale

Q **If you are first setting the confidence level, why did you select that confidence level?**

CONFIDENCE LEVEL RATIONALE



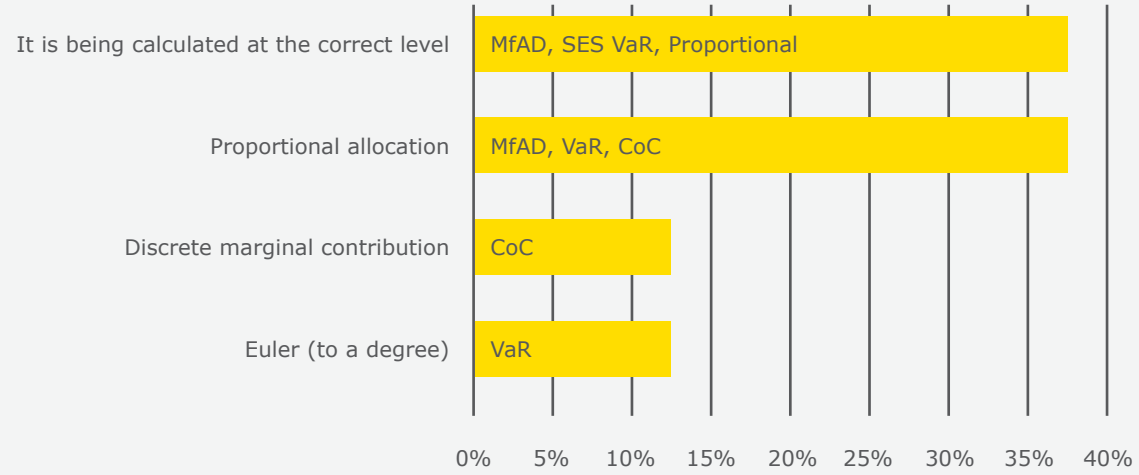
Confidence levels are mostly being set in line with respondents' risk appetites.

Half of the respondents indicated that their targeted confidence level was at least partly based on their perception of market consensus, suggesting that entities want to avoid being seen as outliers in this respect.

Allocation Approach

Q **How are you allocating your risk adjustment to the required level of granularity (e.g. to individual contract level or IFRS 17 group level)?**

ALLOCATION METHODOLOGY



Most of the respondents either plan to calculate their risk adjustment at the correct level or use some kind of simple, proportional allocation.

The text in the graph shows the corresponding risk adjustment calculation methodologies for each allocation approach.

5.

Discount Rates
8 Respondents

5. Discount Rates

Approach

Six of the eight respondents are exclusively, or almost exclusively, employing the bottom-up approach to determine discount rates (one is using it for all but with-profits business).

Of the remaining two respondents, one is exclusively using the top-down approach, while the other is using it for all but their unit-linked business.

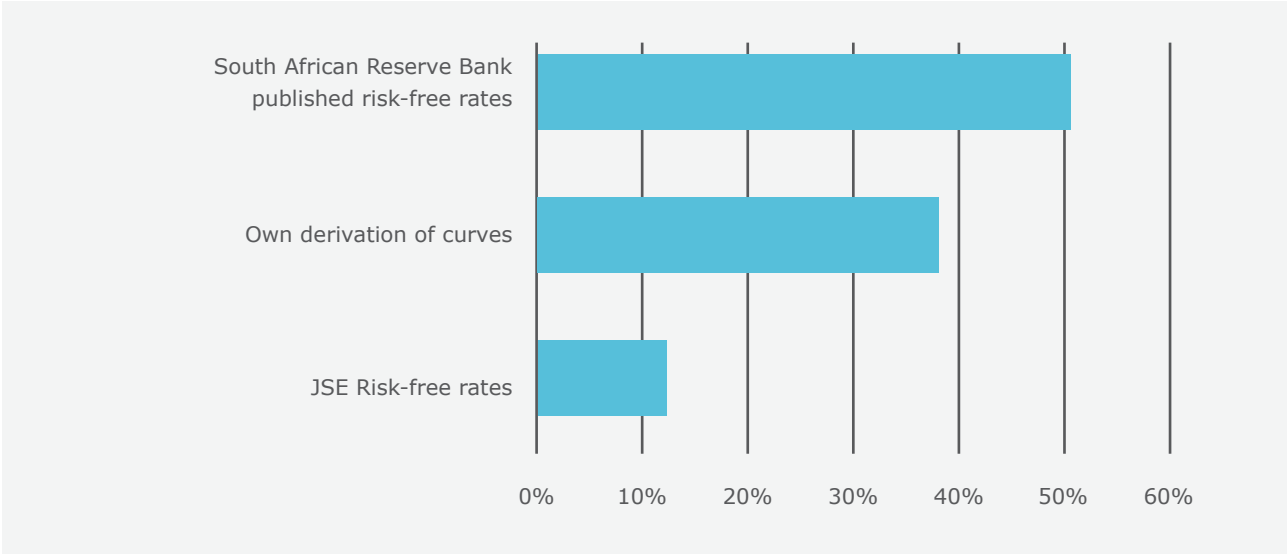
Of the two organisations applying the top-down approach extensively, one is using market-based methods to remove credit risk components and the other is using structural modelling techniques (e.g. Merton, Kealhoffer-Vasicek or similar).

Both of the organisations applying the top-down approach extensively are defining their yield curves based on actual portfolios.

Risk-free Rate Source

Q **For your bottom-up portfolios, what will your benchmark be for the risk-free curve underlying the discount curve?**

