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# **EIOPA's analysis of IFRS 17 Insurance Contracts**

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## Executive Summary

This report presents several aspects of EIOPA's assessment of IFRS 17 Insurance Contracts: potential effects on financial stability and the European public good, on product design, supply and demand of insurance contracts – and IFRS 17's practical implementation in light of the applicable inputs and processes for Solvency II.

Overall, EIOPA found that the increased transparency, comparability and providing insights into insurers' business models through IFRS 17 have the potential to strengthen financial stability in the EEA and therefore regards the implementation of IFRS 17 as beneficial for the European public good. IFRS 17's current, market-consistent and risk-sensitive measurement for insurance obligations reflects on economic reality. This supports efficient risk management and allows stakeholders to gain insights into the entity's business model, exposures and performance.

The introduction of IFRS 17 can be described as a long overdue and positive shift of paradigm compared to IFRS 17's predecessor IFRS 4 Insurance Contracts. Notwithstanding the significant improvements to the financial reporting applying IFRS 17, EIOPA has reservations on a few concepts that may affect comparability and relevance of IFRS 17 financial statements.

There is certainly understanding for the challenges of a market-consistent valuation of insurance liabilities, where such liabilities are infrequently traded in mostly illiquid markets, which necessitates the consideration of entity-specific inputs and assumptions in the valuation. IFRS 17's requirements on determining the applicable discount rate and risk adjustment may have exceeded the appropriate level of entity-specific inputs and consequently may give rise to significantly different and potentially incomparable results.

In other areas, EIOPA found that the solutions provided by IFRS 17 may not be perfectly designed to capture the economics of certain aspects of insurance and reinsurance contracts held and therefore may lead to further complexity of the financial statements. Issues such as level of contracts' aggregation or gains from reinsurance contracts held may require further consideration in the implementation of IFRS 17 and potentially amendments through targeted improvements by the IASB in the future.

The effects of IFRS 17 on insurers' investments and product availability have been considered in analogy to the studies conducted by EIOPA following the introduction of Solvency II. The market-consistent Solvency II balance sheet valuation can be regarded as a proxy to the application of IFRS 17 and IFRS 9 Financial Instruments. In its studies, EIOPA observed that developments in the economic environment, such as the recent, persistently low interest rates and yields, do shape the availability of certain contracts, the pricing of such contracts as well as the consumer demand and can affect investment decisions. So far, EIOPA has not found that changes in the regulatory environment, particularly the implementation of Solvency II, have had similarly clear effects.

Finally, for the actual implementation of IFRS 17, EIOPA's analysis concluded that crucial inputs and processes developed for Solvency II can be used, but may need adaptation to varying degrees. Notwithstanding potential need for adaptation, it is expected that significant efficiency gains can be reaped. These efficiency gains are most prevalent in the building blocks of IFRS 17: cash flows, discount rate and risk adjustment.

# 1. Introduction

On 18 May 2017 the IASB published IFRS 17 *Insurance Contracts*, closing a project that has been running for 20 years. Considering that its predecessor, IFRS 4 *Insurance Contracts*, set out a limited set of high-level guidelines and disclosure requirements for the accounting of insurance contracts, this new accounting standard means a significant change to insurers' and reinsurers' accounting and consequently their financial statements. IFRS 17 is expected to bring greater consistency, as the application of IFRS 4 allows for inconsistent accounting policies and a vast array of grand-fathering provisions.

The importance of IFRS 17, together with the then mandatory application of IFRS 9 *Financial Instruments* for insurers by 2021, to further European insurers' financial reporting, calls upon EIOPA to act in view of a common supervisory culture and consistent supervisory approaches in the implementation of IFRS 17.

The building blocks of IFRS 17's recognition and valuation requirements stem from the same, or very similar, underlying concepts as Solvency II (SII)<sup>1</sup> to depict a current, market-consistent valuation and to support a risk-based approach, so one can assume that there are substantial efficiency gains for the implementation of the current valuation approach in IFRS 17 by European insurers applying Solvency II. IFRS 17's predecessor, IFRS 4 *Insurance Contracts*, sets out minimum requirements on the recognition and valuation of insurance liabilities in IFRS financial statements. The consistent implementation and application of that standard has remained challenging, as IFRS 4 allows for grandfathering of local GAAP and for the use of non-IFRS accounting standards, such as the US GAAP. Since the implementation of Solvency II and promoting the use of relevant, market-consistent valuations, insurers can employ Solvency II's valuation inputs and processes for technical provisions in IFRS financial statements.

The use of Solvency II figures and the introduction of Solvency II public disclosures has been welcomed by the actors on financial markets for bringing much needed consistency, comparability and transparency to financial indicators published by European insurers. However, one needs to remember that the Solvency II framework primarily assesses the solvency position of insurers and is not designed to depict the financial performance of an insurer in a specific reporting period – which has been the, as yet unfulfilled request of financial analysts regarding Solvency II public disclosures.

IFRS 17 *Insurance Contracts* – together with IFRS 9 *Financial instruments* - is anticipated to bring further consistency and transparency to European insurers' IFRS financial statements through a principle-based approach that is consistent with the accounting by other sectors. For European insurers applying Solvency II, EIOPA acknowledges that there are efficiency gains to be reaped by using Solvency II inputs and processes for the application of IFRS 17, to the extent that these are consistent with the principles of IFRS 17.

Based on its founding Regulation, EIOPA has been actively promoting high-quality international accounting standards affecting the core sectors of EIOPA's mandate. Herein EIOPA supports EFRAG, the European Commission and the Accounting Regulatory Committee in the endorsement process of IFRS 17, with a particular focus of its analysis on the financial stability aspects and the public good considerations of applying IFRS 17 (together with IFRS 9).

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<sup>1</sup> Directive 2009/138/EC.

Consequently, EIOPA's assessment of IFRS 17 focusses on the conditions relevant for the endorsement according to Regulation (EC) no 1606/2002 and in particular on whether:

- IFRS 17 can provide for a 'true and fair view' of the undertaking's assets, liabilities, financial position and profit or loss; and
- Meets the criteria of understandability, relevance, reliability and comparability required of financial information needed for making economic decisions and assessing the stewardship of management.

In addition, the European Commission identified a number of issues to be elaborated upon, which also have been taken into consideration: <sup>2</sup>

- Potential effects on financial stability: improved transparency in the insurance sector 'is expected to contribute to long-term financial stability by revealing useful information that will enable actions to be taken in a timely manner'
- Potential effects on competitiveness
- Potential impact on the insurance market: availability of insurance products
- Cost-benefit analysis: including potential ability to benefit from applying Solvency II

## **2. Expected impact on financial stability and the European public good**

### **2.1. Objective of the analysis**

The actions of investors, debtors and a number of entities' stakeholders are determined by financial information. Therefore, accounting standards that shape financial information can have a significant impact on financial markets.

It is worth mentioning that insurance undertakings' financial reporting covers financial information beyond accounting-related data, as the reporting of insurers may fulfil a range of objectives, including:

- (1) informing equity and debt investors in the financial markets, as well as other stakeholders, most importantly policyholders, about the financial situation and the performance of the entity;
- (2) determining profit and dividend distribution or equity allocation and often tax payments; as well as
- (3) supplementing the information available to supervisors and policyholders, for example the entity's Solvency II Regular Supervisory Report (RSR) or the publically disclosed Solvency and Financial Condition Report (SFCR).

Realising each one of these three objectives requires a specific set of information due to the different needs and interests of stakeholders. Of course, there are significantly divergent needs that eventually determine which information is useful for decision-making and relevant for the specific purpose. However, there are also significant overlaps and common interests in the same set of information. That is not necessarily

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<sup>2</sup> See European Commission (2017): Endorsement advice on IFRS 17, FISMA/B3/VL/fv/Ares(2017)5943078.

an expression of inefficiency, but a consequence of the different objectives of financial reporting and public disclosures by financial institutions, and in particular by insurance and reinsurance undertakings in Europe.

For the analysis at hand, the focus must lie on IFRS 17's relevance to provide useful information about an insurer's financial situation and performance from the perspective of the capital market. Any supervisory, prudential, tax or capital maintenance considerations should be separated from the core analysis. It is worthwhile mentioning that IFRS 17 will not affect the European prudential framework for insurers and reinsurers, Solvency II, as Solvency II is built on a specifically designed valuation framework and a dedicated Solvency II balance sheet.

The impact of IFRS 17 information on the financial markets and therewith the impact on financial stability is a major concern for EIOPA. EIOPA's assessment of IFRS 17's potential impact is outlined here. The structure of the assessment follows the approach developed for previous exercises and relates to analysing the following criteria of accounting standards:<sup>3</sup>

- Reliance on principle-based accounting standards
- Use of reliable and relevant values
- Recognition of the allocation and magnitude of risks
- Provision of comparable financial statements
- Provision of clear and understandable financial statements
- Portrayal of the financial situation (liquidity, profitability, solvency)
- Alignment of accounting rules with sound risk management practices
- Promotion of a forward-looking recognition of risks
- Avoidance of negative and promotion of positive externalities
- Enhancement of market confidence and corporate governance

EIOPA's analysis of financial stability implications is by its very nature limited to a pre-implementation assessment of potential impacts and therefore sets out mostly qualitative observations and conclusions. Where possible, the analysis was complemented by quantitative analyses of Solvency II data.

