A publication for insurance carriers

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PKF

Insurer Update

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Welcome to our new publication for **insurance carriers**

Insurer Update aims to help carriers across the insurance market understand and digest some of the more pertinent financial reporting and tax developments, and the implications for medium sized and smaller insurers.

Although there have been no major accounting standard changes or amendments for accounting periods beginning in 2022, that doesn't mean that the 2022 year end won't be without its challenges.

As ESG becomes more and more key for stakeholders, in this edition, we look at how insurers have developed their climate change reporting in the past 12 months, and what they should be thinking about for their upcoming year end.

Also in this edition, in May the Government published its response to its *Restoring trust in audit and corporate governance* White Paper consultation. We look at some of the key aspects of the consultation and how you might be affected.

July's Finance Bill included details of the proposed 'multinational top-up tax'. But what exactly is it, who will it affect and what will UK insurers need to do? Our tax experts explain. We also highlight the key tax implications if your business is considering expanding overseas.

We also look to the future. On 1 January 2023, the new accounting standard IFRS 17 Insurance Contracts will come into effect and change the financial reporting of insurance companies. We reflect on how it will impact our clients.

We hope you find this edition useful and thought provoking. Please contact any of the team to discuss how we can support your business and do let us know your thoughts on future topics.

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Audit and corporate governance reforms: how far will they go?

In May, the Government published its response to its *Restoring trust in audit and corporate governance* White Paper consultation. What are the changes and how might you be affected?

The aim of this White Paper, produced in March 2021, was to restore public trust in the way the UK's largest companies are run and scrutinised. Following a consultation period with over 600 responses from interested stakeholders, the Government has taken the next step. The feedback was wide ranging, covering areas from what constitutes a public interest entity (PIE) through to proposals to increase competition and resilience in the audit market.

Most respondents recognised the need for reform, but many also expressed concern about the breadth of the proposed reforms. Would companies, professional services firms and regulators be able to implement them adequately in order to have the desired effect?

Having taken account of these concerns, the Government's proposal is two-fold. Firstly, it has narrowed the focus so that only the most pressing reforms are required. This will reduce their cost and complexity. Secondly, there is no fixed timetable set out in the Government's response. Instead, it lists a series of actions to be taken.

ARGA and the FRC

Critical to the success of the proposals, and the first priority to be actioned, is the establishment of a new regulatory body – the Audit, Reporting and Governance Authority (ARGA). ARGA will have broader powers and responsibilities than the FRC currently has. These will include oversight of both the accounting and actuarial professions.

But the Government will only grant these extra powers and responsibilities when it is confident ARGA has the capability and resources to act on them.

As a sign of things to come, the FRC itself announced, in August, that from 5 December this year all audit firms and responsible individuals who undertake statutory audit work for PIEs must be separately registered with the FRC.

How has the definition of a PIE changed?

The definition of a PIE has been expanded in line with the preference for large private companies to be subject to similar reporting and governance requirements as existing PIEs. These existing PIEs include, for example, listed entities, banks and insurers. The original expansion was cautious, to ensure the audit profession had the ability to deliver more audits in line with PIE reporting standards. It is now expected that private companies with more than 750 employees and a turnover above £750m will be included (the 750:750 test). But most public authorities and Lloyd's syndicates will remain outside of the PIE scope, regardless of the 750:750 test. In addition, it is expected that certain smaller entities currently classified as PIEs will eventually be descoped.

More choice and resilience

As well as the introduction of stronger internal controls and related director accountability, the most significant change is perhaps the package of measures designed to increase choice and improve resilience in the audit market.

Principal among these is the managed shared audit regime. This aims to give challenger audit firms the opportunity to audit a meaningful proportion of subsidiaries of FTSE350 companies. The White Paper defined 'meaningful proportion' with reference to one or more of the total audit fee, group revenues, profits and assets of the company, with the challenger's proportion as no less than 10% of these criteria and preferably nearer 30%. But the Government says the exact definition should be left to ARGA, to keep the proposals flexible.

Like much in the Government's response, it remains to be seen how far the reforms will actually go. Will they lead to genuine, long-lasting change in audit and corporate governance? We at PKF, along with other audit firms and affected companies, will be watching with interest.