RISK-FREE CURVE SOURCE



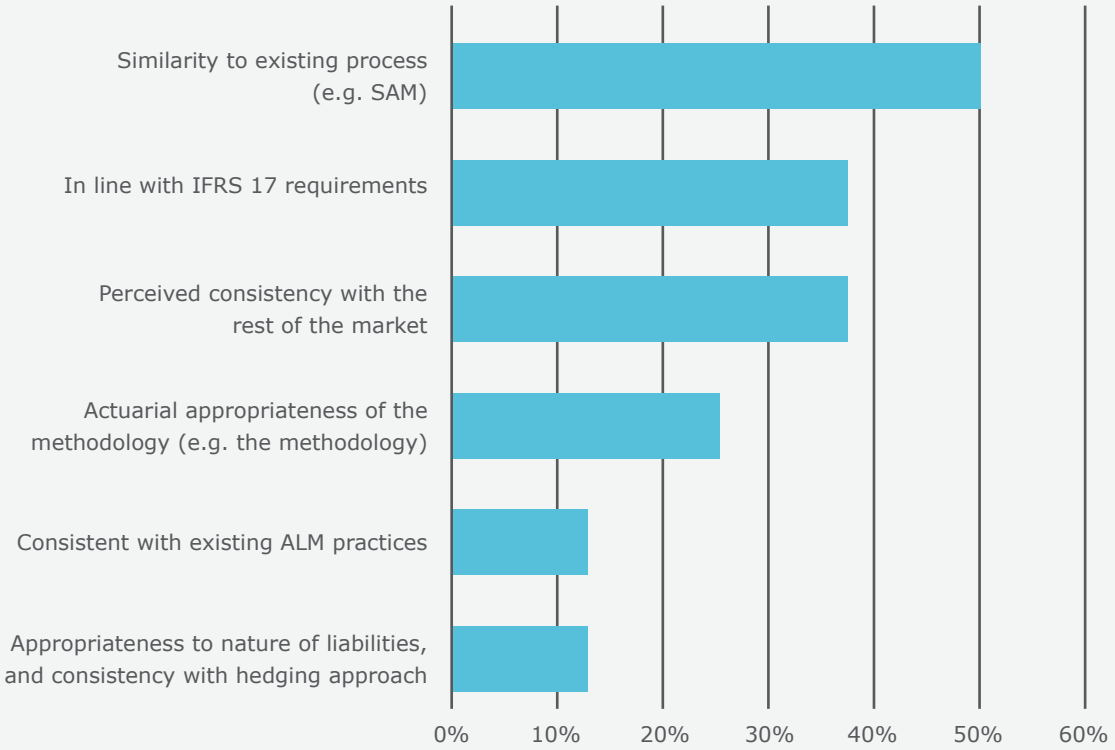
Half of the respondents are using the SARB published risk-free rates.

One of the three respondents who is deriving their own curves said that for products with cash flows that vary with the underlying assets e.g. unit-linked), they plan to use the swap curve as the risk-free curve.

Risk-free Rate Source Rationale

Q What is your rationale for this selection?

RISK-FREE CURVE RATIONALE

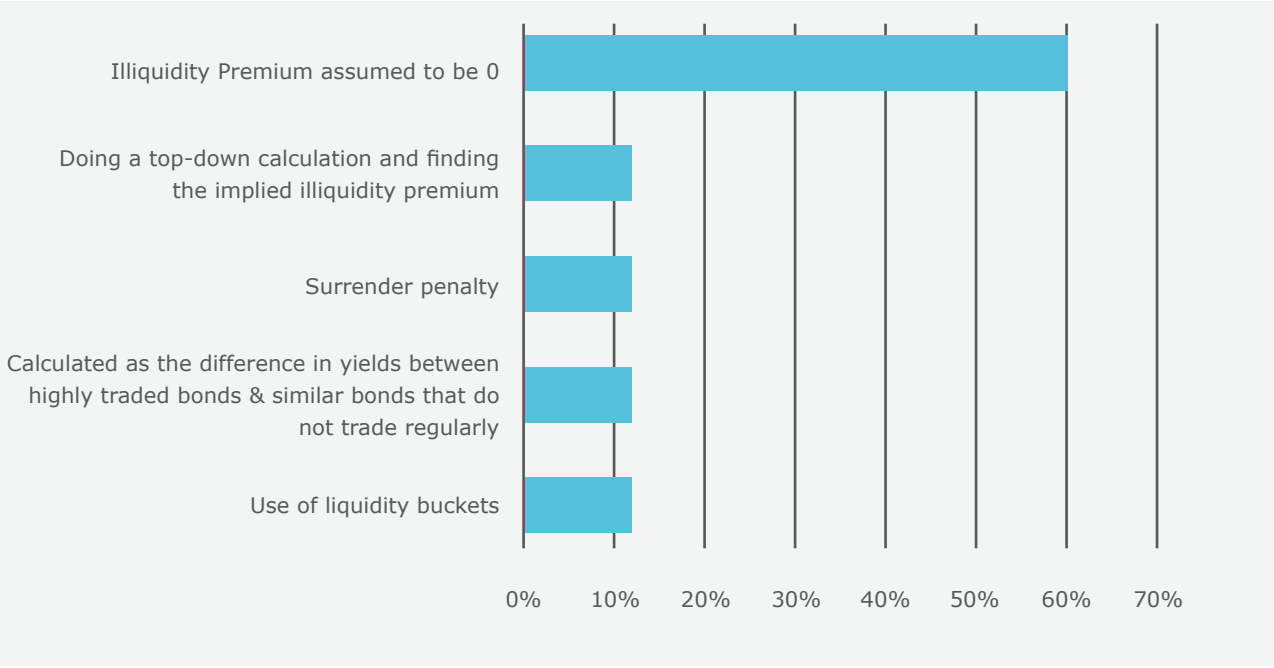


The most common rationale for the choice of risk-free curve was similarity to existing processes (e.g. SAM), which corresponds with those organisations using the rates provided by the SARB.

Illiquidity Premium Calculation

Q **For your bottom-up portfolios, how are you calculating the illiquidity premium?**

ILLIQUIDITY PREMIUM CALCULATION



Most respondents are assuming that the illiquidity premium is 0.

The remainder are using a variety of methods to determine the illiquidity premium, including: the use liquidity buckets, calculating the difference in yields between liquid and less liquid bonds, and first performing a top-down calculation and then deriving an implied illiquidity premium.

Locked-in Yield Curves

Q How will you set your locked-in yield curves?

LOCKED-IN YIELD CURVE APPROACH

Most respondents are using the start of period discount rate for their locked-in yield curves.