## **2.2. Reliance on principle-based accounting standards**

Principle-based accounting standards are generally regarded as being more resilient to changes in the economic environment, so that, for example, new features of contracts can be clearly accounted for following the principle or the logic of the accounting standard. In comparison to rules-based accounting standards, principle-based standards are more accommodative of interpretation and exercise of expert judgement. Surely, there is a trade-off and balance to be struck in order to determine a clear principle to allow appropriate interpretation and to avoid a vaguely formulated principle that is prone to be inconsistently applied.

The principles underlying the valuations in IFRS 17 (use of market inputs to the maximum extent, current assumptions, explicit assessment of risk and profit allocation in line with services provided) are expected to reflect the economic substance of

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<sup>3</sup> See ECB (2006): Assessment of accounting standards from a financial stability perspective, December 2006.

insurance contracts fairly and accommodate a consistent treatment of different types of insurance contracts and risks.

### **2.3. Use of reliable and relevant values**

The accounting standards should foster transparent, relevant and consistent information about the economic substance of the business activities and consequently should be based on reliable and relevant values. The measurement and changes in values over time should fairly reflect the underlying economic phenomenon, and so build trust about the relevance and reliability of the reported figures in the financial markets.

The use of current market inputs generally generates relevant information. However, in markets with infrequent market transactions and low liquidity, the use of market data may skew the reflection on the underlying economics of the transactions. That is a particular challenge for the insurance sector, as insurance risk is rarely traded in a deep and liquid market. Both mark-to-market and mark-to-model modelling will be needed for IFRS 17, which naturally limits the reliability of the eventual information reported, yet is needed and appropriate in the absence of adequate market information.

### **2.4. Recognition of the allocation and magnitude of risks**

From a financial stability perspective, it is a major concern that the risk exposure of the entity is fairly presented. IFRS 17 provides for an explicit measurement of the insurance risk inherent in insurance contracts – measured from the perspective of the entity, considering all market inputs. Further, reinsurance contracts held shall explicitly reflect the risk transferred to the reinsurer.

The allocation of the risk between different economic actors will be visible for the financial markets through IFRS 17's requirements. However, the magnitude of the risk remaining with the insurer and the risk transferred to the reinsurer is conceptually entity-specific, which certainly introduces some subjectivity in the measurement.

### **2.5. Provision of comparable financial statements**

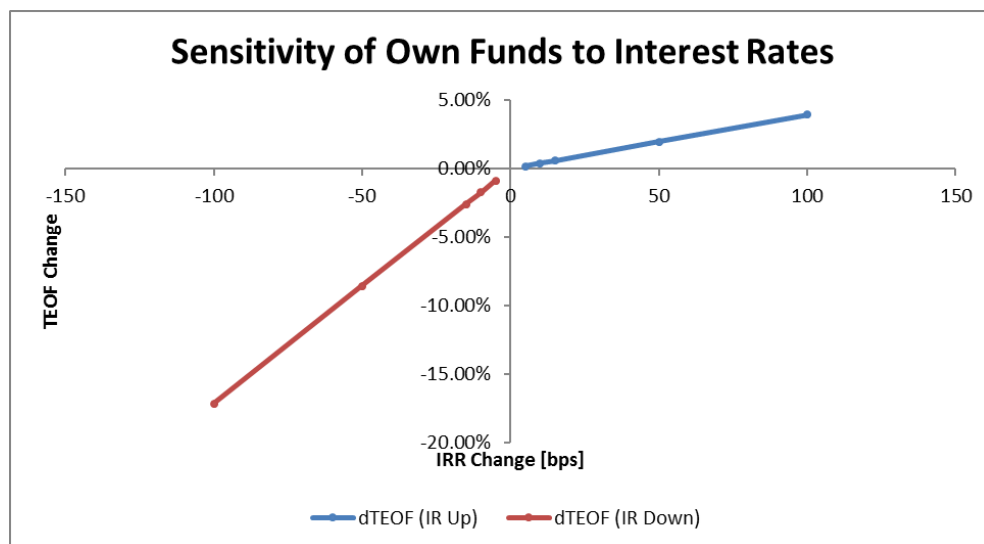
The insurance sector is widely perceived as subject to diverse accounting practices should benefit most from a harmonised accounting framework that ensures comparable information amongst different insurers within the EEA and globally. Global comparability of financial information fosters cross-border activities and efficient allocation of capital.

The introduction of IFRS 17 can be described as a shift in paradigm to bring comparability to insurers' financial statements and to allow for consistent accounting practices beyond different jurisdiction, compared to its predecessor IFRS 4.

Notwithstanding that and whilst IFRS 17 regulates the accounting relatively prescriptively in a number of areas, its principle based nature allows scope for interpretation and judgment in other cases, which may affect the comparability of the financial statements. Most prominently, the determination of the applicable discount rate appears to be relatively loosely defined. EIOPA believes that a relevant risk-free interest rate term structure should be used to reflect the characteristics of the insurance contract liability. However, IFRS 17 allows entities to use either a top down or bottom up approach to calculate the discount rate. The guidance on applying the top down and bottom up approaches seems broad and potentially inconsistent. Theoretically, both

approaches should arrive at the same result; practically that cannot be certain. Due to the importance of the relevant discount rate for interest-rate sensitive assets and insurance liabilities, the comparability of insurers' financial statements may be significantly impaired. The required disclosure of the applied, underlying yield curve may not suffice to allow for appropriate comparability.<sup>4</sup>

To illustrate the effect of different discount rates on equity<sup>5</sup>, EIOPA used data of a recent survey to portray the sensitivity of European insurers' SII total eligible own funds (TEOF) to changes in the discount rate (interest rate, IR)<sup>6</sup>:



## 2.6. Provision of clear and understandable financial statements

For the stakeholders to trust and understand financial information, the accounting should provide clear and comprehensible information. Financial analysts should be able to understand the sectoral specificities.

The principles underlying the valuations in IFRS 17 (market consistency, current assumptions, explicit assessment of risk and profit allocation in line with services provided) are expected to reflect the economic substance of insurance contracts fairly and accommodate a consistent treatment of different types of insurance contracts and risks. IFRS 17 financial statement therefore are expected to be clearer and easier to understand than the current IFRS 4 financial statements. Of course, the performance and functioning of underwriting insurance business is relatively complex, so that the accounting is supposedly relatively complex as well.

Further, IFRS 17's principle-based nature, a number of accounting options and room for judgment may affect the clarity and potentially the understandability of the IFRS 17 financial information. Also, the disclosure requirements cannot fully mitigate the risk of partially ambiguous information.

<sup>4</sup> See IFRS 17, paragraph 120.

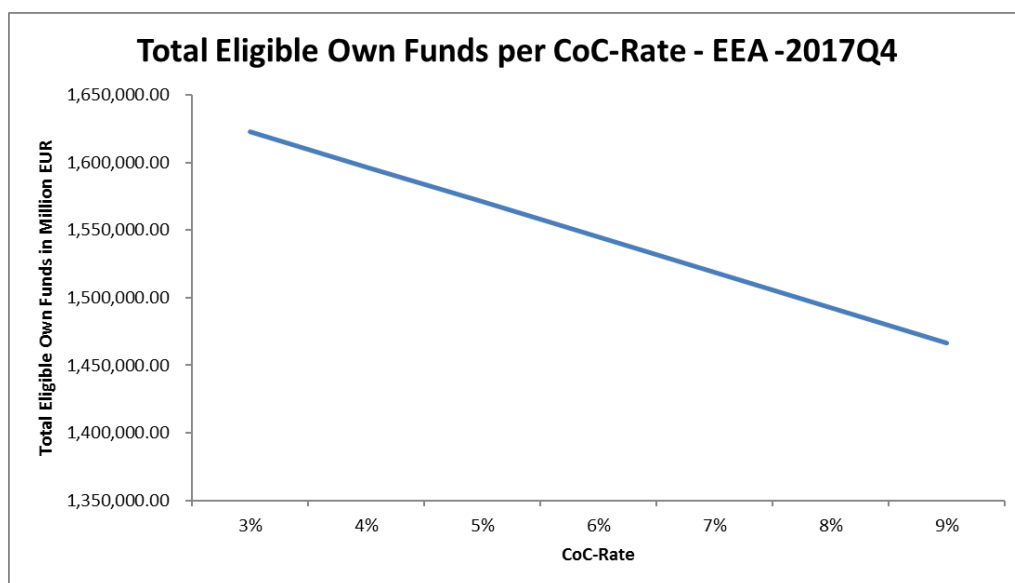
<sup>5</sup> Please note that IFRS 17 will not have any effect on Solvency II valuations or Solvency II's own funds.

<sup>6</sup> The sensitivity of Solvency II own funds to changes of the interest rates is estimated based on the SCR Review interest rate risk impact assessment, see EIOPA (2018): EIOPA's second set of advice to the European Commission on specific items in the Solvency II Delegated Regulation, [https://eiopa.europa.eu/Publications/Consultations/EIOPA-18-075-EIOPA\\_Second\\_set\\_of\\_Advice\\_on\\_SII\\_DR\\_Review.pdf](https://eiopa.europa.eu/Publications/Consultations/EIOPA-18-075-EIOPA_Second_set_of_Advice_on_SII_DR_Review.pdf), February 2018. The underlying dataset provided the total eligible own funds (TEOF), the interest rate sensitive assets and liabilities, per different interest rate risk scenarios, of EEA insurance undertakings as of 31st of December 2016.