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Climate change reporting – what's been happening?

As it becomes more and more key for stakeholders, we look at how insurers have developed their climate change reporting in the past 12 months. Given this, what should mid-sized insurers be thinking about for their upcoming year end in this area?

Climate change and ESG related reporting could well be the main financial reporting development of recent times. It will be increasingly important as users of financial information place more emphasis on organisations' consideration of these factors.

What are the latest regulatory developments?

Most mid-sized UK insurers will still be swapping notes with their peers as to how they intend to build on their approach to meeting the Prudential Regulation Authority's (PRA) supervisory expectations issued in 2019. Whilst SS3/19 still represents the primary framework for most non-listed UK insurers, developments during 2022 may point to how this framework will evolve.

A new body, the International Sustainability Standards Board (ISSB), has been created to sit alongside the International Accounting Standards Board under the International Financial Reporting Standards (IFRS) Foundation.

In March this year, the ISSB published for comment proposals for general sustainability-related disclosure requirements and climate-related disclosure requirements. The UK Government's Roadmap to Sustainable Investing published in 2021 stated that the ISSB's standards will form the backbone of the UK's sustainability disclosure requirements in the future.

The FCA plans to work with the Financial Reporting Council (FRC), and others including the PRA, to set up an appropriate way of overseeing and enforcing disclosures against these new standards.

It is unclear how these new standards will impact smaller insurers reporting under UKGAAP, but all insurers will need to keep an eye on developments in this space.

The PRA has also been busy publishing the results of its Climate Biennial Exploratory Scenario exercise (CBES). Its aim is to examine climate-related financial risks that might arise over a timescale of 30 years or more and assess the industry's resilience to those risks.

Although the results show that losses for both life and general insurers appear manageable under the scenarios modelled, the PRA makes it clear that this is only the beginning of its work. It says insurers must continue to develop more advanced methods to identify, measure and manage climate risks. We are already seeing their supervisory influence in action in this area.

What has changed in the last 12 months?

Governance changes

Looking at publicly available information, it is clear that the UK's largest insurers continue to develop their governance structures to place greater emphasis on climate change and broader sustainability factors. More organisations have set up board sustainability committees or their equivalent. Many are also creating more dedicated executive roles, such as the Chief Sustainability Officer.

But we are not seeing the same trend for medium sized insurers. Taking into account proportionality, it makes sense that current governance processes (where climate change oversight is embedded in the current governance structure) are not changing, with many viewing them as already fit for purpose given supervisory expectations.

Reporting trends

The UK's largest insurers have continued to evolve their public reporting, with more granular detail on risk management and scenario analysis.

For medium sized insurers, external reporting is not changing drastically. The most common approach is concise disclosure structured around the TCFD framework. We generally see climate risk scenarios continue to be assessed qualitatively, with limited disclosure in the annual report or SFCR of how any impact on liabilities would be managed. We know medium sized insurers have been focusing on their investment portfolios to meet the COP26 agenda and we expect this to continue to be their key priority.

Reserving trends

For the general insurance sector (specifically household and commercial exposures) there seems to have been little explicit allowance in key assumptions, such as inflation or rates, to reflect higher claims cost from exposure to climate risk.

Few doubt the UK will face increased risk from climate change-related dangers such as floods and wildfires. Until now there has been little consideration of wildfire risk in the UK, but we expect this to change following the summer's extreme heatwave.

Amongst our life and health insurer client base, we have seen minimal impact from climate change factors, which reflects the lack of industry-level data currently available as to any impacts on mortality and morbidity.

What should mid-sized insurers focus on for the 2022 year end?

Regulators and other stakeholders recognise that climate change related disclosure is still a relatively new area. This likely explains why the level of feedback for medium sized insurers has been limited. We therefore wouldn't expect insurers to make sweeping changes to their existing 2021 external reporting, but this is not to say they shouldn't continue to make improvements.

One of the PRA's conclusions from its CBES is that many firms lack the resources for climate risk modelling and data analysis. Some insurers may only be able to close any data gaps once industry-wide studies are available. But others, with shorter tail exposures, will be expected to model impacts more readily.