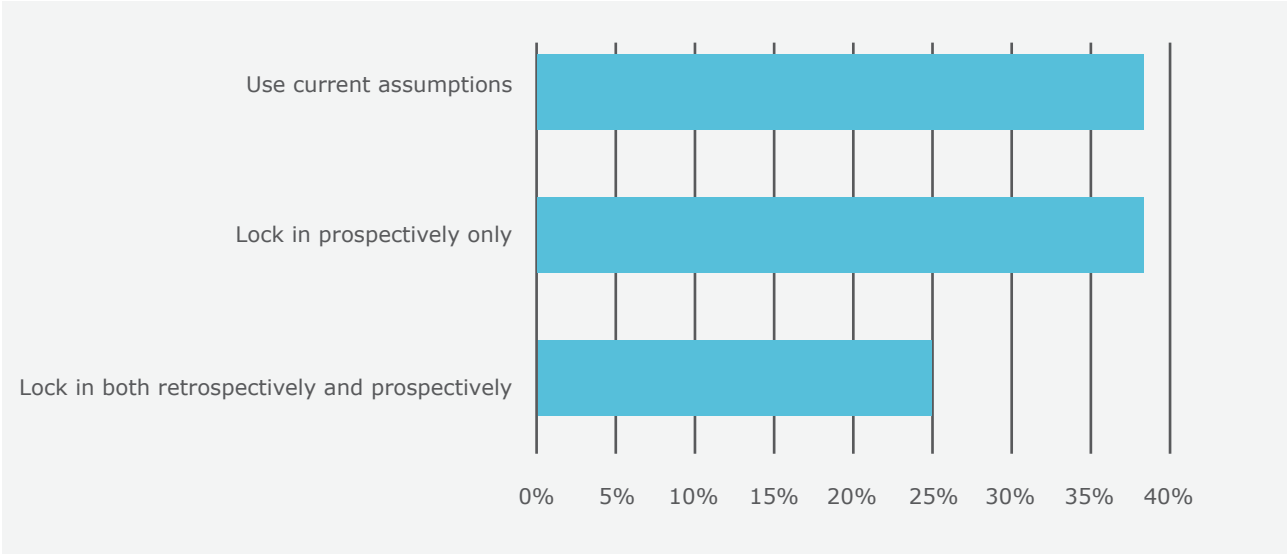
The most commonly cited rationale for this was operational simplicity, but one respondent also noted that these rates were closest to what would be used for pricing.

The approaches of those who selected "Other" were: the use of "dynamic" weighted averages (where the weights change with time to reflect the change in the composition of the group); and use of the start of period discount rate, but potentially changing to the end of the year rates if the weighted average by policy count is materially different by the time the group is closed to new business.

Locking in of Inflation Assumptions

Q What approach will be used for locking in inflation assumptions?

LOCKING IN OF INFLATION ASSUMPTIONS



While the Standard makes it clear that the time value of money, should be locked-in from initial recognition (paragraph B97) it is less clear as to whether inflation is considered a financial risk and therefore whether it should be locked-in.

Most respondents are locking-in inflation assumptions, either only prospectively (basing the adjustment to CSM on the actual contract value at reporting date) or locking in retrospectively and prospectively. The latter is the most complex in practice as it would require maintaining a 'shadow' value of benefits as if the past had emerged in line with the original locked-in assumptions.

These respondents are not distinguishing between expense inflation (which may not have an explicit link to a market observable index), and premium/benefit inflation (which probably is directly linked to CPI).

The remainder of respondents are using current assumptions for inflation; i.e. they do not consider inflation to be a financial risk. At least one of these respondents does not offer inflation-linked premium/benefit escalations. In this case, inflation assumptions are most likely not linked to an observable index and it would therefore make sense not to lock them in.

6.

Grouping & Level of Aggregation
9 Respondents

6. Grouping and Level of Aggregation

Grouping

- All respondents but one plan to use annual cohorts. The remaining respondent will use monthly cohorts for annuities and annual for everything else.
- All respondents indicated that their IFRS 17 cohorts align with their financial year.
- Eight of the nine respondents are not utilising paragraph 17 for their life insurance books. The remaining respondent is using it for both retrospective and prospective measurement.
- Eight of the nine respondents are not utilising paragraph 20 for their life insurance books. The remaining respondent is using it for both retrospective and prospective measurement.

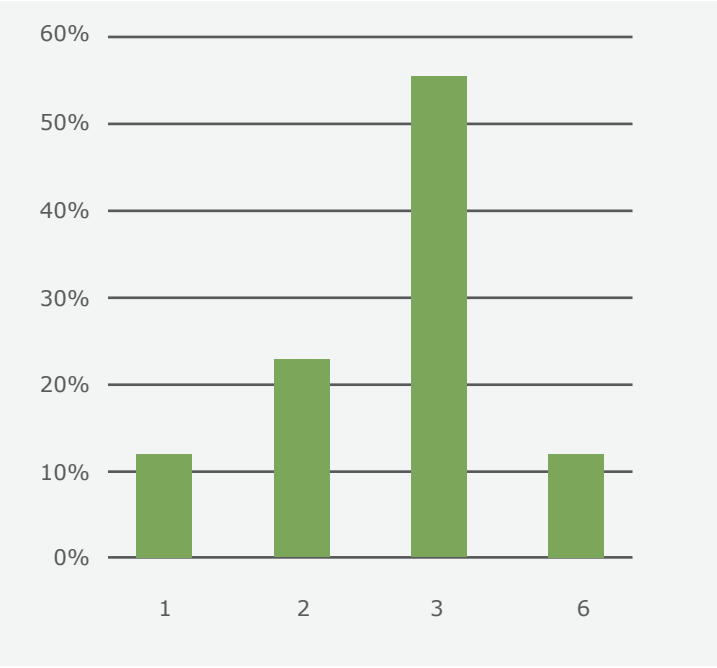
Paragraph 17 states that if an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group, it may measure the set of contracts to determine if the contracts are onerous and assess the set of contracts to determine if the contracts have no significant possibility of becoming onerous subsequently.

Paragraph 20 states that if contracts within a portfolio would fall into different groups only because law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, the entity may include those contracts in the same group.

Number of Profitability Groups per Cohort

Q **Paragraph 21 of the IFRS 17 Standard permits entities to subdivide the 3 profitability groups described in paragraph 16 into further groups. What is the maximum number of IFRS 17 profitability groups you have per cohort?**

NUMBER OF PROFITABILITY GROUPS



All of the respondents have the same number of profitability groups for all of their major product lines.