The most controversial area with regards to this criterion is IFRS 17's risk adjustment for non-financial risk, which is a key input to the appropriate valuation of insurance obligations. Due to the marginal, observable market transactions, the inputs will mostly be entity-specific and subject to the insurer's own view on the risk. The IFRS 17 requirement to disclose the implicit confidence level, in case an approach different to the confidence level approach is used, may not in itself create clarity on the risk adjustments' basis or the understandability of differences between insurers' financial information and risk appetite. The confidence level is just one, yet an important one, of the building blocks of a risk margin. The required disclosure of the confidence level that 'corresponds' to the results of the technique means translating the results of other methods than the confidence level approach into the implicit confidence level. For example, Solvency II uses a cost of capital approach with a 99.5% confidence level over a 12 month period with a 6% cost of capital rate over the total timespan of the liabilities, which means that the underlying 99.5% confidence level has to be re-calculated into the implicit confidence level, whereas the horizon of the calculation is unclear.<sup>7</sup>

To illustrate the impact of using different inputs to measure the risk margin, EIOPA analysed the impact of changes in the cost of capital (CoC) rate on EEA insurers' SII equity (total eligible own funds)<sup>8</sup>:



## 2.7. Portrayal of the financial situation (liquidity, profitability, solvency)

Financial information should fairly reflect on the financial position of an entity. The information should be accurate and relevant for the current, short-term and long-term assessment of the entity's financial situation. IFRS 17's underlying current, market-consistent valuation of insurance obligations, the appropriate allocation of gains and losses, as well as transparency about written onerous contracts are certainly most relevant for that assessment.

<sup>7</sup> For an exemplary translation from underlying confidence levels of the Cost of Capital approach into the implicit one, please refer to IASB/FASB (2010): Insurance Contracts. Risk adjustment techniques, Agenda item 1B/49B, June 2010.

<sup>8</sup> The calculation is based on EIOPA's own Solvency II data with reference to EEA insurance and reinsurance undertakings as of 31<sup>st</sup> December 2017.

One of IFRS 17's building blocks is the consideration of the time value of money, which means that expected future cash flows have to be discounted. As current rates should be used to reflect on the actual economic environment and as current rates change over time, the valuation of the liabilities will be affected by changes in interest rates. For that, IFRS 17 provides for the option to present the effects of changes in interest rates either in the statement of profit or loss or in other comprehensive income (OCI). Even though there are disclosure requirements around this accounting policy choice, it is unclear if, and if so how comparable or relevant, the information about liquidity and profitability would be.

Another example could be the difference in treatment between onerous insurance contracts and corresponding reinsurance contracts held, which may be contracted to cover the losses made on the underlying contracts. Yet IFRS does not distinguish between the different economic circumstances or the rationale for taking up reinsurance and in the described case would not allow for immediate recognition of both the losses from the underlying onerous contracts and the profits made from the reinsurance contract held. In other cases, where the circumstances are different, it is indeed a better reflection on performance if gains from reinsurance are not immediately recognised. Concluding, 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.

## **2.8. Alignment of accounting rules with sound risk management practices**

Risk management is crucial to an insurers' business and an insurer's accounting should fairly reflect its risk management. To some extent that means that the risk management perspective shall be the starting point for the accounting of the transaction in question. By comparison, it would be counterproductive - from a financial stability perspective - if financial information drove risk management practices to achieve beneficial financial results. Such an outcome may lead to suboptimal risk management and impair the sustainability of the business.

IFRS 17's measurement model is - in principle - following an entity's own view on its risks and therefore the entity can apply the principles of its risk management to fulfil the requirements with regards to market inputs and entity-specific inputs.

Insurers' risk management processes are closely linked to asset-liability management. IFRS 17 takes that into consideration by providing, for example, the 'variable fee approach', which acknowledges the specificities of insurance contracts, in which the policyholder directly shares the investment risk of the underlying asset portfolio. In line with IFRS 17's conceptual approach to define the scope of the variable fee approach, EIOPA supports that the scope of the approach is fairly limited to properly represent the economics of those specific contracts.

## **2.9. Promotion of a forward-looking recognition of risks**

To assess risks adequately, the objective of the financial information needs to be forward looking. A current valuation approach, using actual market inputs, inherently has a forward-looking perspective. From a financial stability perspective, it is indeed preferable to take a forward-looking perspective, and so to allow for a current appreciation of market volatility in the short run and expectations about longer-term

developments. It is important that changes in the economics of the contracts and changes in the economic environment are reflected in the valuation of insurance obligations, as the reported volatility and changes in the expected performance adequately reflects economic reality.

IFRS 17 sets out that changes in assumptions and experience adjustments, which change fulfilment cash flows relating to future services, adjust the expected profit margin (contractual service margin) instead of being recognised as an immediate profit or expense. This approach consistently reflects that the profit of an insurance contract is earned over the service of the contract, yet is subject to future conditions and may change accordingly.

## **2.10. Avoidance of negative and promotion of positive externalities**

Financial information shall fairly reflect the financial situation and the risk exposures of an entity. The valuation of balance sheet items should be consistent with the risk profile of the assets and liabilities in a neutral manner, so not to incentivise or disincentivise specific asset classes or business activities. That approach supports sound risk management and appropriate allocation of resources within the entity and in the capital markets.

IFRS 17 is expected to improve the transparency of insurers' business activities and profitability patterns, as IFRS 17 aims to neutrally present the underlying economics of insurance contracts. In the context of so far divergent accounting practices within and amongst different legislation, the added insights, in particular regarding sources of profitability, profit and risk margins in a comparable manner, may lead to reassessing premiums, contract features and pricing practices. In case there are such effects, the development can actually strengthen both the sustainability of the business model and consumer protection and overall may contribute to a more efficient capital allocation in the European capital markets.

## **2.11. Enhancement of market confidence and corporate governance**

Accounting standards should be sufficiently clear and rigid to avoid manipulation or 'creative accounting', which would disturb financial stability due to mistrust or second-guessing of actors on financial markets. Most importantly, IFRS should reflect the economic reality of the transaction and insurance contracts, so as to prevent any manipulation. Also, standards should be sufficiently precise and clear in their objectives in order to limit the extent to which malicious interpretations are possible. Even though IFRS 17 provides for a number of options and room for judgement, due to its principle-based nature and requirement of market-consistent valuation, it would not be comprehensible to describe IFRS 17 as particularly prone to encourage 'creative accounting'.

## **2.12. Main findings**

Concluding on the analysis whether IFRS 17 matches the discussed criteria to strengthen financial stability, EIOPA found that:

- IFRS 17 is expected to enhance transparency through a risk-oriented and current valuation of insurance obligations and deeper insights in insurers' profitability. Through better insights into insurers' business activities, it is reasonable to conclude that market participants may feel more confident in the financial information presented and can take economic decisions based on consistent and comparable data.
- IFRS 17's concepts can be described as complex and generalists may not easily understand the resulting information, including disclosures. Communication with financial analysts will be an important part of the implementation efforts. The complexity of the accounting according to IFRS 17 stems from the inherently complex insurance business and the relatively high degree of optionality and loosely described principles in key areas, such as the risk adjustment or the discount rate. Whilst scope for judgement can enrich the quality and relevance of the information reported, it bears the risk to potentially negatively affect the understandability and therewith the fair assessment of insurers' business and financial situation.
- IFRS 17 is expected to reflect volatility in the balance sheet of insurers through a current valuation based on current inputs from financial markets, since both insurers' assets and liabilities are indeed exposed to interest rate and other financial risks. That is a reflection of economic reality and to the extent that economic reality is reflected, the impact on financial stability is nevertheless positive, as market participants do expect changes in the valuation and equity when economic reality changes. Insurers hedging their interest rate and other financial risk consequently will experience less volatility in equity than insurers that do not hedge those risks.

### **3. Potential effects on attractiveness, competitiveness and availability of insurance products**

#### **3.1. Observable trends and developments in life and non-life insurance**

EIOPA annually reports on observed consumer trends in Europe's insurance sector and analyses market developments with an impact on consumers. In its last report<sup>9</sup> EIOPA presented on-going trends in the sectors of life and non-life insurance.

EIOPA found that in a context of a persistent low interest rate environment and moderate economic growth, coupled with the introduction of the Solvency II regulatory framework, life insurance premiums decreased in a majority of Member States during 2016. Guaranteed products, such as with-profit life insurance, put considerable pressure on insurance undertaking's liabilities in the context of a low interest rate environment, prompting business shifts. As a result, based on the information provided to EIOPA by NCAs, with-profit life insurance premiums have decreased in several Member States.