Everyone knows it is a challenge for modellers to quantify climate change risk financially, using limited past claims data. Perhaps claims experience has been gradually reflecting climate risk but, as this risk is ever-changing, standard actuarial methods that rely on stable claims development won't be suitable for reserving purposes.

We would recommend that all insurers, as part of their 2022 public reporting, acknowledge the findings of the CBES. They should explain what actions they are taking in relation to any data and modelling gaps they've identified. Alternatively, they could explain why they are not yet able to take any action.

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Global mobility beyond the EU: how to prepare

We are getting accustomed to the challenges of Brexit, but what are the key issues when expanding your business further afield?

The combination of Brexit and the pandemic was, for some, the perfect storm and many companies put their international expansion plans on hold. But now that we are getting used to Brexit, and COVID restrictions have been lifted, it is clear companies are dusting off their stalled plans or embarking on brand new expansion exercises.

Much of the focus has been on the UK leaving the EU and the many issues it has raised. For some these include the need to establish a corporate presence in Europe to be able to continue to trade in Europe.

Changes brought about by Brexit have meant paying closer attention to international compliance rules and regulations. These include visas, payroll reporting requirements and more robust employment contracts. But what about conducting business in the world beyond Europe?

New focus territories

Whilst the USA is and always has been a key location for UK businesses, many are exploring new territories. Singapore, Australia and Canada are proving popular. International tax rules are generally well developed for these territories, and tax treaties and social security agreements exist. But remember: the rules around tax and social security reporting for employees differ with each country and are dependent on the individual treaty agreements. Social security agreements are also different from the European A1 regime.

How tax havens differ

Like many sectors, the insurance industry often includes one of the so called tax havens (such as Bermuda, the Caymans or the British Virgin Islands) as a location for a group entity.

Many tax havens do not require businesses to operate out of their country or individuals to reside there to receive tax benefits. But it is often the case that companies like to have a presence on the ground. So how should these overseas entities be staffed? Team structure is an important commercial decision, and where there is an international element it can be complex.

Does someone senior go out for a period of time (or perhaps permanently) to set up the operation, and then recruit locally? Or does a whole team relocate?

Many companies are keen to offer employees the chance to experience working in an overseas environment, often as an incentive to attract and retain the best talent. But compliance is vital, as treaty protection is often not available and the resulting tax and social security rules can be complex and costly.

Bermuda, for example, has a social security agreement with the UK. But there is no tax treaty, so any employee visiting the UK from Bermuda for work instantly creates a payroll reporting requirement for the UK company. It is worth noting, though, that with the right documentation, UK National Insurance contributions can be exempted.

Non-resident directors

Overseas groups expanding to the UK for the first time, either by acquisition of UK groups or formation of new UK entities may mean that non-resident directors of UK companies are appointed. These directors are assessed under specific legislation, and treaties often have a separate article setting out where the taxing rights lie: whether with their individual country of residence or the country of residence of the company.

Social security is assessed separately and may be exempt in the UK if they qualify under an HMRC concession or are based in a country with which the UK has a social security agreement.

Governments across the world are looking for ways to raise revenue, and the UK is no different. Businesses with internationally mobile employees, seconded employees, non-resident directors, or simply overseas financial interests, attract attention. This is because the authorities know there is a significant risk of non-compliance, and hence a ready source of additional income.

Don't get caught out

New markets bring in new business and can provide exciting opportunities. But it is important to adhere to relevant legislation and be aware of the risks it brings.

Always seek professional opinion or advice when thinking of expanding internationally. Taking advice will almost certainly cost less than correcting mistakes afterwards.

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Global minimum tax: a UK update

July's Finance Bill included details of the proposed 'multinational top-up tax'. What exactly is it, who will it affect and what will UK insurers need to do?

In 2021, 136 of the 140 countries in the OECD Inclusion Framework agreed to the proposal to implement a 15% global minimum Corporation Tax rate. This aimed to set a 'floor' for the level of tax competition between jurisdictions. The plan was to implement the rules from 2023. The primary measure agreed was the Income Inclusion Rule (IIR).