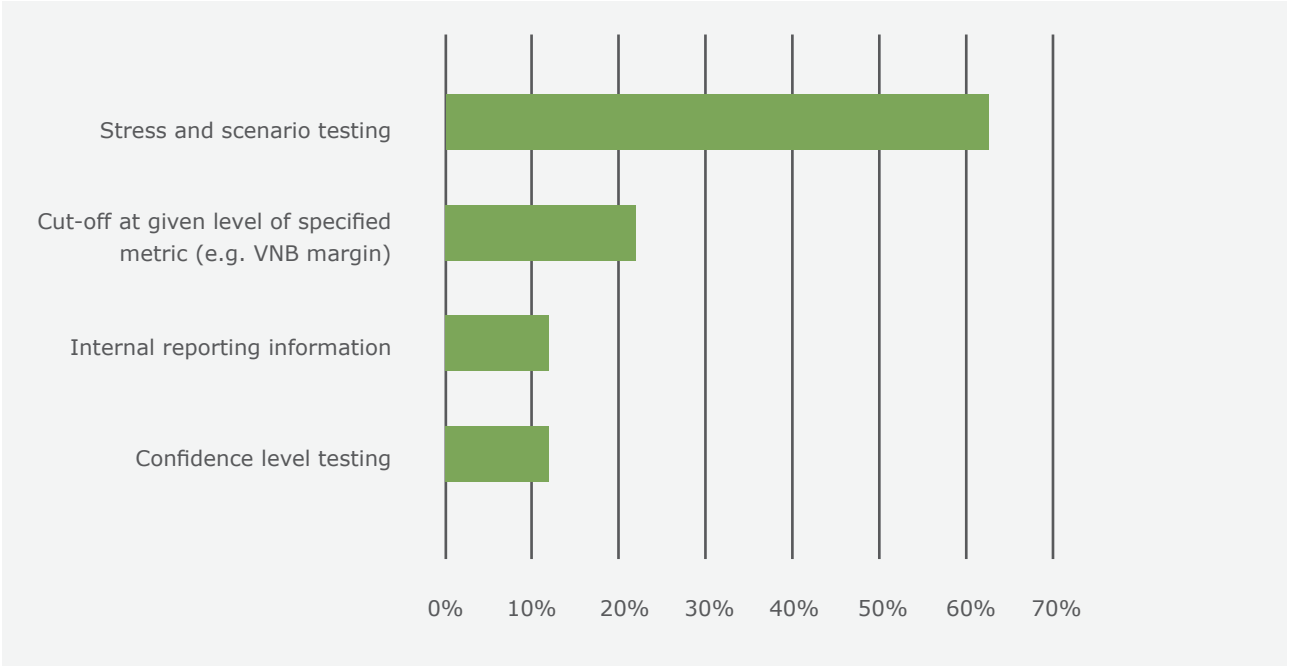
Most have the standard three profitability groups. One respondent has six groups to account for business conducted in two different currencies. One of the respondents with two groups believes that there are no contracts that have no significant probability of becoming onerous (hence this group would be empty).

Apart from the currency split mentioned above, only one other respondent will be splitting groups based on another characteristic, namely distribution channel.

Identification of Profitable Contracts

Q How do you identify contracts that have "no significant possibility of becoming onerous"?

IDENTIFICATION OF CONTRACTS THAT HAVE NO SIGNIFICANT POSSIBILITY OF BECOMING ONEROUS



Most respondents are using stress and scenario testing, while some (two of nine) are cutting off at a given level of a specified metric.

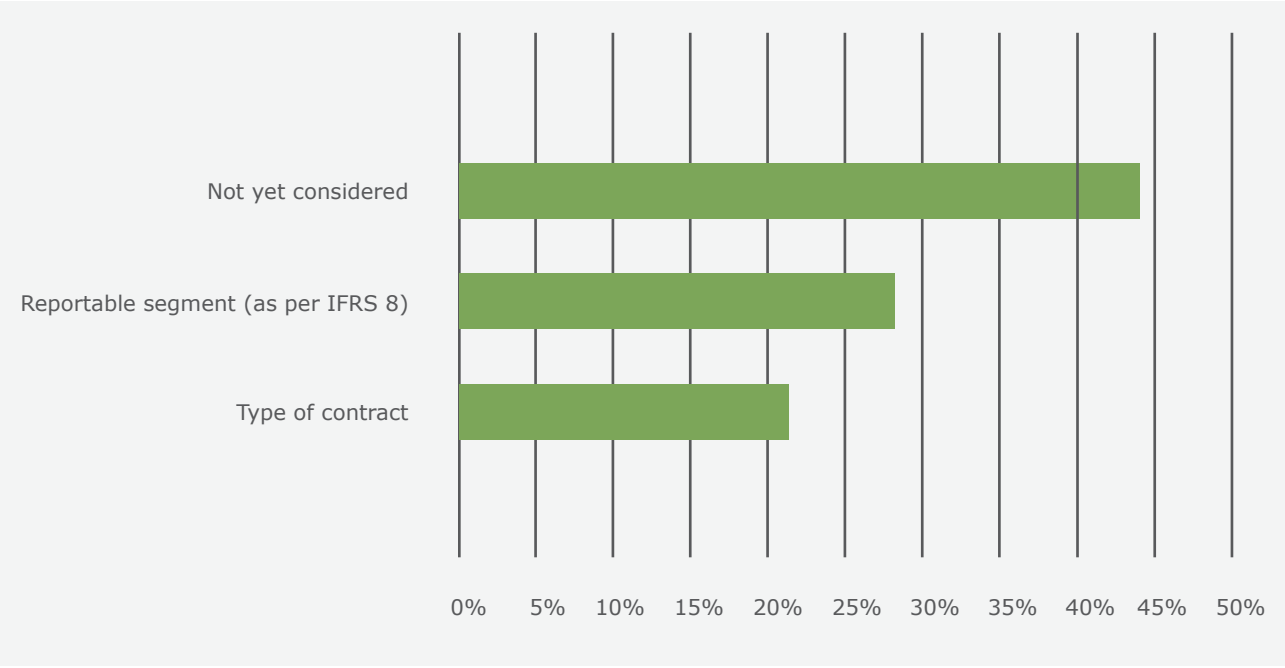
One respondent is using internal reporting information and one is conducting confidence level testing (i.e. testing profitability at a higher confidence level than the base confidence level used for risk adjustment calibration).

One respondent indicated that current margins and prior stress testing suggest that most contracts do have a significant possibility of becoming onerous. Hence, this respondent only has two profitability groups (the one for contracts with no significant possibility of becoming onerous is empty).