During 2016, most of the new life insurance contracts by number of contracts were reported as "other life insurance" line of business, which generally covers premiums from products, such as traditional life insurance protection products without an

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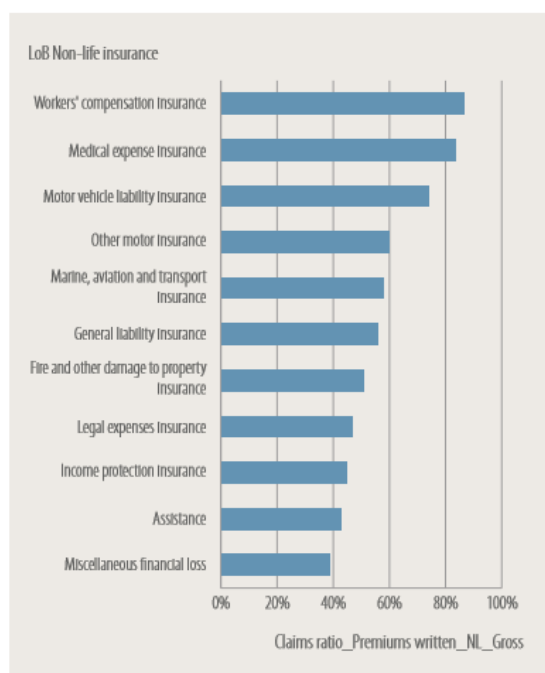
<sup>9</sup> EIOPA (2017): Sixth Consumer Trends Report, <https://eiopa.europa.eu/Publications/Reports/Sixth%20Consumer%20Trends%20report.pdf>, December 2017.

investment component or mortgage protection life cover (term insurance). While the number of new “other life insurance” contracts - as well as the commissions paid for the sale of these contracts - are more than double than for the other life insurance lines of business, in terms of gross written premium (GWP) this line of business is still relatively small. Finally, it is noteworthy that the number of new with-profit life insurance contracts was greater than the number of unit-linked and index linked contracts in 2016, which shows that consumers still look for some level (even if small) degree of guarantee when purchasing life insurance products.<sup>10</sup>

For 2017, most Member States experienced a year-over-year premium increase in their respective non-life insurance markets. The premium growth has generally been stronger in Eastern European Member States, while in Central and Northern Europe the premium growth has been more moderate. According to the information provided to EIOPA by NCAs, the increasing sales of motor vehicles are reportedly one of the key drivers of the motor insurance premium growth.

Claims ratios for “medical expenses insurance” and “workers compensation insurance” are 84% and 87% respectively suggests that they are good value for money for consumers and that they may be relatively expensive for insurance undertakings, possibly as a result of increased health care costs, although cross-selling with other less expensive lines of business (e.g. legal expenses insurance) might mitigate costs.

The claims ratios for lines of business such as assistance (e.g. assistance to motor vehicles on the road or travel insurance) or miscellaneous financial loss (e.g. employment risks in payment protection insurance, mobile phone insurance or cyber insurance) were the lowest.<sup>11</sup>



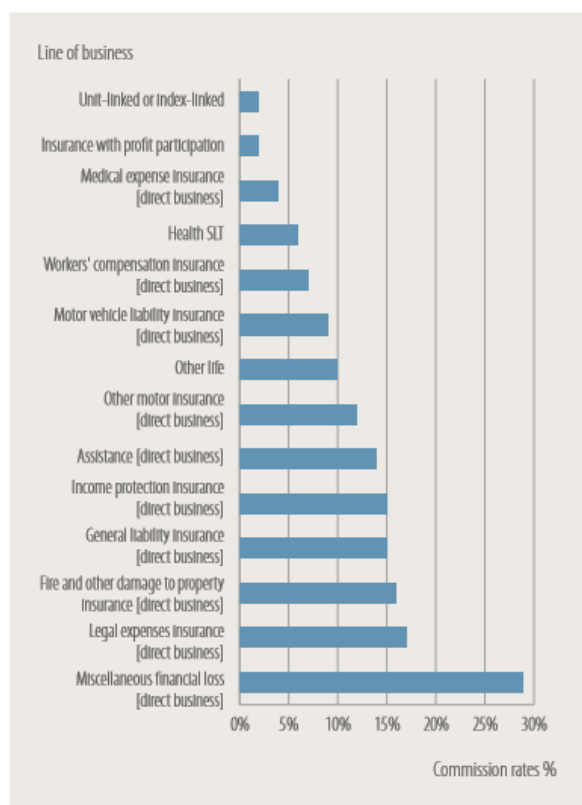
Source: EIOPA Solvency II database

Another interesting analysis is that of commission rates. For the lines of business “miscellaneous financial loss” and “legal expenses insurance” the commission rates

<sup>10</sup> EIOPA (2017), pages 9-10.

<sup>11</sup> EIOPA (2017), page 12.

were the highest amongst the life and non-life insurance lines of business. Generally, the percentage of the premiums paid in commission for life insurance lines of business are lower than for non-life insurance lines of business, with the exception of “other life insurance”. From a consumer protection perspective, high commission rates could disproportionally provide incentives to distribution channels to sell products to consumers, potentially triggering a conflict of interests that may not be effectively mitigated, and may lead to poor consumer outcomes. However, commission rates need to be jointly analysed with other retail risk indicators, and mitigating effects, such as adequate governance and control frameworks need to be taken into account.<sup>12</sup>



Source: EIOPA Solvency II database

In life insurance one can observe developments in the design of the contract and with that on the features of the insurance obligation. In the on-going context of low interest rates environment and the increasing aging population, guaranteed products have continued to give way to non- or less guaranteed products. Insurance products in which insurance undertakings guarantee an annual benefit and thereby bear the risk of adverse financial markets are progressively being replaced by products, in which customers increasingly bear to a greater extent the investment risk.

This trend is driven by commercial strategies put in place by insurance undertakings towards the selling of unit-linked products and/or to incentivise consumers to switch from guaranteed products to products with fewer guarantees. From insurance undertakings' perspective, life insurance products with low or no guarantees offer the advantage of reducing the insurer's liability resulting from contractual guarantees.<sup>13</sup> As

<sup>12</sup> EIOPA (2017), page 13.

<sup>13</sup> EIOPA (2017), pages 14-15.

a result, pure unit-linked life insurance products, where there are no financial guarantees at all and the investment risk is born completely by the consumer, are increasingly popular in some Member States. However, in other Member States, there is evidence that poor investment performance in recent years has led consumers to demand the more traditional life insurance products.

Insurance companies also increasingly offer new “with profit life insurance” products, where the economic value of embedded guarantees and the associated interest rate risk is significantly lower compared to traditional with profit products. Some of the main features of these new life insurance products are the following:

- The full guaranteed interest rate is not guaranteed for each single year, but only for a certain number of years or on average for the whole lifetime of the contract.
- Very often, no interest rate is explicitly guaranteed, but insurers guarantee that the accumulated capital at least reaches the sum of paid premiums at the end of the contract or until the start of annuity payments (minus fees and charges and without taking into account inflation).
- For annuity products, the conversion rate, which is used to convert the accumulated capital into an annuity, is set at the time when annuity payments start. Only a very small conversion rate is guaranteed at the inception of the contract.

Another example of new life insurance products are the hybrid products that are a combination of pure unit-linked products and traditional with-profit products. The accumulated capital of such contracts is typically split into a unit-linked part and a traditional mathematical reserve calculated with a guaranteed interest rate. These types of products may sometimes include sophisticated financial strategies and automatic or discretionary switching mechanisms from one component to the other one.

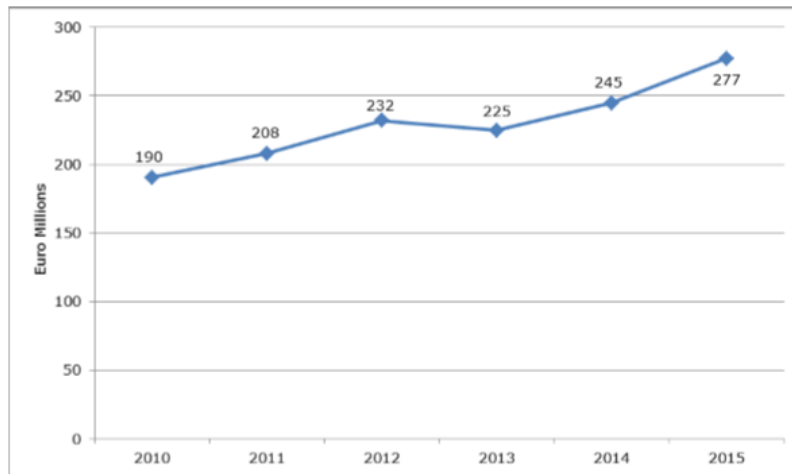
Moreover, new investment strategies are being developed and marketed to consumers, with non-guaranteed products typically including a higher proportion of investments in equities and fewer investments in bonds relative to total investment assets. The underlying assets are also frequently invested either in mutual funds or internal funds managed by the insurers themselves. Similarly, the proportion of alternative investment products, e.g. in infrastructure, forestry and alternative credit, is generally larger in non-guaranteed products. Finally, in some Member States a trend has also been observed towards the inclusion of biometric risk coverage such as death, disability, critical illness and sometimes health in life insurance products.