Although the regime framework has been internationally agreed by member countries, each needs to incorporate the rules into domestic tax legislation. In the UK, the proposals to adopt the IIR have been subject to consultation by HM Treasury. The Finance Bill 2022-23, released on 20 July, includes the relevant provisions (to be known in the UK as the 'multinational top-up tax') and is subject to further consultation. The conclusions are expected to be announced in the Autumn Budget, for inclusion in the 2023 Finance Act.

A secondary Pillar Two measure (the Undertaxed Profits Rule) will act as a backup to prevent profit shifting to low tax jurisdictions. As in most jurisdictions, its implementation has not yet been announced by the UK - and will follow later.

What are the principles of the multinational top-up tax?

UK parent companies within the scope of the regime will need to consider, subsidiary by subsidiary (whether held directly or indirectly), the accounting profit for each overseas subsidiary (or overseas permanent establishment) against the current tax charge applied to those profits in the financial statements. Where a subsidiary has an effective tax rate of less than 15%, the UK parent will pay the new tax to make up the difference.

It is important that each jurisdiction is considered separately. Where the combined entities in one jurisdiction pay more than 15% effective tax rate, these 'overpayments' cannot be offset to reduce the exposure from subsidiaries in other jurisdictions paying less than 15%.

A number of adjustments to both the profits and tax base for each subsidiary must be made to determine the scale of any potential charge. The chief aim is to remove the effect of intra-group dividends or equity sales. The calculations will be complex, even if not quite so challenging as under the existing UK CFC regime, where overseas profits need to be rebased to UK Corporation Tax principles.

What is its scope?

The tax will apply to UK parented groups with global annual revenues over €750m in at least two of the previous four years. But the multinational nature of the regime means that purely UK domestic groups will not be captured. Bear in mind, though, that a single overseas permanent establishment within the group will be enough to bring the whole group into the regime.

However, 'small' subsidiaries can be excluded from the calculation for companies within the scope of the rules, where average revenue in the given jurisdiction is less than €10m and average profits lower than €1m.

Implementation and requirements

Although initially planned to take effect from 1 April 2023, the new tax regime is so complex that the legislation will only be implemented for accounting periods starting on or after 31 December 2023. For most insurance groups, therefore, the first period covered by the new tax will be the year ending 31 December 2024.

There will be a one-time requirement to register with HMRC when they first come into the regime. After that, groups will have 15 months from the accounting period end to report their top-up tax liabilities. It will also be the payment date. This is much simpler than the originally proposed nine-month window. For the first year a group is in the regime, the 15-month window is extended to 18 months.

This all means that in-scope insurance groups should mark 30 June 2026 in their calendar as the date for the first submission of a return, together with payment of associated top-up tax liabilities.

What is the impact for UK insurers?

Insurance carriers have long argued that the benefits of operating in low-tax jurisdictions, such as group reinsurance vehicles in Bermuda, are secondary to the wider regulatory, commercial and operational benefits the group derives from these structures. In fact the unilateral base erosion tax measures implemented in recent years, such as ‘diverted profits tax’ in the UK, or BEAT in the US, will, for many, have reduced or cancelled out the benefits of purely tax motivated structures.

Regardless, and despite the long-lead time for implementation of the new charge and reporting requirements, all insurers operating internationally must review their global tax structure and potential exposures in the UK or other jurisdictions regarding the top-up tax (which will be implemented globally). Their systems must adequately capture the required data, both for the top-up tax and for forthcoming changes.

Any such review should be considered against a shifting tax landscape, with low-tax jurisdictions changing their approach in light of these global changes.

Several no-tax jurisdictions have already announced new Corporation Tax regimes, imposing the tax for the first time on local entities of groups exceeding the €750m revenue threshold. Their justification is that if the tax benefits of operating from their jurisdiction are eroded, they should benefit locally, rather than the overseas parent company.

Indeed, the UK Treasury too is considering the merits of a domestic minimum tax rate, to capture within the UK tax net liabilities that may otherwise accrue to other jurisdictions.

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IFRS 17: the major implications for you

In just over three months, on 1 January 2023, the new international accounting standard, IFRS 17 Insurance Contracts, will come into effect and change the financial reporting of insurance companies. We explain how this will impact our clients.

