



The influence of IFRS 17 on reward KPIs – Volatility of pay parameters and new opportunities

According to the IASB board, financial statements in the insurance sector currently do not truly reflect the nature and extent of risks embedded in insurance contracts.

The new accounting standard for insurance contracts, IFRS 17 (formerly known as “IFRS 4 Phase II”), redefines the calculation of certain financial metrics and thereby establishes a new framework for corporate performance measurement.

As most performance metrics, such as profit and Return on Equity (“RoE”), may change considerably under the new standard, individual performance assessments linked to these values will have to be reevaluat-

ed as well, especially at the executive and management level. Consequently, to ensure that remuneration plans still reward good performance and lead employee behavior in the right direction, compensation systems will have to be adjusted to the new IFRS 17 regime.

Adjusting for remuneration KPIs

Several financial metrics that are commonly also used as remuneration KPIs will change under IFRS 17. For instance, reported

The key changes under IFRS 17 and why it affects executives' reward design in the insurance industry

Under the new standard, revenues and expenses will be recognized as they are received and paid and not as they are earned or incurred (as currently done).

This will lead, ceteris paribus, to greater volatility in accounting KPIs. In particular, the profitability of a book of business will become more volatile.

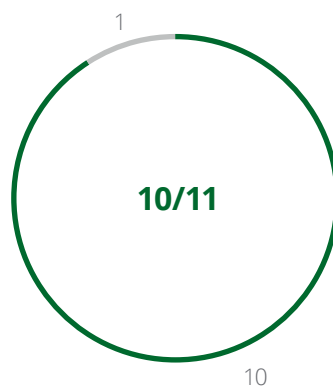
As these financial metrics are used in the determination of executive compensation packages, the introduction of IFRS 17 will necessitate an overhaul of their compensation design.

expenses for claims which, under the new standard, will more accurately reflect actual economic expenses because companies will report estimated future payments to settle incurred claims on a discounted basis. Currently, some companies do not consider the time value of money in their liabilities for claims incurred which leads to a distortion in the results for insurance contracts for which settlement claims may take several years. Depending upon each company's applied practice and specific liability structures, this change is expected to affect companies to different degrees. The result is that compensation and performance KPIs that are directly influenced by changes due to IFRS 17 might increase or decrease materially, independent of the employees' actual performance. An executive might deliver similar work as in previous years, but, due to changes in the way the corresponding performance KPIs are computed, this is likely to be reflected differently in the performance review leading to a change in pay. Note that, due to balancing effects over the total period, decreasing KPIs now will be followed by increased KPIs in future, and vice versa.

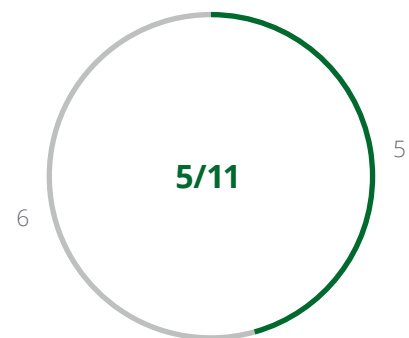
As a consequence, remuneration is in danger of becoming volatile (decreasing, or even increasing) in an unpredictable manner. Incentive systems only have a positive effect on managers' behavior if they feel that they can actively influence them so pay designs in the insurance sector are in jeopardy of losing their directive force or even lead to perverse incentives.

Looking at Europe's top 11 insurance companies that apply IFRS by gross written premiums, the new standard is likely to have substantial effects on executive compensation. For most of these insurers, several KPIs used for the calculation of annual bonuses as well as performance condition KPIs in the long-term incentive (LTI) plan design will be directly impacted. Two examples are revenue and RoE as both these measurements will change under IFRS 17. In 2016, ten out of Europe's 11 biggest insurers used revenue based KPIs in their variable compensation systems. Moreover, 5 out of 11 used RoE based measures as performance conditions in their LTI plans or in their mid-term incentive (MTI) plans.

Usage of revenue based KPIs



Usage of RoE in MTI or LTI performance conditions



■ used
■ not used

The influence of IFRS 17 on reward KPIs

None of Europe's top 11 insurers are unaffected by IFRS 17. Instead, for most of them, several to all variable pay KPIs are imperiled by the changes. This, in fact, influences their executives' compensation packages enormously. At the upper end of Europe's top 11 insurers, variable pay

components can account for up to 93% of the entire executive remuneration. On average, 66% of pay mix is designated with variable components when looking at target amounts. When looking at maximum achievable bonuses, an average 70% is variable compensation.