Level of Aggregation for Disclosure

Q **What level of aggregation do you plan to use for disclosure purposes?**

LEVEL OF AGGREGATION FOR DISCLOSURE



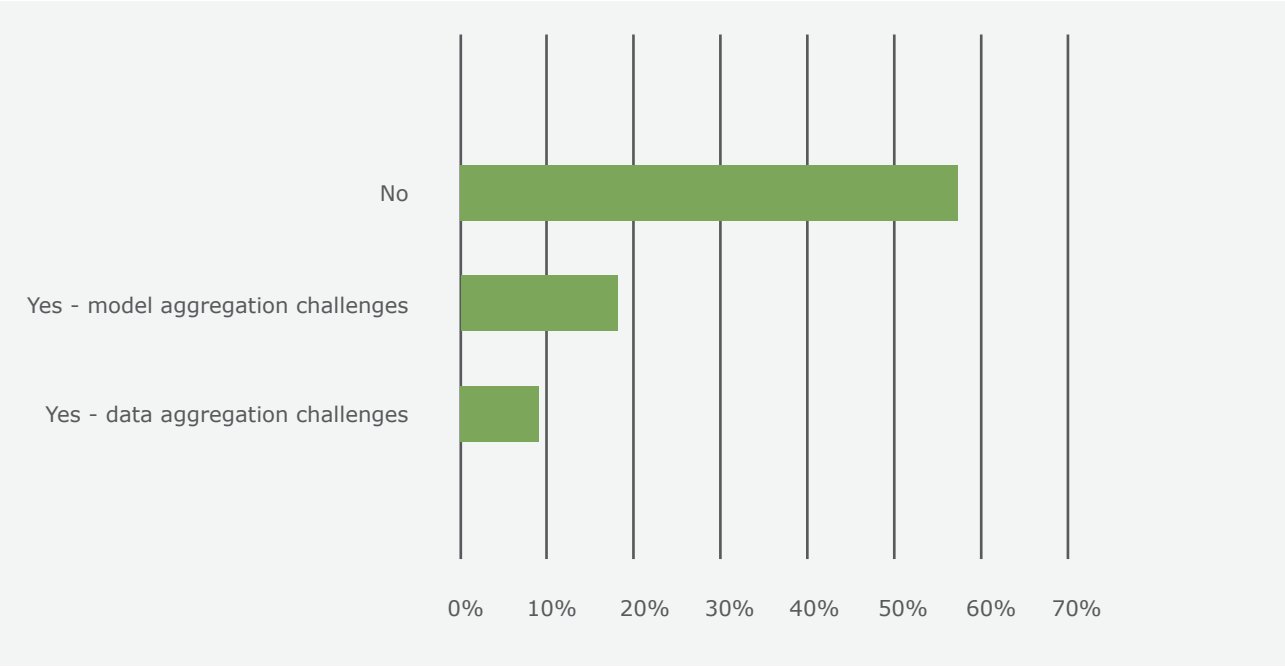
Four of the nine respondents have not yet considered the level of aggregation at which they will be presenting their disclosures. One of these is currently aiming to disclose at a portfolio level, but this may change if this level of detail turns out to be too onerous.

The remaining respondents are either disclosing at a reportable segment level or contract type level.

Challenges in Measuring Complex Contracts

Q **Have you encountered challenges in measuring and aggregating complex contracts, e.g. those with multiple benefits that are modelled separately?**

CHALLENGES IN MEASURING COMPLEX CONTRACTS



Most respondents (six of nine) have not encountered challenges with complex contracts as defined, with the remainder encountering either model or data aggregation challenges.

7.

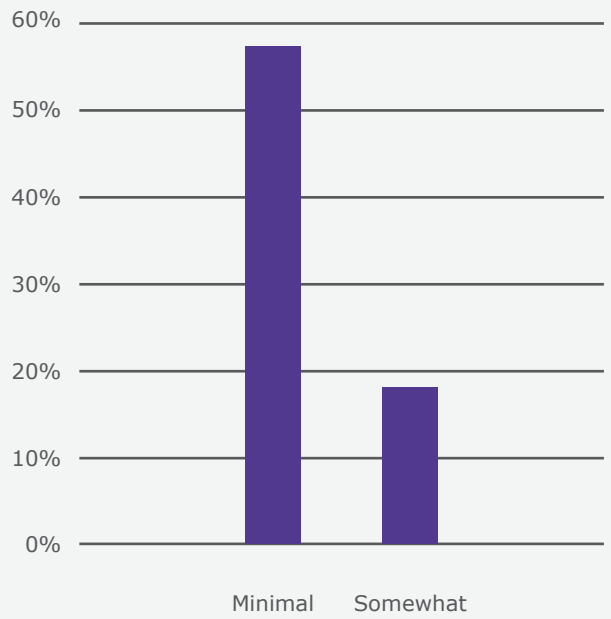
Reinsurance
6 Respondents

7. Reinsurance

Changes to Reinsurance Arrangements

Q **To what extent have IFRS 17 requirements with respect to reinsurance led to a change in your reinsurance arrangements?**

EXTENT OF CHANGE TO REINSURANCE ARRANGEMENTS

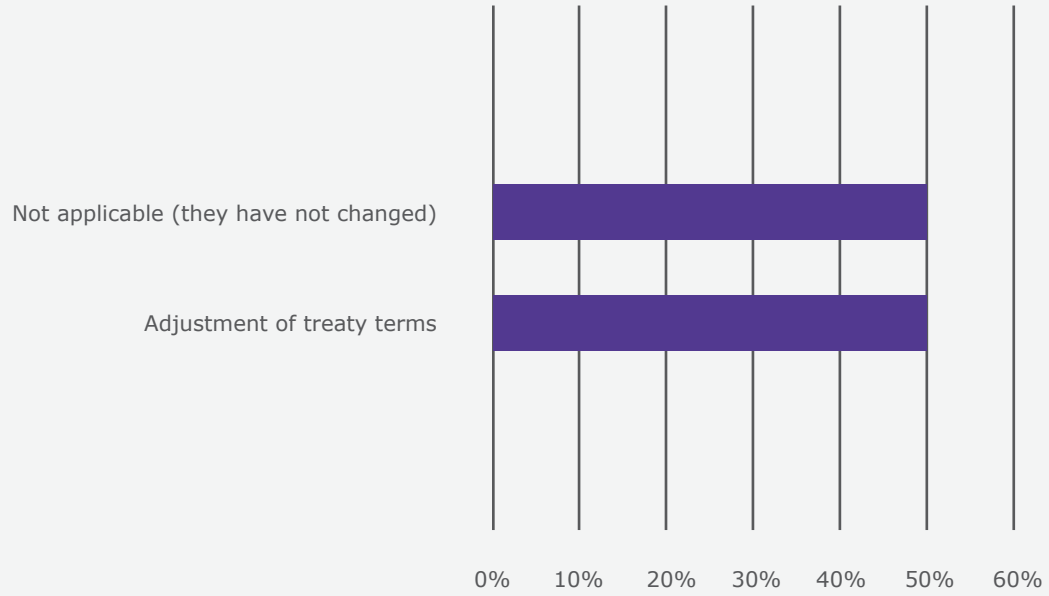


No respondents are expecting to make major changes to their reinsurance arrangements due to IFRS 17. Half noted that minimal changes would be made and the other half expect their arrangements to change "somewhat".

