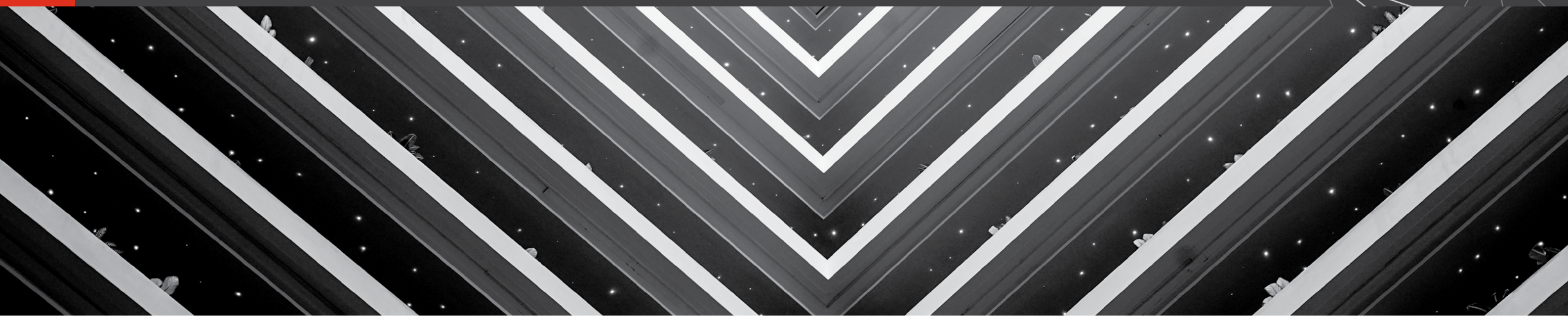
COVID-19: Financial reporting considerations for life insurers

September 2020



Changes to actuarial assumptions

COVID-19 is having a significant impact on many reporting entities including life insurers. There are numerous uncertainties and practical difficulties which will translate into many challenges and risks in preparing financial statements, specifically in the setting of actuarial assumptions. During August 2020, we benchmarked changes to actuarial assumptions that life insurers have made in response to COVID-19 in their half-year or year-end reporting. A total of 11 life insurers in New Zealand and four in Australia were included. We note that the outcomes from COVID-19 continue to be uncertain and any changes to assumptions are a matter of significant judgement.

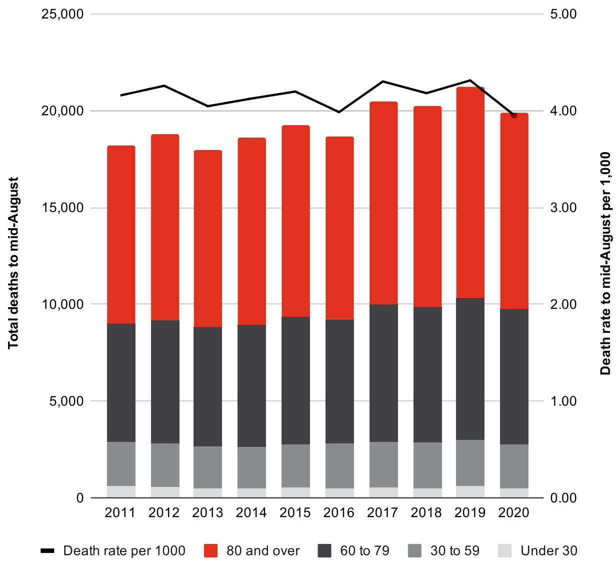
Mortality assumptions

Most life insurers have not made any significant changes to mortality assumptions due to COVID-19. This aligns with the strong public health mitigation measures (lockdowns, social distancing, masks) to reduce the spread of the virus and number of deaths.

Two insurers adjusted mortality assumptions for their funeral product exposures due to the higher risk of death from COVID-19 based on the age profile. Two insurers increased mortality rates for short-term periods, while another increased assumptions by a fixed percentage permanently due to limitations of modelling short-term shocks. Generally insurers noted that other than the direct deaths from COVID-19, there may be an increase in suicide claims too.

So far in New Zealand we appear to have reported fewer deaths since 2016 in the period to mid-August each year. The death rate per thousand people is the lowest it has been in a decade (see chart on the right). The lockdowns may have reduced the total number of deaths by eliminating other illnesses or reducing other causes of deaths in the short-term, but will there be longer term effects?

Deaths in New Zealand up to mid-August each year



Source: Statistics NZ,
https://www.stats.govt.nz/experimental/covid-19-data-portal

Income protection (IP)

Most life insurers with exposure to long-term IP claims risk have made some adjustments to their income protection claims assumptions as a result of COVID-19. This clearly reflects the severity that the long-term economic impacts could have on long-term IP claims, particularly due to mental illness.