The goals of IFRS 17 are to ensure consistency across the accounting for all insurance contracts, increase comparability between insurance companies, and drive more detailed disclosures.

The reporting of larger insurers' interim results at 30 June 2022 was expected to provide more detail on the impact of IFRS 17. But most insurers have decided to wait until later this year and into 2023 to disclose the full accounting consequences of adopting this new standard. This reflects the substantial amount of work that insurers still need to do.

IFRS 17 will bring substantially larger changes to the multi-line and life insurers that dominate the IFRS 17 headlines, with less of an impact for those writing short tail business. Along with the accounting policy practices already in force, the impact of the introduction of IFRS 17 may be more modest for the latter. It's worth noting, though, that IFRS 17 will change the presentation of all insurer financial statements on transition and in the future.

Earnings recognition and measurement

A key element of IFRS 17 is the requirement to use a measurement model for insurance contracts, relating to how estimates are remeasured in each reporting period.

There are three options available:

- General Measurement Model (GMM) – suitable for long-term contracts
- Premium Allocation Approach (PAA) – suitable for short-term contracts
- Variable Fee Approach (VFA) – suitable for contracts with discretionary participation features

Are we eligible for PAA?

In order to implement the simplified PAA over the more granular and time-consuming GMM option, the company must be satisfied that:

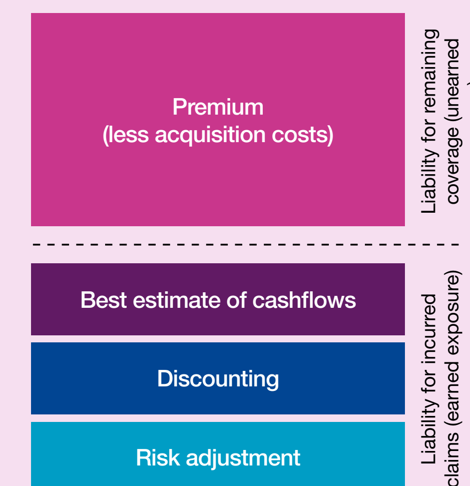
a) the coverage period for each contract is no longer than one year, or
b) the measurement of the contract is not expected to be materially different by applying PAA rather than GMM.

For the majority of our clients in the non-life insurance sector, the contracts they write satisfy either of the above two requirements. As expected, our clients are opting for the PAA approach for its simplicity and ease of use over the more technical and detailed GMM.

Overview of PAA

The chart to the right shows the different components of the balance sheet under IFRS 17 when using the PAA approach. Under the PAA approach the liability for remaining coverage (unearned exposure) is analogous to the UPR less DAC under IFRS 4.

For the liability for incurred claims (earned exposure) there are two key changes. These are the implementation of discounting of reserves and the use of a risk adjustment. The approach for determining these two elements is outlined below.



Discounting

The key considerations when working out suitable discount rates to use include:

- choosing between a 'top-down' and 'bottom-up' approach to calculate discount rates, and
- identifying the inputs required, where these inputs will come from, and how discount rates will be updated over time.

Top-down vs bottom-up

A bottom-up approach involves selecting a risk-free yield curve and determining an appropriate illiquidity premium based on the nature of the liabilities.

A top-down approach uses a yield curve based on a notional target investment portfolio and deducts an allowance for credit risk and for asset-liability mismatching. The majority of our clients implement a bottom-up approach.

This is because, although there can be challenges in determining an appropriate illiquidity risk premium, this should be more straightforward than both estimating the credit risk premium and selecting the notional investment portfolio.

Determining discount rates

If implementing a bottom-up approach, which seems to be the industry standard, the first step is to determine the appropriate risk-free rates. Clients are tending to implement risk free rates consistent with those adopted in their *Solvency II Technical Provisions* models. For the vast majority this leads to using risk free rates published by EIOPA. These have key advantages including timely publication and extensiveness, such as long maturity periods and range of currencies.

Some clients are deciding not to allow for any illiquidity premium in their discount rates. But we believe the accounting standard expects insurers to implement this. Many firms are using the *Volatility Adjustment* published by EIOPA, which tends to be used in *Technical Provisions* models.