Changes to Reinsurance Arrangements

Q **In what way have your reinsurance arrangements changed due to IFRS 17?**

CHANGES MADE TO REINSURANCE ARRANGEMENTS



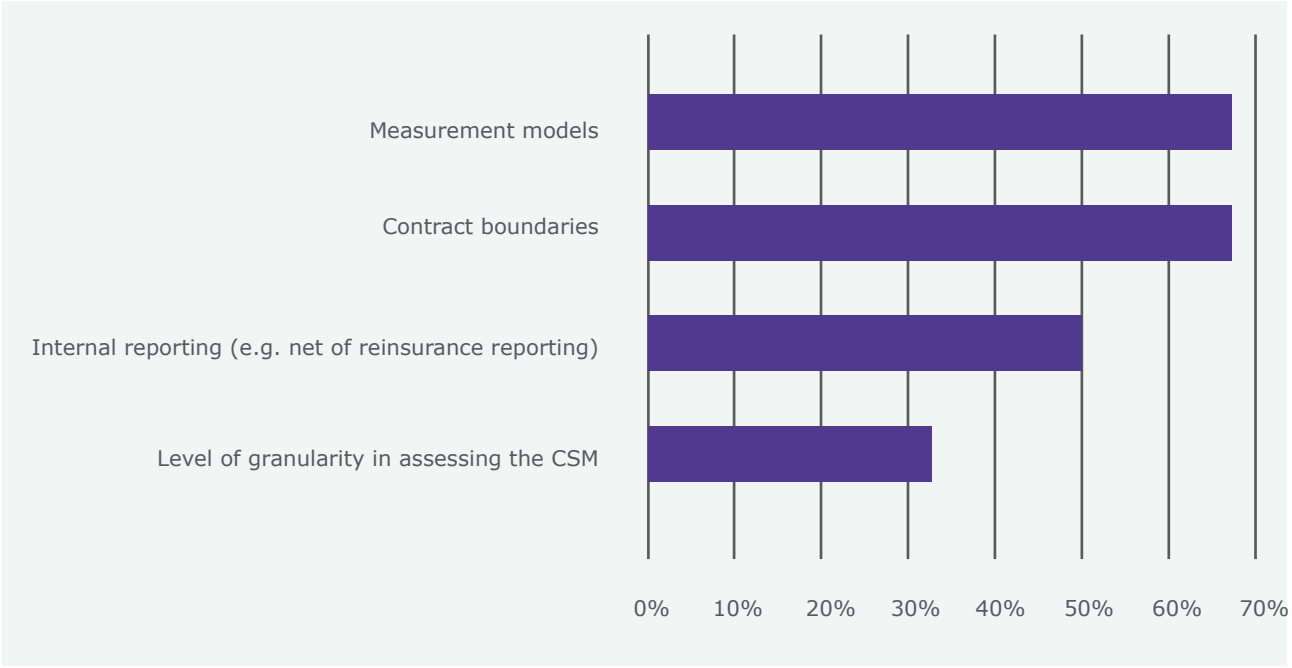
Half of the respondents expect to make changes to their reinsurance arrangements. All of these changes will entail changes to treaty terms, and generally have to do with aligning underlying contracts with reinsurance contracts for grouping and measurement purposes. Examples of expected changes are: reducing the notice period on new business from 90 days to 30 days to avoid 3-month contract boundaries and aligning notice periods/ cancellation dates with financial year ends.

Changes that will help insurers avoid the need to model future new business are also expected to take place.

Accounting and Methodology Mismatches

Q **Which accounting/methodology mismatches between your insurance contracts issued and reinsurance contracts held do you expect to encounter?**

ACCOUNTING/METHODOLOGY MISMATCHES



Two-thirds of respondents expect mismatches in measurement models (e.g. underlying contracts being measured under the general measurement model and reinsurance contracts under the premium allocation approach).

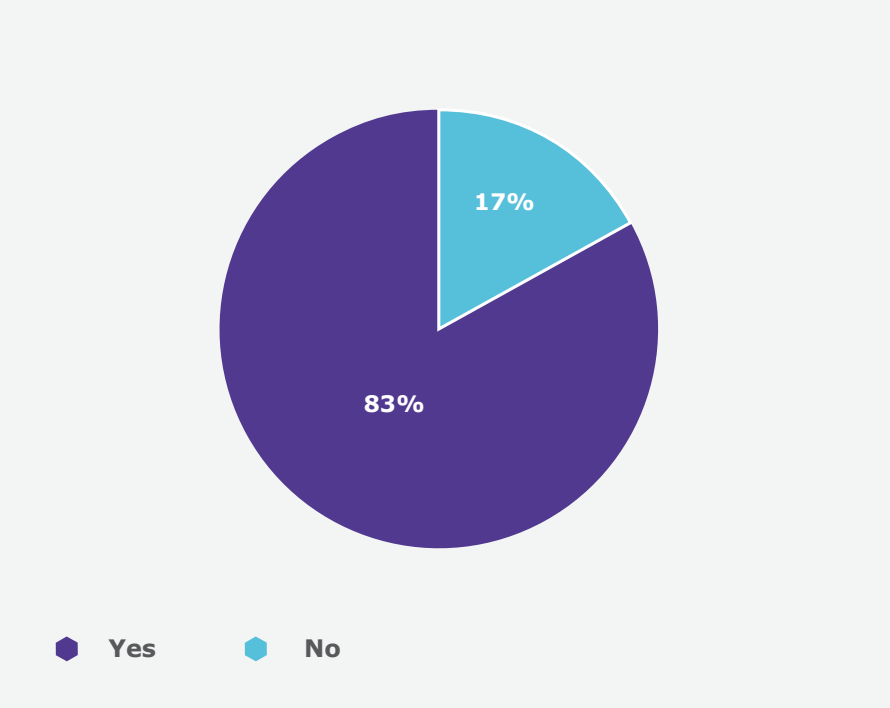
The same proportion also expect mismatches regarding contract boundaries (with reinsurance contracts generally having a 180 day or 3-month notice period).

Reinsurance Modelling

Q **Are you modelling reinsurance anywhere other than where your insurance contracts are modelled, e.g. catastrophe treaties?**

Only one of the six respondents (17%) is modelling their reinsurance contracts – specifically their personal accident and life catastrophe excess of loss and their non-life stop-loss – in a different model from their underlying contracts.