Changes have been more prevalent in Australia where many of the IP portfolios are in loss recognition, which means that insurers have been recognising impacts in the current year.

Within New Zealand, the expected claims generally increased by 20-30% over the next year due to a combination of incidence and termination changes, reducing over time. The timeframe for the impact of the shock varied – from six months, to four years, to a permanent shock (but smaller in size). One insurer implemented changes to termination rates only, assuming that there would be fewer accident claims to offset any additional illness claims.

Common sources of information to guide assumption setting were studies from after the GFC that demonstrated links between the unemployment rate and disability rates. In particular, a GenRe study across Europe, where disability rates rose by 6% for every 1% increase in unemployment, was often referenced.

There were other insurers that made no changes to their IP claims assumptions in New Zealand. The majority of these life insurers primarily write limited IP or IP with short-term coverage periods where the risk of long-term mental illness claims is limited.

Predicting the long-term economic impacts on IP books were often noted as an area that has been very difficult for life insurers.

Trauma and Total Permanent Disability (TPD)

Changes to trauma and TPD assumptions were limited across the industry. Only four insurers in New Zealand changed either their trauma or TPD assumptions.

Changes to TPD assumptions were common in Australia, primarily due to the much larger TPD portfolios as a result of group risk. It has been estimated that as much as 25% of TPD claims are linked to severe mental illness. TPD exposure in New Zealand is limited and therefore unlikely to be material.

Within the trauma product, the main cause for concern appears to be ICU benefits or longer term comorbidity impacts of an economic recession (for example, additional stroke or heart attack claims arising from the stress caused by an economic downturn).

Redundancy

Only a few insurers offer redundancy and those that do are expecting substantial increases in claims. Redundancy claims are a direct consequence of an economic recession and rising unemployment. The level of claims have been assumed to double or triple within the next six to 12 months; one insurer is estimating the impacts may last as long as three years.

Lapses

Most life insurers have not changed their best estimate assumptions for lapses in response to COVID-19. Recent industry experience suggests lapse rates have been lower than expected, potentially due to premium holiday or suspension offerings, or perhaps due to customers viewing life insurance as being more important.

Four insurers in New Zealand increased their assumptions over a period of six months to 24 months. The level of the shock was generally 1-2% absolute change in lapses or +20% proportionate change. A number of insurers have commented that it will be when the wage subsidies are exhausted that lapses may start to increase, but in the meantime lapses may in fact be less than long-term expectations.

Private health insurance

Conversely, insurers with health insurance products have had fewer claims reported due to the lockdown(s) and are grappling with timing issues related to the reporting of claims.

This raises the issue of when a claim is 'incurred' from a financial reporting perspective. For customers with private health insurance, the underlying need for an elective procedure has not gone away due to COVID-19, it has just not been possible to progress consultations during lockdowns and therefore the claim has not been reported. Based on an insurer's definition of a claim, this may mean that the claim has not been 'incurred' and therefore technically would not form part of an insurers' outstanding claims reserves or IBNR.

In Australia, APRA have been aware of this issue and have issued some guidance to private health insurers in respect of including a 'deferred claim liability' within their regulatory and capital reporting.[1] This is not strictly an IFRS provision, so insurers should consider how to best comply with IFRS standards whilst ensuring there are sufficient capital reserves to meet claims as they fall due.

[1] https://www.apra.gov.au/application-of-capital-framework-for-covid-19-related-disruptions

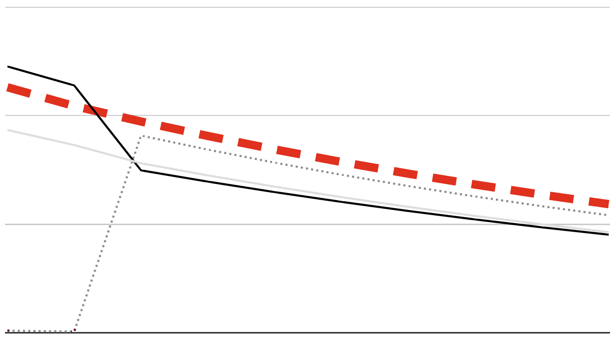
Other financial reporting implications

Are you providing a 'greater service' during a pandemic?

Life insurers account for their contracts in Australia and New Zealand under a 'Margin on Services' method, which spreads future profits in line with a profit 'carrier'. For a typical risk portfolio, the carrier is either expected premiums or expected claims as these are deemed appropriate as the measure of the service provided to policyholders.

The future profit emergence from COVID-19 will critically depend on whether the insurer changes assumptions or not, and whether the profit carrier is premiums or claims. We have produced examples of the potential profit emergence on the right, based on an illustrative closed YRT portfolio where claims are 50% higher and lapses are 20% higher than pre COVID expectations over two years.