Alternatively, there is the option to estimate the liquidity premium from first principles using internal models. Either of these approaches would be reasonable. Note that all liabilities have different characteristics (for example, the *Liability for Remaining Coverage* is much more liquid than the *Liability for Incurred Claims*). But we think the best approach is to derive a single illiquidity premium based on the overall or average level of liquidity of the liabilities.

Risk adjustment

There is a requirement for reserves under IFRS 17 to be set on a pure best estimate basis.

Insurers are then able to make a separate allowance, via a risk adjustment, for the uncertainties related to the amount and timing of cash flows. Under the PAA approach, the primary risk allowed for within the risk adjustment for the liability for incurred claims is reserve risk (uncertainty of the projected claims cash flows).

Calculation method

IFRS 17 does not specify how the risk adjustment should be calculated. Despite this, most clients adopt the same methodology. This is a confidence level approach, where a distribution of outcomes is derived and the confidence level selected so that there is a certain probability of the reserves being sufficient. For example, if they selected a 90% confidence level for the risk adjustment, the total reserves would be sufficient to cover the ultimate claims nine times out of ten.

The confidence level approach is more popular than the alternative cost of capital approach. This is because it is relatively easy to calculate and explain and offers more timely availability of inputs. These are primarily driven by the independence of the calculation to an insurer's capital model results.

Choice of distribution

The approach we are seeing most is for insurers to leverage work done to model reserve risk as part of the *Solvency II* SCR calculations, when determining suitable distributions. In particular, clients are using a log-normal distribution to model reserve risk with a coefficient of variation based on an ultimate time horizon, rather than the one-year time horizon used in the SCR calculation.

Confidence level

The selected confidence level is a decision for management and should reflect their risk appetite. But it is important that the selection is broadly in line with that of other insurers in the market. Most insurers are expected to set the confidence level at somewhere between 70% and 90%.

How are our clients responding to IFRS 17?

We've talked about some of the choices insurers will need to make in adopting the new standard. Many of our clients are progressing well in finalising their accounting policies and measurement models.

But, for all insurers, operating under IFRS 17 will require additional data and a more challenging measurement model. This introduces further complexity and cost and requires substantial investment in finance and actuarial processes. And this has prompted some of our clients, with our help, to consider whether IFRS 17 is the best accounting basis for their business.

As a result we have seen clients elect to voluntarily change the basis of their accounting from IFRS to Generally Accepted Accounting Principles in the United Kingdom (UKGAAP), if they are domiciled in the UK. If they are domiciled in an overseas jurisdiction, some have opted for United States of America (USGAAP). The main reason for adopting these different GAAPs is the substantially increased complexity when accounting for legacy insurance transactions, both historically and in the future. Not to mention the ever more onerous disclosure requirements of IFRS 17.

What is clear is that for insurers adopting IFRS 17, early engagement with auditors is vital. This will allow potential issues to be identified and resolved early on, minimising the chances of last-minute surprises.

It will also mean that feedback is received in good time, giving confidence over the key decisions that are critical to the project. Engaging auditors early will help insurers to be compliant with the requirements of IFRS 17 and many of our clients have already reached out to us for assurance over their dry runs. Ultimately, this reduces pressure on both finance and audit teams in the year of transition.

There are many moving parts to the implementation of IFRS 17 on 1 January 2023. Insurers are setting up and testing systems and refining critical accounting judgements. And, over the next few months, insurers will be releasing more information about the real-world consequences of IFRS 17. It is an interesting time not only for insurers, but also for shareholders and other stakeholders.

UK decides on tax implications of transition

Upon transition, life insurers will have a large one-off transitional profit or loss, which is undesirable both for them and for the tax authorities.

On 20 July 2022 the UK Government announced that it will allow the insurers' adjustment to retained earnings at transition to be spread over 10 years for tax purposes. General insurers are not expected to experience a significant impact from transitional earnings, so this transitional measure will not apply to them. The regulations will be put into law during the autumn, to apply to accounting periods beginning on, or after, 1 January 2023.

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Annual report preparation – food for thought

There have been no major accounting standard changes or amendments for accounting periods beginning in 2022. But that doesn't mean the 2022 year end will not be without its challenges.