In addition, EIOPA carried out a thematic review on unit-linked business.<sup>14</sup> This review shows the growing importance of unit-linked business as a reaction to developments in the economic environment and in light of consumers’ preferences. The unit-linked industry has grown at a robust pace since 2010, with gross written premiums posting an average annual growth rate (2014-2015) of 8.0%.<sup>15</sup>

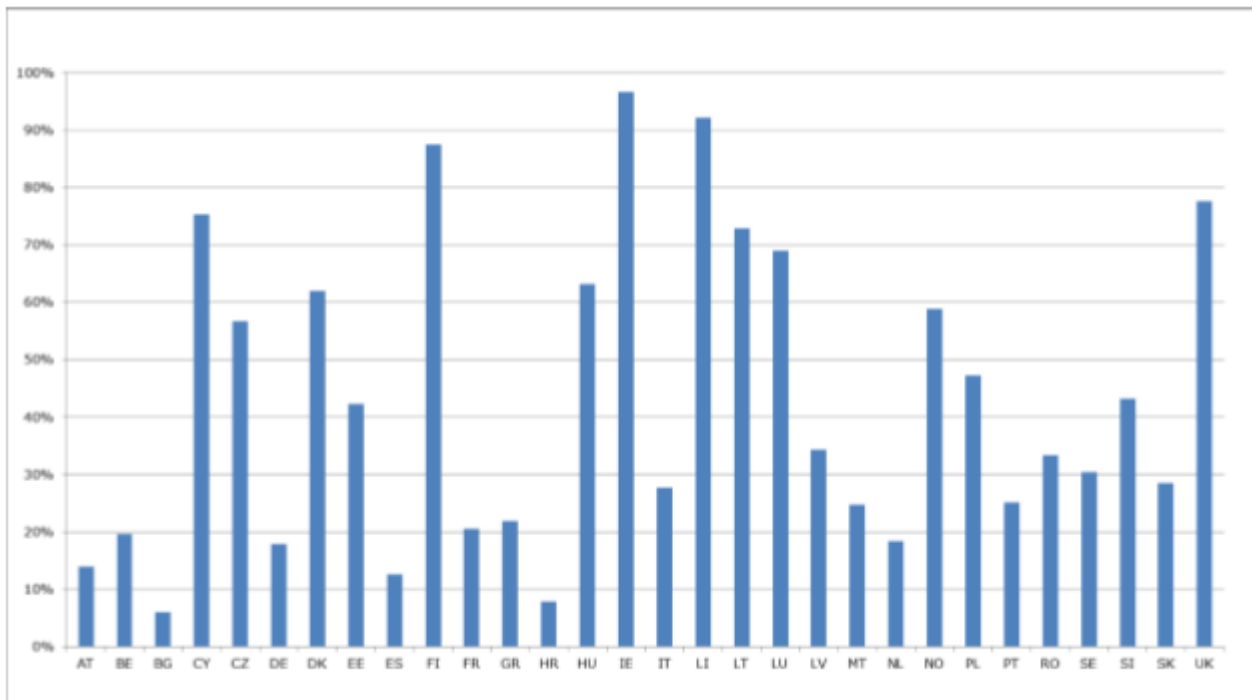
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<sup>14</sup> EIOPA (2017a): Report on Thematic review on monetary incentives and remuneration between providers of asset management services and insurance undertakings, <https://eiopa.europa.eu/Publications/Reports/16.%20EIOPA-BoS-17-064-Report%20Thematic%20review%20on%20monetary%20incentives%20and%20remuneration.pdf>, April 2017.

<sup>15</sup> EIOPA (2017a), page 88.



With a total value of EUR 277bn in 2015, unit-linked products accounted for a significant share of total life insurance premiums. The next graph shows gross written premium of unit-linked business as percentage of total life insurance gross written premium per Member State in 2015.<sup>16</sup>



- Recent economic developments have led to significant changes in product design and product availability in the EEA.

<sup>16</sup> EIOPA (2017a), page 90.



### 3.2. Analysis of potential effects of regulatory change

EIOPA analysed in detail effects of Solvency II's 'long-term guarantee' measures on the insurance market.<sup>17</sup> Hereby, based on information received from national competent authorities, EIOPA looked into different areas of potential effects. In this section, EIOPA summarises the most relevant areas when considering potential effects of new accounting standards. It is worthwhile to highlight that any conclusions on the potential, future impact of IFRS 17 can only be drawn in analogy to the post-implementation assessment of potential effects of regulatory change. The actual effects of IFRS 17 may differ.

#### Impact on insurers' investments

For the aforementioned report, about half of the national competent authorities could not report any recent, observable trend or reallocation of investments in their national market regarding the behaviour of undertakings as long-term investors since applying SII. Some national competent authorities observed a reallocation from government bonds to corporate bonds, and a few of them increasing investments in illiquid assets or an increase in government bond investments. One national competent authority reported a trend of investments in riskier assets and an increase of indirect investments.

With regards to holdings in equity instruments, again, the majority of national competent authorities did not observe any changes or trends. One national competent authority reported a slight increase in equity holdings, specifically equities listed in advanced markets. Another national competent authority stated that cases where insurers have changed their holdings of equities were due to idiosyncratic reasons rather than due to any market trends.

Similarly, the duration of bond portfolios did not follow a specific trend. Conversely, three national competent authorities reported a trend for increasing duration in bond portfolios.

National competent authorities perceived the main drivers for these trends and changes to be: the low-yield environment - especially for the reallocation from government bonds to corporate bonds; the search for yield; and asset-liability matching - especially for the increase in duration. To a lesser extent, national competent authorities considered the de-risking of assets, the tax and legal environment and the introduction of Solvency II as drivers for these trends and changes.<sup>18</sup>

In addition to this analysis, EIOPA carried out a survey on the investment behaviour of the insurance sector.<sup>19</sup> This survey was conducted with a particular focus on financial stability effects. The survey was based on data and responses from 87 insurance groups and 4 solo undertakings with headquarters in 16 EEA countries. The survey analysed investment behaviour during the period of 2011 to 2016, hence the period before the application of Solvency II, which was characterised by a persisting low yield environment. The analysis led to the identification of a number of trends that might be associated with a search for yield behaviour:

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<sup>17</sup> EIOPA (2017b): Report on long-term guarantees measures and measures on equity risk 2017, <https://eiopa.europa.eu/Publications/Reports/2017-12-20%20LTG%20Report%202017.pdf>, December 2017.

<sup>18</sup> EIOPA (2017b), page 55.

<sup>19</sup> EIOPA (2017c): Investment behaviour report, [https://eiopa.europa.eu/Publications/Reports/Investment\\_behaviour\\_report.pdf](https://eiopa.europa.eu/Publications/Reports/Investment_behaviour_report.pdf), November 2017.

- A trend towards lower credit rating quality fixed income securities can be seen in the data. At the same time, the large number of sovereign and corporate downgrades during the observation period needs to be considered.
- A trend towards more illiquid investments such as non-listed equity and loans excluding mortgages can be identified. However, a decrease in the value of property investments could be seen.
- The average maturity of the bond portfolio, for the majority of the sample, has overall increased in the past 5 years.
- Insurance groups tended to invest in new asset classes. Although the amounts are currently low compared to the size of the portfolios, almost 75% of the sample responded positively towards increasing their investments in asset classes such as: infrastructure, mortgages, loans, real estate.
- A small decrease in the debt portfolio was observed against a small increase in 'other investments' between 2015 and 2016. The allocation to equity investment has remained unchanged.
- Concluding, when assessing the developments in the investment allocation on an aggregate level, changes in all three main investment categories from 2011 to 2016 have only been marginal.<sup>20</sup>

As regards the impact of Solvency II or any particular measures of Solvency II on the investments of undertakings, one cannot draw any clear conclusions at this stage. Half of the national supervisory authorities did not observe a clear trend in their national market regarding the behaviour of undertakings as long-term investors. Almost all national competent authorities stated that they did not observe any significant link between the measures and the reported changes.<sup>21</sup>

In analogy to the learnings from Solvency II, one may expect similarly insignificant effects on insurers' investment stemming from the introduction of IFRS 17.

## **Impact on product availability**

Similarly to the analysis described in chapter 3.1 Observable trends and developments in life and non-life insurance, EIOPA assessed potential effects of regulatory change in the availability of insurance contracts, in particular of certain life insurance contracts. The survey found that a number of national competent authorities have observed - both in case of a decreasing availability and of an insignificant change in the availability of such products - , the following phenomena:

- a shift to unit-linked, pure protection or hybrid products;
- a decreasing level of financial guarantee included in the contracts or a change in the way the guarantee is accounted for (not year by year, but only at the end of the contract)
- a decreasing duration of the guarantees.<sup>22</sup>

Mostly, the phenomena could be explained by the low interest rate environment or:

- the increased cost of guarantees caused by the low interest rate environment and the reflection of the cost in the Solvency II requirements, in particular in the calculation of the technical provisions and the SCR
- the introduction of the Risk Margin that is particularly high for products with significant non-hedgeable risks such as longevity risk; and

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<sup>20</sup> EIOPA (2017c), page 3.

<sup>21</sup> EIOPA (2017b), page 56.

<sup>22</sup> EIOPA (2017b), December 2017, page 60.

- taxation regulation.

Other reasons included reinvestment risk, decreasing mortality risk, mis-selling issues and change in government policy on retirement income.<sup>23</sup>

- Economic reality determines business strategies, supply of contracts or contract features, pricing and consumers' demand.
- So far, EIOPA has not found indications of significant effects of the SII framework and its market-consistent, risk-sensitive valuation on insurers' investments or product availability.
- The impacts of accounting frameworks' reforms are not directly comparable to those triggered by reforming prudential frameworks. However, EIOPA's analysis suggests that while insurers' behaviour is certainly influenced by economic conditions, insurers' behaviour was not significantly influenced by the introduction of Solvency II.
- Following the introduction of Solvency II, it was observed that economic reality has greater impact on business strategies, supply of contracts or contract features, pricing and consumers' demand than changes to the regulatory framework. That observation may be relevant when considering the potential impact of IFRS 17.

## 4. Using Solvency II inputs, approaches and processes

### 4.1. Objective of the analysis

EIOPA analysed commonalities and differences between IFRS 17 *Insurance Contracts* and the measurement of technical provisions according to Solvency II (SII). The objective of the analysis was for EIOPA to be able to conclude on potential efficiency gains of applying SII inputs and approaches for the implementation of IFRS 17 by European insurers.

