ACTUARIAL ASSOCIATION OF EUROPE

IFRS 17 vs. Solvency II balance sheets
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Kristoffer Bork, Chairperson IFRS17 Working Group

Agenda

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2. Balance sheet and valuation approach
3. Specific items analysed by EIOPA*) and commented by the AAE**)
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    2. Cash flows
    3. Grouping, aggregation, and contract boundaries
    4. Discount rates
    5. Risk Margin vs. Risk Adjustment
    6. Reinsurance

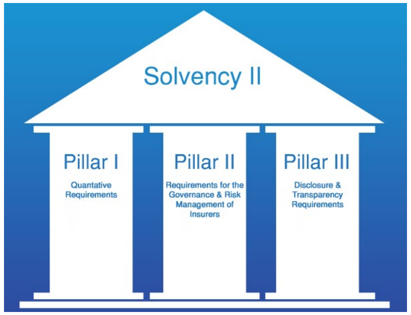
*) EIOPA's analysis of IFRS 17 Insurance Contracts, 18 October 2018

**) See under publications at www.actuary.eu

Scope and the obvious differences

Different purposes

- Solvency II is a complete regulation framework for consumer protection and risk management of insurance companies
  - Consumer protection
  - Governance structure
  - Compliance
  - Capital requirement
  - Common definitions for all companies
  - Long-term ERM perspective
  - The regulation applies to *insurance companies*
- IFRS is a reporting standard
  - Measure financial performance over a period
  - Partially based on company-specific definitions
  - Audit requirements
  - The reporting standard applies to *insurance contracts*



IFRS 17
Insurance Contracts

What is all new?

- The Solvency II framework does not describe a profit and loss statement
- The IFRS 17 standard introduces a new profit and loss that is different from earlier reporting standards
- The supplementary information requirements for the notes are significant and challenging

Balance sheets

Balance sheets - similarities

- Both sets of regulation contain a balance sheet
- Forward looking approach to valuation
- Asset valuation based on fair values
- The value of insurance liabilities is determined from the expected value of future cash flows of the insurance portfolio
- The cash flows are determined incorporating expected customer behaviour in relation to customer options
- The cash flows are discounted to reach at a net present value
- Allowance for risk adjustment

Balance sheets – immediate differences

- In the Solvency II balance sheet, future expected profit is part of "own funds"

- In the IFRS 17 balance sheet, future expected profit is part of the insurance liabilities, contained in the contractual service margin and will gradually be recognised as profit over the life span of the contract

- In the Solvency II balance sheet, reinsurance contracts and the underlying insurance contracts will be accounted for on a net basis.

- In the IFRS 17 balance sheet, reinsurance contracts and the ceded underlying insurance contracts will be accounted for separately

- But the devil is in the details.....

Specific items, the AAE response to EIOPA’s analysis on IFRS 17 vs. Solvency II balance sheet

Specific items analysed by EIOPA*) and commented by the AAE**)

1. Initial recognition - Future profit vs CSM
2. Cash flows
3. Grouping, aggregation, and contract boundaries
4. Discount rates
5. Risk Margin vs. Risk Adjustment
6. Reinsurance

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Initial recognition

EIOPA conclusion

- *The point in time at which insurance obligations are recognised under both frameworks is conceptually similar. However, IFRS 17 introduces a simplification, which may lead to differences in some cases. The practical impact of such differences is not expected to be significant.*
- *Expected profits at inception are recognised in the reconciliation reserve (equity) of that period under Solvency II and are allocated over the lifetime of the contract according to the service provided under IFRS 17. This is reflective of the different objectives of regulatory and accounting frameworks. The accounting framework needs to present the entity's performance, including the allocation of gains and losses to specific reporting periods.*