UK GAAP update

Significant changes in UK GAAP are not expected until the FRC completes its second periodic review of the standard, which is currently under way, an exposure draft of the proposed changes is expected before the end of 2022, with changes not effective until 1 January 2025 at the earliest.

We expect this periodic review to focus on the potential introduction of all or some of the requirements of IFRS 9 Financial instruments, IFRS 15 Revenue from contracts with customers and IFRS 16 Leases. Insurers should consider what impact these standards may have on their financial statements (and potentially their capital position), taking lessons from IFRS reporters.

Corporate reporting – FRC annual and thematic reviews

Annual review of corporate reporting 2020/21

Every year, the FRC releases a summary of the findings from its corporate monitoring work, undertaken by its Corporate Reporting Review (CRR) team. This aims to communicate the FRC's view of what better quality reporting looks like, as well as areas where it sees a need for improvement. The top 10 areas for improvement in the most recently released report are:

1. Judgements and estimates
2. Revenue
3. Statement of cash flows
4. Impairment of assets
5. Alternative performance measures (APMs)
6. Financial instruments
7. Strategic report and the Companies Act
8. Provisions and contingencies
9. Leases
10. Income taxes

We expect these 10 to be continued areas of focus when the CRR reports its most recent findings for 2021/22.

Thematic reviews

Given the continuing need for improvement in reporting relating to judgements and estimates, it is not surprising to see the FRC undertake another thematic review on this subject. The following areas were identified as requiring improvement:

- Companies should explicitly state whether estimates have a significant risk of a material adjustment to the carrying amounts of assets and liabilities within the next financial year
- Sensitivity disclosures should be provided more often and in the way that is most meaningful to readers
- Sources of estimation uncertainty may vary from year to year. Companies should reassess whether disclosures made in a previous year need to be revised
- Where additional estimate disclosures are provided, such as those carrying lower risk, having smaller impact or crystallising over a longer timeframe, they should be clearly distinguished from those with a significant short-term effect.

Another key thematic review focused on the FRC's findings in relation to climate change disclosures under the TCFD framework. Whilst this framework is currently mandatory for only certain companies in the UK, insurers have been set certain expectations for their assessment and disclosure of climate risk.

The findings commented on areas such as the balance, granularity and specificity of the information disclosed, as well as the interlinkage with other parts of the annual report. It is likely this feedback will also be relevant to PRA authorised insurers.

Global trend impacts upon insurer results for the 2022 year end

Currency rates

As at the end of August 2022 the US dollar was at 1.16 to the pound compared to 1.35 at 31-21-21 - a 14% decrease and the lowest rate since 1985. However, the euro at 1.16 was only 3% up on 1.19 at 31-12-21. The very high US dollar to the pound will make US dollar driven results expressed in pounds look more dramatic. This will increase income and profits for many, but potentially make losses look even worse for some. These effects will not only be felt in exchange profits and losses but could also feed through to asset values and claims costs.

UK insurers with large US business portfolios are likely to show some impressive results. The Lloyd's half-year results, for example, show 17.4% growth in written premium with exchange accounting for 5.0%, price increase 7.7% and volume 4.7%.

Many insurers will need to think carefully about how they articulate their 2022 performance to users of their financial statements. We expect some entities will make use of alternative performance measures on a constant currency basis, which will need to be clearly explained.

Investment returns

Generally, the first half of 2022 led to very significant (mostly unrealised) investment losses for many insurers. This has two main elements.

- For those involved in equities there were falling stock markets as concerns about inflation, global politics and stalling economies increased. There has been some recent recovery after the large losses earlier in 2022 but the trends for the rest of the year remain uncertain.
- For most insurers their portfolios are heavy with bonds that have partly been affected by the ability of issuers to repay on time. But the greater effect is from increasing interest rate expectations. As interest rates increase, bond yields need to increase to remain competitive and this can only happen if bond prices fall. The currently high inflation levels have caused most major economies to increase government interest rates for the first time in several years. And, as inflation expectations grow, so the pace of recent increases picks up. For the rest of 2022 it will be interesting to see whether inflation expectations start to decrease and future interest rate rises slow.

The overall Lloyd's market result before tax for the first half of 2022 is a £1.8bn loss compared to a £1.4m profit for the first half of 2021.