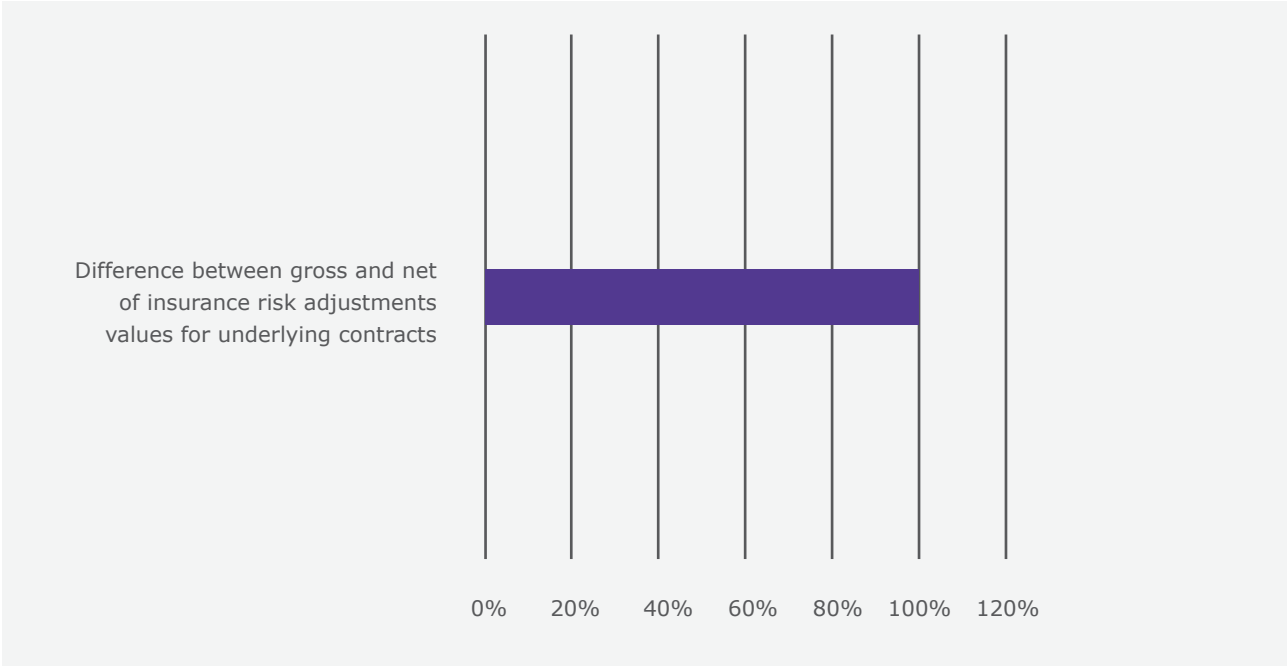
MODELLING REINSURANCE ELSEWHERE?



Risk Adjustment

Q **What approach are you taking to calculating the risk adjustment for your reinsurance contracts held?**

RISK ADJUSTMENT

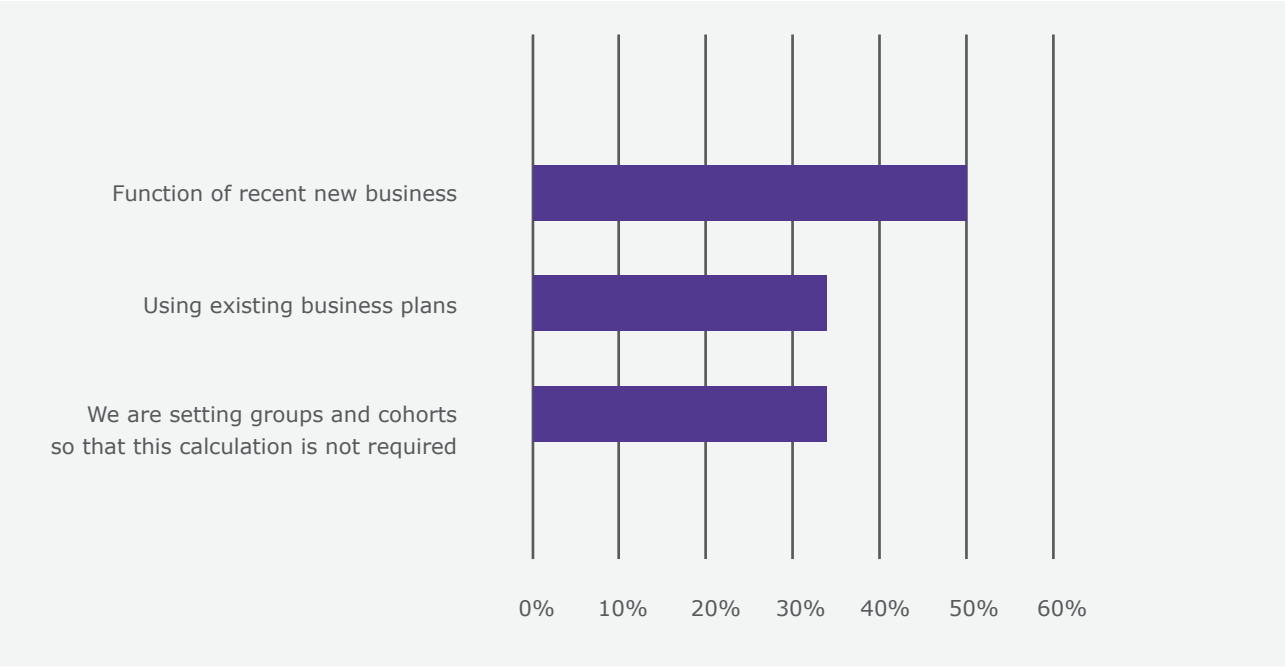


All respondents plan to calculate their reinsurance risk adjustment as the difference between their gross and net risk adjustment results, rather than calculating the reinsurance risk adjustment independently.

Projection of Future New Business

Q **For the purpose of measuring reinsurance contracts, are you valuing expected future new business? If so, how are you calculating future new business?**

FUTURE NEW BUSINESS CALCULATION



In their February 2018 staff paper, the Transition Resource Group for IFRS 17 Insurance Contracts (TRG) said that "…the boundary of a reinsurance contract held could include cash flows from underlying contracts covered by the reinsurance contract that are expected to be issued in the future."