Initial Recognition - Contract boundaries

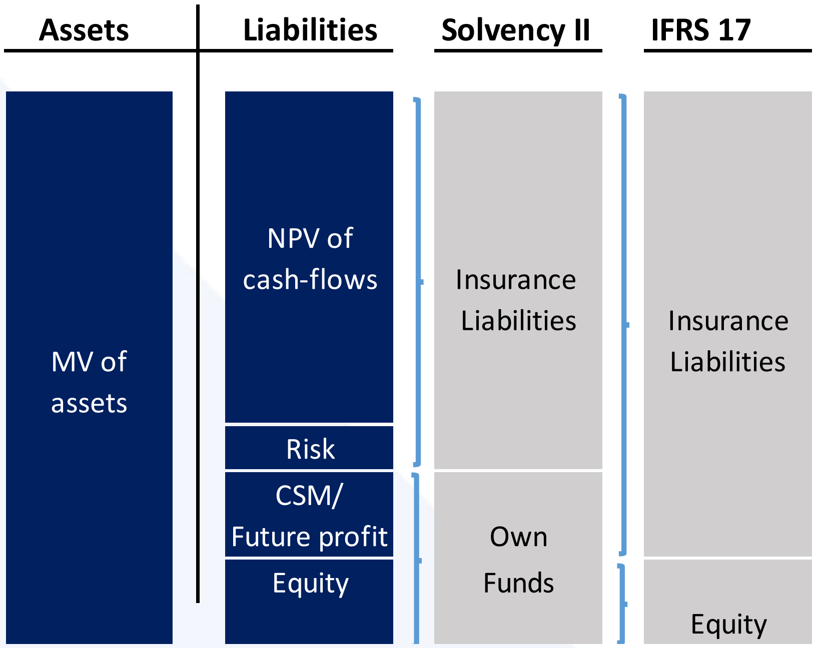
- Differences in definition of contract boundaries for non-onerous contracts is a practical obstacle
- EIOPA concludes that the differences are not material. This may be an optimistic conclusion in some cases.

Initial recognition –
Future profit vs. Contractual Service Margin

- Under Solvency II, future expected profit and loss are recognized immediately as future profit

- Under IFRS 17, future expected loss is immediately recognized whereas future expected profit is only gradually released from the Contractual Service Margin (part of the insurance liabilities)

Illustrative (notation not precise)



Initial recognition – Future profit vs. Contractual Service Margin

- At initial recognition, the CSM reflects the value of future expected profit – in principle similar to future profits in Solvency II

- Discount rate used for valuation at initial recognition is locked in to the entire duration of the contracts, i.e. the unwinding of the CSM of an insurance company requires a multiple of different discount rates

- EIOPA does not look at the unwinding of the CSM in their analysis. The definition of coverage units and practical execution of the unwinding of CSM for different groups of insurance contracts is a new exercise for European insurers

- At initial recognition, the CSM in IFRS 17 may closely relate to the future expected profit in Solvency II, but at subsequent measurements, this is not likely to be the case

Cash flows

EIOPA conclusion

- *Cash flows and expenses included in the valuation of SII technical provisions are expected to be consistent with IFRS 17 in most cases.*

Cash flows

- In relation to expenses, some conditions need to be met in order to reuse assumptions from Solvency II.
- Solvency II specifies that all costs must be allocated to the cash flows, i.e. under a full expense allocation approach (ex new business)
- IFRS specifically mentions costs (meaning expenses and commissions) that cannot be directly attributed to the portfolio of insurance contracts shall not be included.
- The initial acquisition cost are under IFRS17 allocated during the time, when the services are provided, while under Solvency II these are immediately expensed, decreasing the net equity immediately.
- Further, different treatment of reinsurance contracts may also generate differences in the cash flows.

Grouping, aggregation, and contract boundaries

EIOPA conclusion

- *In principle, the Solvency II approach to determine the relevant level of aggregation for expected cash flows and other inputs is anticipated to be consistent with IFRS 17. However, further disaggregation by "annual cohorts" to group according to profitability is needed for IFRS 17.*
- *The Solvency II requirement to identify homogeneous risk groups can be considered as a basis for IFRS 17's requirements on grouping contracts.*
- *The contract boundaries have been found to be similar in principle, differences for certain contract types cannot be ruled out.*

Grouping, aggregation, and contract boundaries

- Separations of components may cause differences in the cash flows (at least when looking at IFRS 17 separate from other standards).
  - Example: The kick-back cash flow paid by the fund manager to the insurance entity. Unclear if this cash flow is within the insurance contract boundary or whether it relates to a separate (investment) service contract reported under IFRS 15.
- The disaggregation requirement of IFRS 17 may cause many practical challenges, but when added together the disaggregation may not necessarily cause significant changes to the Solvency II framework.
- But significant differences in the cash flow structure may occur e.g. if a single contract contains several non-distinct insurance components belonging to different risk groups.