This adverse £3.2bn swing has been driven by a £3.7bn adverse swing in investment returns to a £3.1bn investment loss for the period. Most of this loss is unrealised.

£1.5bn of the loss is changes in equity prices but £3.0bn of the loss is attributable to the repricing of yields on fixed interest bonds.

These bond losses are therefore likely to be recouped by higher yields on the bond portfolios over subsequent years, unless there are further major changes in future interest rates.

Premium rates

Global premium rates are still continuing upwards in 2022 to date, although at a slower pace now of around 9%, compared to a high at the end of 2020 of around 22%. The UK and US have seen the fastest decrease in rates.

Cyber continues to have high price increases, but this is aligned to high levels of claims. The sanctions arising from the Russian attack on Ukraine will have impacted certain lines of business. The changing sanctions picture means insurers need to be careful to control the business they accept.

The reported income at the top line will be influenced not only by pricing but also exchange rates, particularly for UK insurers with large US portfolios. At Q2 2022 the Lloyd's market has reported 19 consecutive quarters of positive price movements. Casualty has the highest current improvement, and energy and motor the lowest.

Inflation

As well as driving up all types of costs from fuel to salaries and, indirectly, interest rates and the impact of imports priced in US dollars, the effects of inflation are likely to be felt particularly by insurers in their claims costs.

This can manifest itself not only in increased costs of replacement parts, but supply chain problems that mean remedial action is delayed. This in turn can cause more damage to occur, increased periods of loss of income and require even more costly parts when they are finally received.

High demand for repair staff across most sectors also adds to inflation. What is more, the disruption to economies caused by the pandemic has led to more indirect impacts upon claims costs. These include the shortage of new cars, which increases second hand car prices where a replacement is required.

We should also mention the effects of social inflation upon awards and the increase in claims as economic conditions for some individuals deteriorate.

It will be a major challenge for claims handlers and actuaries to identify the impact of these various factors. Not only have they clearly been in a state of flux in the last year or two, but how they will develop over the next couple of years is also uncertain.

In debate will be how much inflation has already been factored into case reserves, and how much above this should actuaries allow for.

For Lloyd's, administration expenses are only up by 0.1% of premiums in the first half of 2022 but there has been a saving of 0.4% in acquisition costs such as brokerage.

The regulators are keen for the impact of inflation on claims reserving and premium pricing to be well understood by insurers. That is why they have issued guidance. Lloyd's, in particular, expects a clear demonstration of this in capital modelling by the syndicates. A key element is to identify excess inflation that insurers may face if the business they are involved in is above the pure inflation level shown by the Consumer Prices Index.

Accountants and actuaries should exercise significant judgement in their next year end reporting, where there is a need to take a medium or long term view of inflation. Where this is a key judgement or estimate, appropriate disclosure will be necessary.

Preparers of financial statements will also need to monitor inflation rates in overseas territories where they have business operations and consider whether hyper-inflationary accounting will be necessary. The International Practices Task Force (IPTF) of the Centre for Audit Quality (CAQ) monitors the status of 'highly inflationary' countries to aid in this assessment.

Particular claims

The hurricane season to the end of August has been very benign. But there are still a couple of usually very active months to go. Despite this, global insured losses are some 22% above their 10 year average. These are mostly severe weather and flooding events from around the world, rather than dominated by the US.

Most insurers have now emerged from the pandemic without major disruption to their business. But business lines such as travel insurance were severely impacted, and some insurers suffered significant business interruption claims.
Many of these have now been resolved but for the unlucky there are still ongoing disputes regarding coverage.

For the first half of 2022 compared to the first half of 2021, Lloyd's is showing major losses up from 6.8% of premiums to 9.9%. These are driven by £1.1bn of losses from the Ukraine conflict.

This includes the Lloyd's share of claims related to leased aircraft stranded in Russia, which are uncertain in outcome and which policy will respond to these losses, but some analysts believe could ultimately across the global insurance market be 7 times the scale of the World Trade Center Loss in 2001. Attritional losses as a percentage of premium are down by 1.6% to 48.9% and prior year releases are up from 0.9% of premium to 2.8%.

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