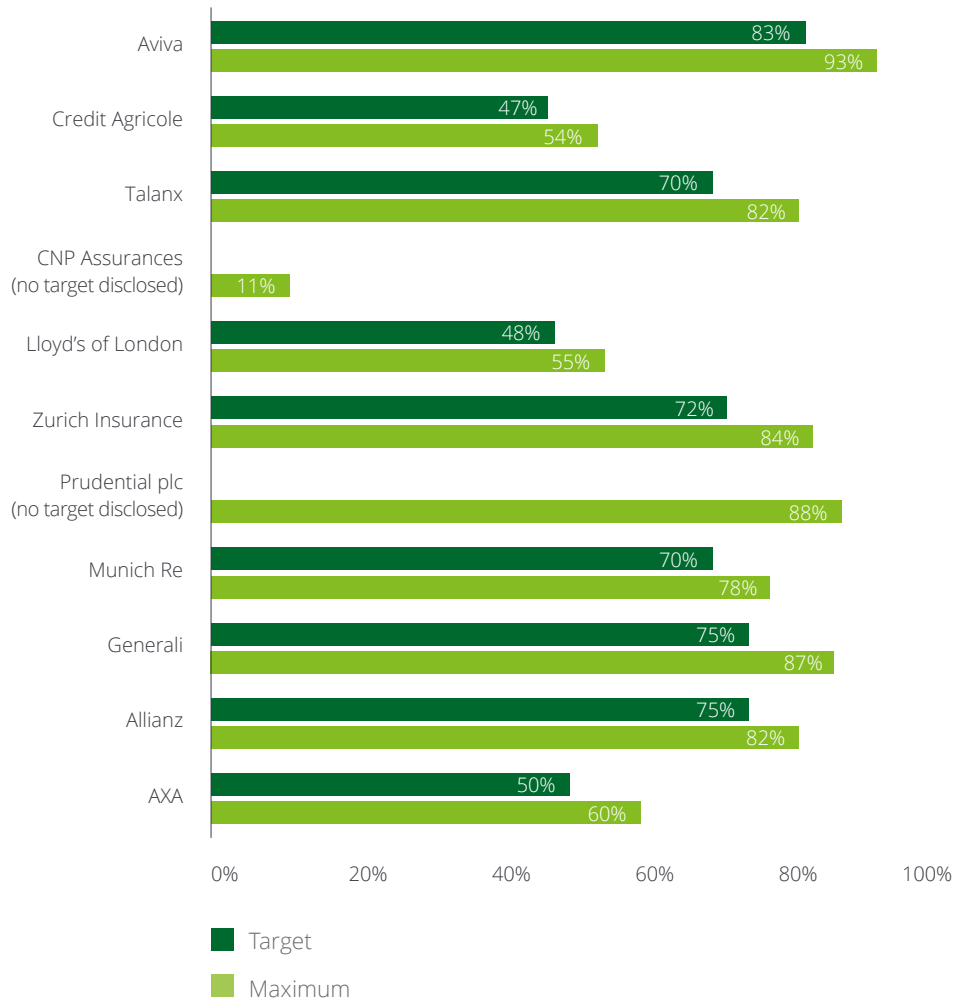
Variable pay and underlying KPIs of Europe's top 11 insurers

Company	GWP in €bn	% of variable pay on total compensation*	Examples for KPIs affected by IFRS 17
AXA	94.2	Maximum: 60% Target: 50%	<ul style="list-style-type: none"> • Gross revenue • Current year combined ratio • Economic expenses
Allianz	76.3	Maximum: 82% Target: 75%	<ul style="list-style-type: none"> • Operating result • Net profit • Return on Equity
Generali	70.5	Maximum: 87% Target: 75%	<ul style="list-style-type: none"> • General expenses • Return on Equity • Combined ratio
Munich Re	48.9	Maximum: 78% Target: 70%	<ul style="list-style-type: none"> • RORAC • Value added
Prudential plc	46.1	Maximum: 88% (no target disclosed)	<ul style="list-style-type: none"> • Business unit profit • Group operating profit • IFRS profit
Zurich Insurance	45.8	Maximum: 84% Target: 72%	<ul style="list-style-type: none"> • NIAS Return on Equity • Operating profit • BOP
Lloyd's of London	35.0	Maximum: 55% Target: 48%	<ul style="list-style-type: none"> • Combined operating ratio • EBIT • Profit Before Tax
CNP Assurances	31.5	Maximum: 11% (no target disclosed)	<ul style="list-style-type: none"> • EBIT • Cost/ income ratio
Talanx	31.1	Maximum: 82% Target: 70%	<ul style="list-style-type: none"> • Return on Equity • Gross premium growth • Net combined ratio
Credit Agricole	30.3	Maximum: 54% Target: 47%	<ul style="list-style-type: none"> • Revenue • Gross operating income • Net income
Aviva	29.8	Maximum: 93% Target: 83%	<ul style="list-style-type: none"> • Combined operating ratio • Return on Equity • Profit Before Tax

*Containing only fixed salary, STI, MIT and LTI. CEO data used where no common measure was available.

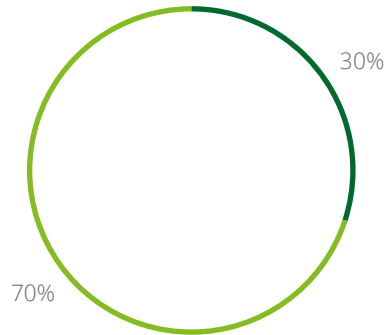
To maintain accurate and effective compensation systems, insurers will have to revisit them to realign them with how these KPIs will actually work under IFRS 17. Note that IFRS 17 will affect all peer group insurers so any performance measures that use relative performance will need to be reviewed.