Illustrative profit emergence post COVID



There were three possible scenarios under this situation:

1. The insurer did not change any assumptions, which resulted in lower profits over two years before reverting to levels similar to pre COVID.
2. The insurer did change assumptions and **premiums** were the profit carrier. In this situation, the impacts are spread across all profits in the future.
3. The insurer did change assumptions and **claims** were the profit carrier. This resulted in higher profits for two years with much lower profits thereafter.

The last scenario is effectively saying that the life insurer is providing a "greater service" during the pandemic period. However, the **results are counterintuitive** and a lay person would expect results to be closer to the first scenario.

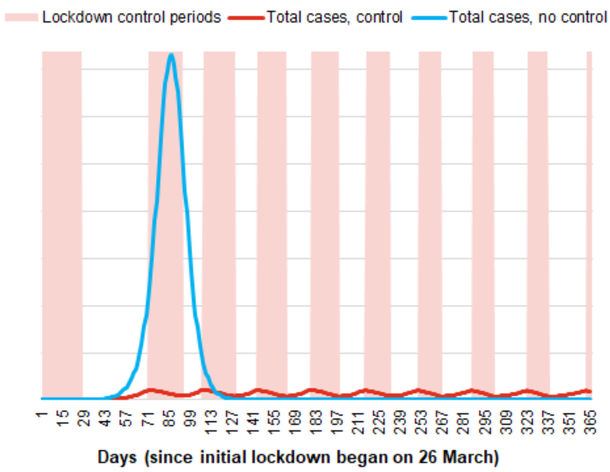
Other considerations

What did we learn from previous pandemics?
The WHO reports that about 33 million people have died from HIV since the global epidemic began. Life insurers initially adjusted financial models and underwriting requirements. Medical advancements have reduced the mortality rate, yet there continues to be a steady number of HIV diagnoses in New Zealand. The strong public health response to limit exposure and treat the illness has significantly reduced the impact on society (and life insurers). While HIV has not created direct economic impacts in developed countries, due to the speed at which the virus spreads, the investment in creating more flexible models has given management more tools to simulate scenarios and make timely decisions for future outbreaks.

What about your financial statements?
Significant accounting estimates and judgements should be adequately disclosed within the financial statements to meet the requirements of the accounting standards. PwC has previously issued guidance[2] around considerations of other items in response to COVID-19. These include the measurement of non-financial assets and leases along with disclosures.

What about the effect of further lockdowns?
Further lockdowns to limit the spread of COVID-19 are likely to have economic consequences. Based on a simple epidemiological model constructed in April 2020, it was estimated that further lockdowns in various parts of the country are inevitable as we continue with the Government's elimination strategy. However, they are likely to reduce in length and the time between them is likely to extend until a vaccine becomes available.

Results of a SIR epidemiological model for COVID-19



[2] https://www.pwc.co.nz/services/audit-and-assurance/financial-reporting/financial-reporting-tools/accounting-implications-of-the-effects-of-covid-19.html

Beyond the crisis

Five key strategic priorities

Adjusting to a “new normal” has presented its challenges. Immediate health concerns required rapid changes to how insurers operated and many insurers continue to offer flexible working arrangements while the pandemic continues to be present in our community. For life insurers, initial assessments of the financial impacts focussed on the mortality risk, operational costs and how best to support intermediaries. These were quickly replaced by concerns over the longer term effects of an economic shock after New Zealand flattened its curve. Some insurers have noted that they are concerned more about the long term solvency capital impacts rather than the impact on their financial results over the short-term.

PwC’s global insurance leaders produced a thought leadership document setting out five key strategic priorities to focus on in order to be a stronger business following the crisis. These are shown on the right. While established with a Global insurance lens, they are just as relevant to the New Zealand insurance sector. The lessons learnt from our lockdown experiences can be leveraged to execute these priorities. As we’ve all found new ways of working, we have a better appreciation of technology and customers are now more accustomed to engaging via digital channels.

We encourage you to read the full report “Beyond COVID-19” and reach out to our local insurance team if you’d like to discuss any aspects further.

1. **Realign your cost structure and sharpen productivity**
2. **Supercharge digital transformation to create a digital enterprise**
3. **Carve out new revenue streams**
4. **Prepare your workforce for the new world**
5. **Strengthen capital efficiency**

Source:
https://www.pwc.com/gx/en/industries/financial-services/publications/beyond-covid-19.html

Contact us if you have any queries

Our local insurance team provides a range of services to insurance companies from external and internal audit to specific accounting advice under IFRS standards to actuarial services. Get in touch if you’d like to discuss any aspect of your financial reporting in this period of uncertainty.

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