The analysis targets key areas and building blocks of IFRS 17's accounting model of IFRS 17, for which the application of Solvency II's valuation elements may be particularly useful. Those areas have been identified as:

- Initial recognition of obligations
- Definition and allocation of expected cash flows, with a particular focus on grouping/aggregation of contracts and contract boundaries
- Discount rates, assessing in particular the risk-free rate
- Risk adjustment for non-financial risks (versus SII risk margin)
- Recognition and valuation of reinsurance and its risk-mitigating effects

It is worthwhile mentioning that the analysis had to be kept at a reasonable level to remain relevant to deliver on the set objective. That means that not all commonalities or differences could be assessed in detail and the analysis may not capture potential issues stemming from national implementation and specificities in the design and

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<sup>23</sup> EIOPA (2017b), page 60-61.

treatment of certain contract types<sup>24</sup>. Other issues, like differences in scope: Solvency II applies to insurance and reinsurance undertakings, IFRS 17 applies to insurance contracts, have been found to be less relevant when assessing the areas of potential efficiency gains to be reaped.

#### 4.2. Initial recognition of obligations

- 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.

For the recognition of technical provisions, Solvency II sets out that the obligation needs to be recognised at the earlier date of when the insurer becomes a party of the contract or when the coverage period starts. For reasons of simplification<sup>25</sup>, IFRS 17 requires recognition of the insurance obligation at the earlier of the beginning of the coverage period of the relevant group of contracts and the due date of the first premium payment. In order to recognise losses from onerous contracts in a timely manner, IFRS 17 requires to recognise losses when contracts become onerous, which often is the date of when the insurer becomes a party of the contract or the group of contracts. Whereas for onerous contracts the recognition date appears to be the same for both frameworks, SII requires earlier recognition of technical provisions. It may be worthwhile to monitor the practical implementation of that difference, as often the contract is valid, and therefore the contractual obligation only arises, when the premium is paid.

In SII expected profits of recognised contracts are recognised in the period's reconciliation reserve (part of own funds/ equity), whereas IFRS 17 allocates expected profits to the contractual service margin (CSM), which is part of the insurance liability, and distributes the CSM over the life of the contract. However, both frameworks would recognise losses from onerous contracts immediately when they arise in equity.

#### 4.3. Definition of cash flows

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

The objective of determining relevant cash flows to be taken into account for the valuation of insurance liabilities is the same for both frameworks, i.e. to establish

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<sup>24</sup> For example, the analysis does not cover in detail: the balance-sheet presentation of premiums due, obligations without commercial substance, investment components embedded within an insurance contract.

<sup>25</sup> See IFRS 17, paragraph BC141.

probability-weighted average of future cash flows. Hereby, all cash flows to settle and fulfil the obligation shall be included. That includes all directly attributable expected cash flows, such as expenses for claims handling, and those over which the insurer has discretion, e.g. discretionary bonuses. Regarding applicable assumptions for the valuation of technical provisions both frameworks set out the objective to use market inputs and market-consistent estimates to the maximum extent and to use current assumptions. Notwithstanding that IFRS 17 is based on the notion of 'fulfilment' cash flows and uses current market inputs to the maximum extent, whereas Solvency II is based on a 'transfer value' and prescribes a market-consistent valuation.

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.<sup>26</sup> Reinsurance contracts and corresponding cash flows are recognised as separate contracts under IFRS 17.

Following both frameworks, overheads are to be allocated and attributed in a realistic and objective manner: to the best estimate liability under Solvency II or respectively to the portfolio of contracts under IFRS 17 - to which the overheads belong. In principle, Solvency II's attribution of overheads relates to individual technical provisions, whereas IFRS 17 specifies that overheads need to be 'directly attributable' to a portfolio of contracts.<sup>27</sup>

Solvency II, like IFRS 17, regards expenses as part of the cash flows required to value the best estimates/ contracts in the portfolio. In case expenses need to be projected, the projection shall be carried out under the 'going concern premise' and on the assumption that the undertaking will continue writing business in the future.<sup>28</sup>

#### **4.4. Grouping and aggregation of contracts and contract boundaries**

- In principle, the SII 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 SII requirement to identify homogenous 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.

#### **Groups and annual cohorts**

Solvency II requires that actuarial and statistical methods are used to calculate the best estimate, consistently with, and making use of, all relevant data available for the calculation of the best estimate. In cases where the calculation method is based on grouped policy data, the undertaking has to ensure that the grouping of policies creates

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<sup>26</sup> See Art. 28 and 31(3) of Delegated Regulation (EU) 2015/35.

<sup>27</sup> See Art. 31 of Delegated Regulation (EU) 2015/35 and IFRS 17, paragraph B66.

<sup>28</sup> See Art. 31 of Delegated Regulation (EU) 2015/35.

homogenous risk groups that appropriately reflect the risks of the individual contracts included in those groups.<sup>29</sup>

Life insurance policies generally should be calculated separately unless the separate calculation for each individual policy is an undue burden for the undertaking. The grouping of life policies follows the idea of forming homogenous risk groups. It requires that there are not any significant differences in the nature or complexity of the risks inherent in those contracts, that it does not misstate the corresponding expenses and that the grouping is likely to give approximately the same results for the best estimate calculation as a calculation on an individual basis, in particular with regards to financial guarantees and contractual options.<sup>30</sup>

IFRS 17 allows an entity to estimate the fulfilment cash flows at whatever level of aggregation is most appropriate from a practical perspective. All that is necessary is that the entity is able to allocate such estimates to groups of insurance contracts so that the resulting fulfilment cash flows of the group comply with requirements of IFRS 17. The level of aggregation is also relevant to the recognition of the contractual service margin in profit or loss. An entity should systematically recognise the contractual service margin in profit or loss over the current and remaining coverage period to reflect the remaining transfer of services to be provided by the insurance contracts.

Therefore, the level of aggregation of contracts to calculate and to determine measurement inputs for purposes of IFRS 17 aims at:

- Determining the fulfilment cash flows: identifying expected cash flows of a group of contracts to be allocated to individual contracts;
- Allocating insurance revenues and profits to the appropriate group and the appropriate periods: determining and releasing the Contractual Service margin, which requires further disaggregation into annual cohorts within a group.

For IFRS 17 portfolios of insurance contracts need to be divided into a minimum of three groups:

- contracts onerous at initial recognition, if any;
- contracts without significant possibility of becoming onerous after the initial recognition, if any; and
- other contracts, if any.

Contracts are onerous at initial recognition if their allocated fulfilment cash flows of the contracts, considering recognised, attributable acquisition costs, are a net outflow (IFRS 17.47). The likelihood of a contract becoming onerous is assessed based on information and estimates provided by the entity's internal reporting indicating a future loss (IFRS 17.19). Overall, the requirement aims at identifying contracts that are known to be onerous at the time they are written.

If the insurance undertaking has reasonable and supportable information to conclude that a set of contracts will all be in the same group, it may:

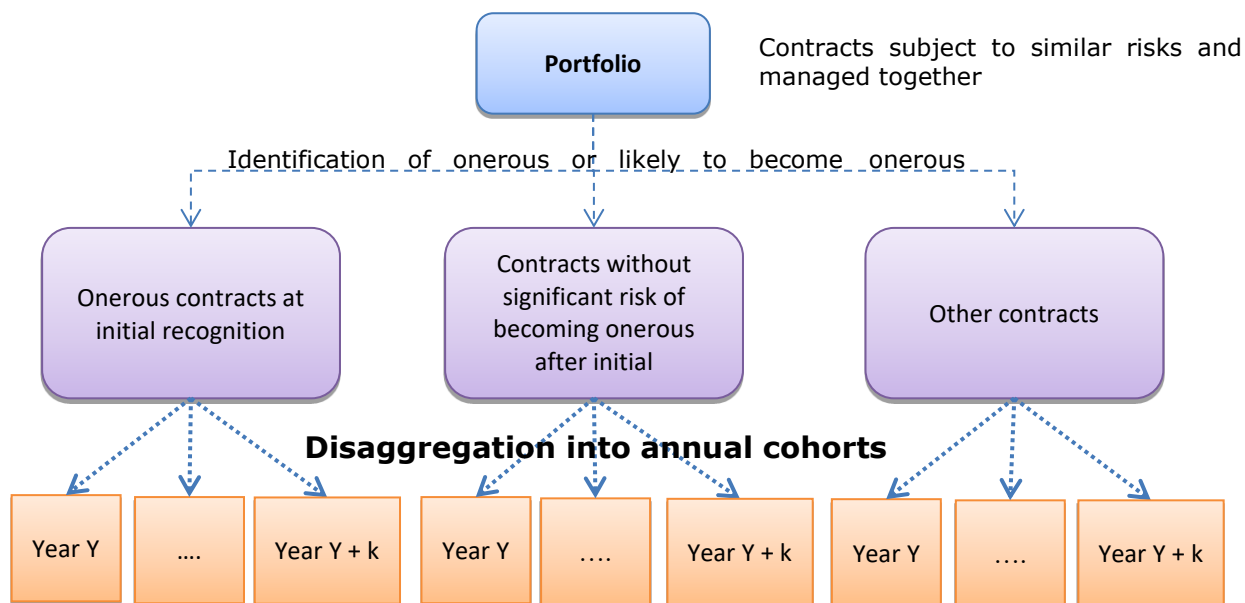
- measure the set of contracts according to IFRS 17 requirements to determine if it is onerous;
- test its overall sensitivity to changes in assumptions to determine if the set has no significant possibility of becoming onerous.

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<sup>29</sup> See Art. 34 (2) and (3) of Delegated Regulation (EU) 2015/35.

<sup>30</sup> See Art. 35 of Delegated Regulation (EU) 2015/35.