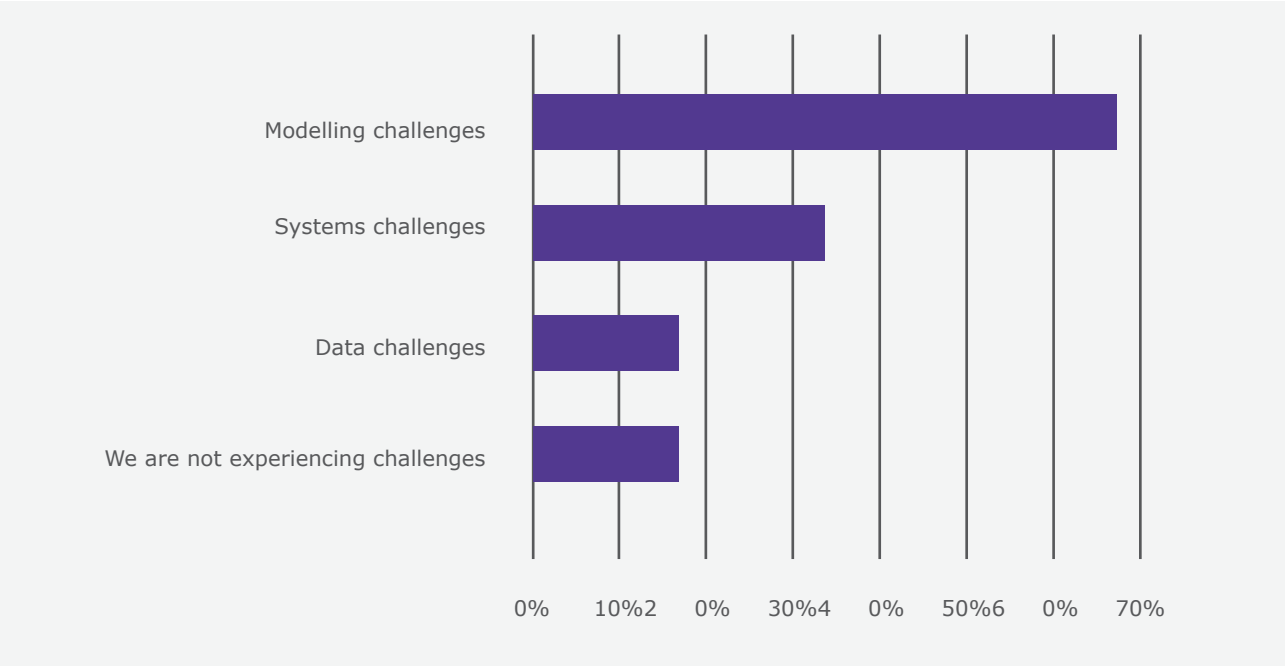
Insurers therefore need to consider whether and how to measure the cash flows of underlying contracts that have not yet been issued.

One-third of respondents are setting their groups and cohorts so that the need to perform this calculation is avoided. The remainder are projecting future new business based on a function of recent new business, existing business plans, or both.

Loss-recovery Component Challenges

Q **Are you experiencing challenges in accounting for the loss-recovery component for the purpose of valuing reinsurance contracts held?**

CHALLENGES PRESENTED BY THE LOSS-RECOVERY COMPONENT



The introduction of the loss-recovery component introduced additional challenges for insurers.

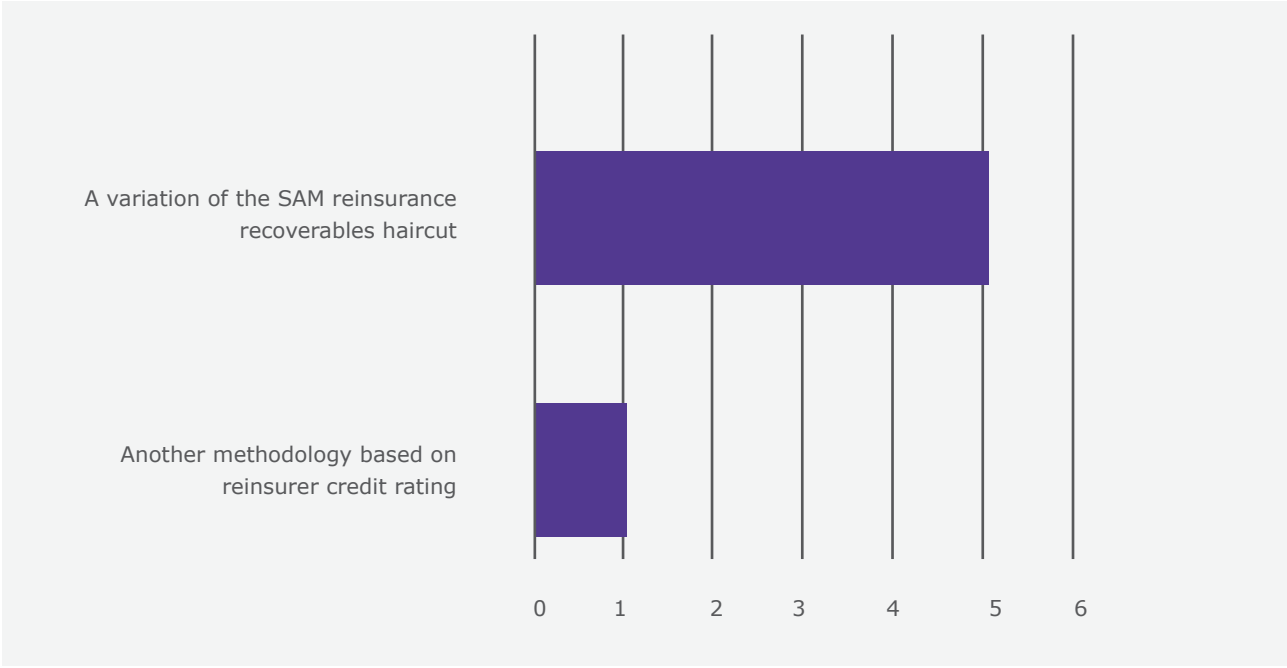
Five of the six respondents are experiencing challenges of some kind. Two-thirds of respondents are experiencing modelling challenges, with others experiencing systems challenges, and data challenges.

One of the respondents (17%) said that they are not experiencing any challenges.

Risk of Non-performance of Reinsurers

Q **What methodology are you using to quantify the risk of non-performance of the reinsurer?**

RISK OF NON-PERFORMANCE METHODOLOGY



Paragraph 63 of the Standard says that "the entity shall include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held the effect of any risk of non-performance by the issuer of the reinsurance contract."

Most of the respondents (five of six) are employing a methodology similar to the reinsurance recoverables haircut calculated for SAM. The remaining respondent is planning to use another methodology based on the reinsurer credit rating.