Discount Rates

EIOPA conclusion

- *IFRS 17 allows for both a top-down and a bottom-up approach, adjusting for illiquidity whilst taking into account all market inputs. SII sets out a bottom-up approach without an explicit measure of illiquidity. It converges to an ultimate forward rate (UFR) after last liquid point.*
- *SII's techniques and approaches for the volatility adjustment (VA) and matching adjustment (MA) may be used, taking into consideration IFRS 17 specific assumptions. The SII extrapolation method may need to be adjusted for IFRS 17, if relevant market input were found to make a significant difference.*

Discount Rates

The SII techniques in terms of the risk free term structure and especially the VA framework may be appropriate as a framework for IFRS 17 discount rates, but:

- Product specific adjustments may be needed under IFRS 17.
- In relation to the UFR definition in SII, IFRS 17 provides no guidelines on how to apply discount rates beyond the last liquid point
- IFRS 17 introduces both the current discount rates and the discount rates at initial recognition
- If European insurers are to use Solvency II inspired discount rates, EIOPA will have to publish the official rates at a higher frequency or at least much faster than today in order for insurance entities to use the rates in a fast close process.

Risk Margin vs. Risk Adjustment

EIOPA conclusion

- *The approach to determining the risk margin in Solvency II is conceptually different from the risk adjustment in IFRS 17 (transfer vs. entity specific)*
- *Nevertheless, for the practical implementation of IFRS 17, SII's risk margin's underlying principles, inputs and processes may be considered for IFRS 17, subject to potential adaptation.*

Risk Margin vs. Risk Adjustment

Several challenges seem to be ignored by EIOPA

- The risk adjustment needs to be allocated at a group level to perform the onerous test
- The risk adjustment figure needs to be presented as a confidence level.
- An insurer needs to consider the implications of moving from a "net of reinsurance" framework under Solvency II to a gross of reinsurance and ceded framework under IFRS 17.
- The risk adjustment under IFRS 17 does not allow for operational risk nor reinsurance counterpart risk. These risk categories are included in the risk margin defined under Solvency II.

Reinsurance

EIOPA conclusion (I/II)

- *Both frameworks set out that reinsurance contracts issued are generally accounted for in the same manner as insurance contracts issued. According to Solvency II, the measurement of reinsurance contracts held is consistent with the underlying contracts issued, while under IFRS 17 the measurement model is applied separately, using consistent assumptions and inputs, to the reinsurance contract held and to the underlying insurance contracts. The separate application of the measurement model may permit differences to arise between the recognised amounts and performance of the reinsurance recoverable and the ceded insurance liability.*
- *IFRS 17 does not seem to acknowledge the different economic circumstances and consequently does not allow the insurer to present a matching treatment of gains from reinsurance contracts, where this may be appropriate.*

Reinsurance

EIOPA conclusion (II/II)

- *Payments (expenses and cash in-flows) related to reinsurance undertakings are part of the gross calculation of the best estimate and technical provision's cash flow projections according to SII. Reinsurance contracts and corresponding cash flows are recognised as separate contracts under IFRS 17.*
- *SII takes a 'net approach' for determining the risk margin of insurance contracts and allocates reinsurance cash-inflows to corresponding insurance contracts, whereas IFRS 17 presents ceded reinsurance as a separate reinsurance asset.*
- *The concept of reinsurance contracts' contract boundaries are different and the application of the different concepts may lead to differences in the valuation of reinsurance held between the two frameworks.*
- *Under IFRS 17 the variable fee approach model is not available for reinsurance contracts issued (or held).*

Reinsurance

- The proposed amendments of the IFRS17 (published after the EIOPA report) in relation to reinsurance will ease implementation and make it easier for companies to explain results.
- For direct insurers, this change removes one of the key differences between SII and IFRS17 relating to reinsurance, especially reinsurance on proportional basis
- Still, there may be some differences in valuation arising under IFRS17 as a result of the separate valuation of reinsurance contracts and underlying contracts, for instance in relation to risk margin and/or contract boundaries.

Response to EIOPA’s analysis on IFRS 17 vs. Solvency II balance sheet

Questions?