## Aggregation of insurance contracts under IFRS 17



Where IFRS 17 sets out principles to define portfolios of contracts as groups of contracts that comprise "contracts subject to similar risks and managed together", Solvency II defines 'Lines of Business' (LOB). LOBs represent different classes of life and non-life insurance, for example accident, ships, fire and health. The definition of a portfolio under IFRS 17 appears to be sufficiently flexible to reconcile portfolios with Solvency II's 'Lines of Business'.

Further, in order to calculate the technical provisions and carry out cash-flow projections, insurance and reinsurance undertakings, in principle, apply the assumptions derived at the level of homogeneous risk groups to individual policies or grouped policies, where the groupings may be more granular than homogeneous risk groups.

Homogeneous risk groups (HRGs) are Solvency II's primary unit of account to measure insurance liabilities. A homogeneous risk group encompasses a collection of policies with similar risk characteristics. In selecting a homogeneous risk group, undertakings have to achieve an appropriate balance between the credibility of data available, to enable reliable statistical analyses to be performed, and the homogeneity of risk characteristics within the group.

Homogeneous risk groups are to be set up in such a manner so that those are expected to be reasonably stable over time. Where necessary, undertakings should for the derivation of risks inter alia take into account the following items: a) underwriting policy; b) claims settlement pattern; c) risk profile of policyholders; d) product features, in particular guarantees; e) future management actions. Undertakings should ensure consistency between the homogeneous risk groups it uses to assess its gross of reinsurance technical provisions and reinsurance recoverables.<sup>31</sup>

For non-life contracts, the disaggregation of insurance obligations from LOB to HRGs is required only to the extent that it is possible and that more than one risk group is material. With regards to life insurance obligations, generally Solvency II requires that

<sup>31</sup> See Guideline 19 of EIOPA Guidelines on Valuation of Technical Provisions.

the Best Estimate Liability (BEL) is determined for each contract separately. Yet an appropriate grouping of life insurance contracts by HRGs is permitted as an operational relief if the following cumulative requirements are met:

- there are no significant differences in the nature and complexity of the underlying risks;
- the grouping does not misrepresent the underlying risks;
- the impact of grouping on the measurement of the liability is unlikely to differ significantly from an individual policy calculation.

Conceptually, it may be possible that differences arise between SII and IFRS 17 with regards to the level of aggregation, and more specifically with regards to the allocation of expected profits (contractual service margin) to specific groups of contracts, which is necessitate by an accounting framework.

### **Separation of different insurance components within a single contract**

IFRS 17 sets out that contract components that are 'distinct' from an insurance contract need to be separated from the host insurance contract.

According to Solvency II, different insurance components have to be separated under certain circumstances, which affects, for example, the corresponding contract boundaries. Unbundling of an insurance or reinsurance contract's obligations between life and non-life risks is required under any circumstances and across lines of businesses, where possible unless only one risk is material.

Solvency II's segmentation requirements are needed to calculate the capital requirements in relation to the relevant risks applicable to the specified insurance obligations and therewith to accurately value the technical provisions.<sup>32</sup> Solvency II sets out that where an insurance or reinsurance contract covers risks across different lines of business, unbundling of the obligations is not required where only one of the risks covered by the contract is material. In this case, the obligations relating to the contract should be segmented according to the major risk driver. Assigning contracts to a line of business is governed by the nature of risk and not by the legal form of the contracts.<sup>33</sup>

Insurance and reinsurance undertakings should determine whether it is possible to unbundle a contract by assessing whether two or more parts are clearly identifiable, and for which it is possible to define different sets of obligations and premiums attributable to each part. Those components are treated according to their individual features.<sup>34</sup>

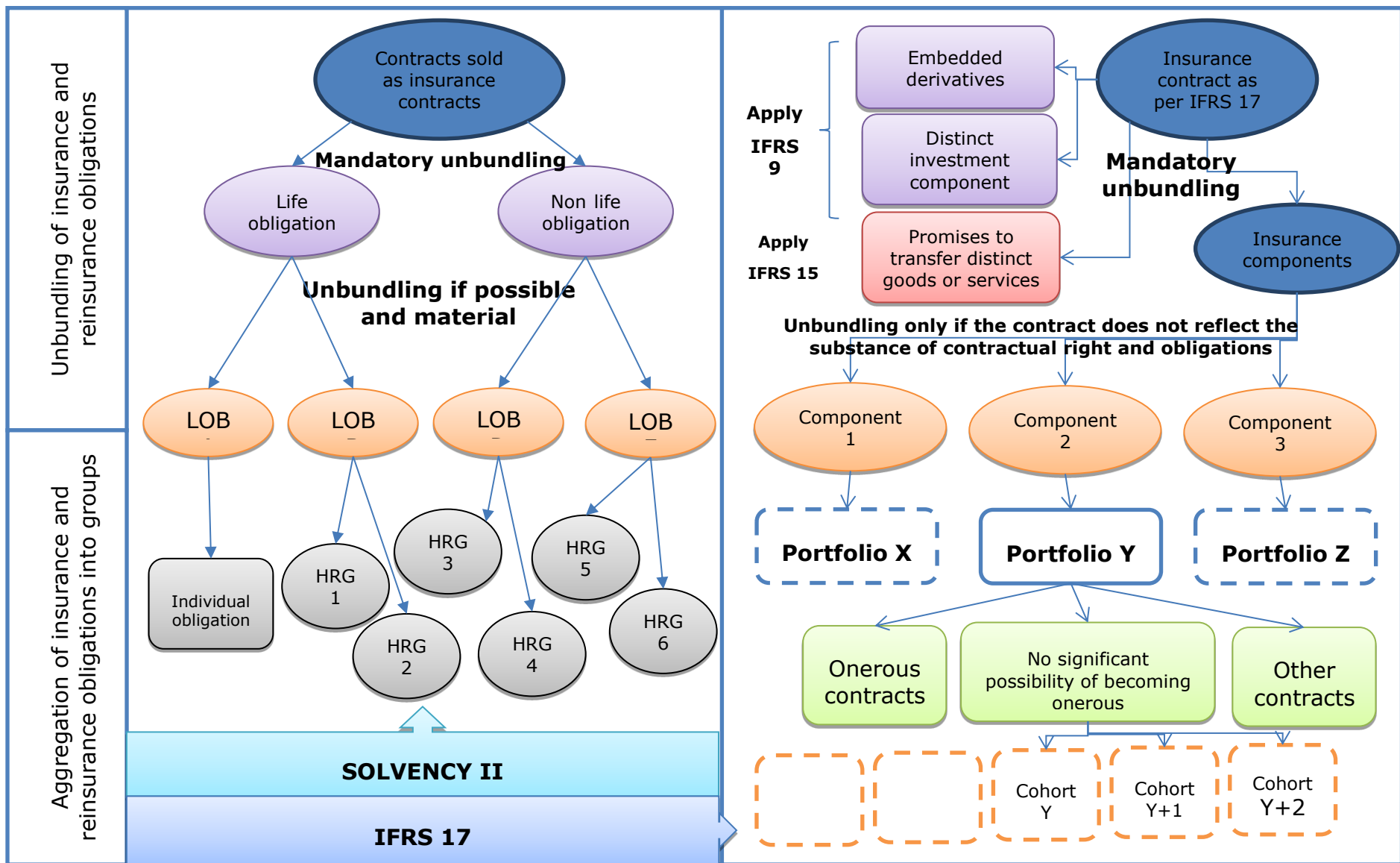
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<sup>32</sup> See EIOPA Guidelines on the valuation of technical provisions, paragraph 1.8.

<sup>33</sup> See Art. 55 of Delegated Regulation (EU) 2015/35.

<sup>34</sup> Guideline 5 of EIOPA Guidelines on contract boundaries.





## Contract boundaries

Both frameworks set out provisions to define 'contract boundaries' to the effect that all expected future cash flows that are relevant are included in the valuation of technical provisions until the date at which the insurer can cancel the contract or can reprice the contract to re-assess fully the risk of the contract or the portfolio.

Even though Solvency II uses slightly different wording than IFRS 17 to express the objective, one cannot expect material differences to the resulting contract boundaries, other than in circumstances where the insurer has the legal right to reprice the premium for the re-assessed risk, but can reasonably justify the insurer does not have the practical ability to reprice. Solvency II specifies that the legal right is decisive in the determination of the contract boundaries, any reputational risk or competitive pressures should not be regarded as limitations of the unilateral right.<sup>35</sup>

IFRS 17 introduces the criterion that 'the pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date' for contracts that are repriced at the portfolio level. Insurers offering disability products, which offer a level premium during the coverage period, which may run from the policyholder's age of 30 to the retirement age. During the coverage period, the risk increases, while the premium remains the same. In some cases, the policy terms determine that the insurer has the right to reassess the risks of the portfolio of insurance contracts (not for the individual contract) and, as a result, can set a price that fully reflects the risk of that portfolio. Some insurers consider this as a very short contract boundary. Applying IFRS 17 to these contracts may extend the contract boundaries, which potentially has significant effects on the valuation of the insurance obligations.<sup>36</sup>

Following IFRS 17, investment contracts with discretionary participation features do not transfer significant insurance risks, so the contract boundary is the period in which the entity has a substantive obligation to deliver cash at a present or future date. Such an obligation ends when the price for the promise to deliver the cash can be revised to fully reflect the amount of cash and the related risks (IFRS 17.71 (b)). Consequently, this may create an inconsistency between:

- the future premiums to be considered under an insurance contract with discretionary participation features;
- the future premiums to be considered under an investment contract with discretionary participation features.

However, an obligation shall be disregarded if it has no commercial substance (i.e. no discernible effect on the economics of the contract).