Percentage of variable compensation on total pay mix

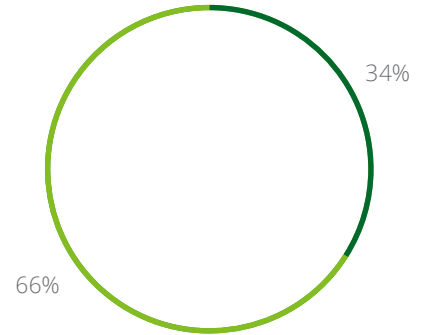


Executive compensation in Europe's top insurance companies heavily relies on variable pay

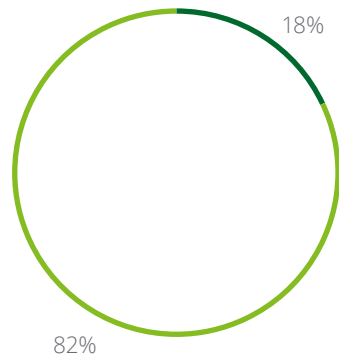
Average at maximum



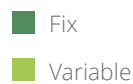
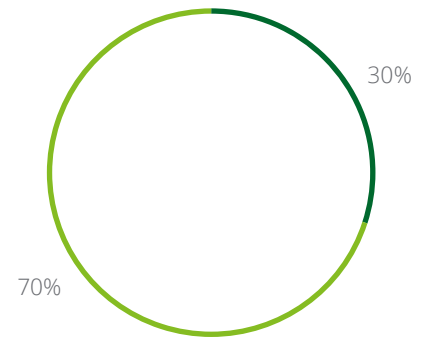
Average at target



Median at maximum



Median at target



How will the KPIs change?

Under the new standard, revenues and expenses are recognized as they are received and paid rather than earned or incurred. Generally, a shift from a retrospective to a prospective basis of analysis takes place. Compensation designs need to echo this shift and be customized to company specific requirements, with appropriately adjusted target KPIs. Additional information about different profit components will be reported and the amount, timing and uncertainty of cash-flows arising from insurance contracts will be easier to assess. Without any change, current KPIs will

automatically reflect these measurement changes and thus drive different behaviors. Besides the changed computation of common financial values, new KPIs are likely to emerge although most likely only on an internal basis. The new standard, for instance, provides novel insights into the risks of insurance contracts. As risks become more transparent, as well as quantifiable, employees on different levels could be guided more effectively into risk reducing behavior via well considered risk related KPIs. Overall, new yet unused, or not yet existing, KPIs are likely to be considered.

Companies need to understand how IFRS 17 will change their results and react by adjusting their pay design accordingly.

New paths for comparing

The IASB board claims that the new standard will increase comparability and transparency. For example, companies are required to disclose the corresponding confidence interval for the risk adjustment liability, even though companies are allowed to adopt varying techniques to calculate this liability. That brings enhanced insights into relative performance. As a result, company performance could be compared more easily which may be an opportunity to refine incentive design. Although the majority of Europe's top 11 insurers already use peer group comparisons of share price developments or relative Total Shareholder Return (TSR) as performance conditions in their LTI plans, the new standard could open the way for the introduction of more thorough peer group performance comparisons coupled to additional KPIs. Thus, compensation systems could be more precisely aligned to competitive goals and strategic objectives.

IFRS 17 is also designed to offer better comparison to other industries paving the way for possible comparisons between insurance companies and other similar businesses, especially financial services. For instance, using current discount rates as proposed by the new standard enables an assessment against banks and asset management. Instead of presenting cash and deposits received as revenue, revenue will reflect the insurance coverage provided, excluding saving components, which establishes better comparability to investment management. Similarly, the standard enables cross-country comparisons both within and across companies. While under IFRS 4 phase I, some companies excluded saving components received from premiums, others recognize all premiums received as revenues which, however, often vary between jurisdictions. Given the new standard, a multinational group should measure insurance contracts consistently allowing for enriched internal benchmarking by product and geographical area.

Conclusion

IFRS 17 redefines several financial indicators typically used as compensation KPIs in the insurance industry. The financial numbers are not expected to change linearly across companies, but, depending on business model and profit structures, most likely affect companies differently. This implies that a certain volatility will need to be considered when setting KPIs and defining targets. To ensure that a pay for performance approach remains valid, currently used KPIs will have to be adjusted to internal changes as well as to corresponding developments in the KPIs of competitors. In the long term, however, the new standard also offers transparency and comparability which implies opportunities to refine pay design.

We believe insurance companies will need to:

- Adjust current remuneration KPIs to reflect greater volatility
- Adjust current remuneration KPIs to reflect changes in the peer group
- Implement new KPIs related to future expected results under the new standard

Key to this will be understanding how IFRS 17 changes an insurance company's own results and redesign or adjust pay design accordingly.

Furthermore, a very close connection will be needed by reward designers and the actuarial and accounting departments to get this right.

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