Considering some concerns that the contract boundaries of ceded reinsurance contracts may give rise to significantly different outcomes, the issue has been further analysed in the chapter on reinsurance.

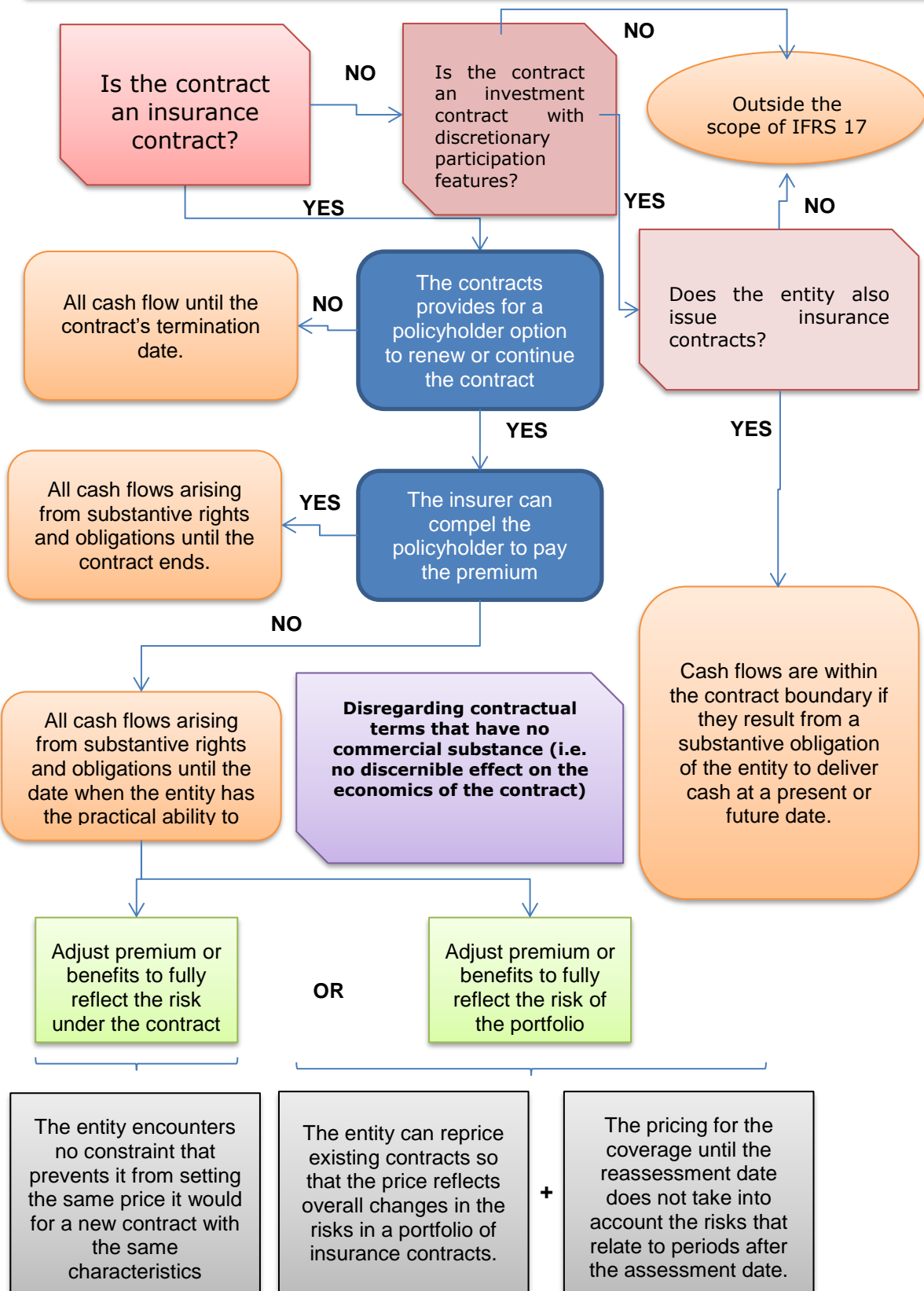
Further, as mentioned in the previous chapter, differences in the unbundling of contract elements between the two frameworks may lead to different contract boundaries for certain types of contracts.

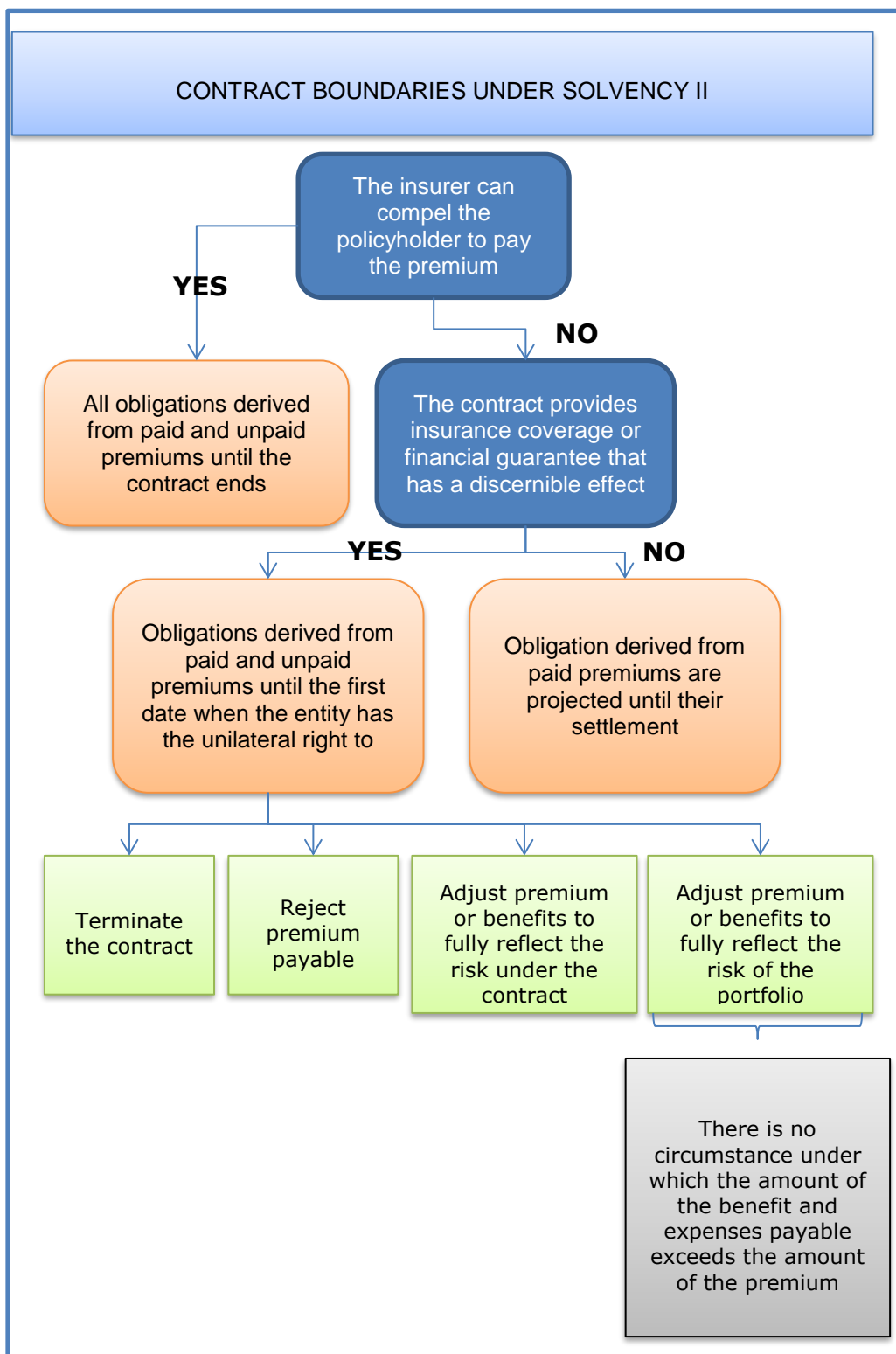
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<sup>35</sup> See Guideline 2 of the EIOPA Guidelines on Contract Boundaries.

<sup>36</sup> See IFRS 17, paragraph 34(b)(ii) and BC 162.

## CONTRACT BOUNDARIES UNDER IFRS 17





#### 4.5. Determination of the appropriate discount rate

- 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 the 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 inputs were found to make a significant difference.

Both frameworks require taking into account the time value of money and discounting the expected future cash flows. Solvency II prescribes using a relevant risk-free interest rate term structure, which requires a specified extrapolation. Generally, the rates of the basic risk-free rate term structure shall be reflective of the rates insurers practically are able to earn in a risk-free manner and shall be reliably determined based on financial instruments traded in a deep, liquid and transparent financial market. The rates are to be calculated separately for each currency and maturity, based on all information and data relevant for that currency and maturity.<sup>37</sup> The basic risk-free interest rates are derived from interest rate swap rates for interest rates of that currency, adjusted to take account of credit risk. For maturities where the markets for the relevant financial instruments or for bonds are no longer deep, liquid and transparent, the relevant risk-free interest rate term structure has to be extrapolated and converges to the ultimate forward rate after the last liquid point. The ultimate forward rate reflects the expectations regarding the long-term real interest rate and inflation of the corresponding currencies.<sup>38</sup>

IFRS 17 sets out two possible approaches (top down/ bottom up) to arrive at an interest rate that reflects the characteristics of the liability. The approaches require extrapolating and considering the relevant market inputs. Liquidity adjustments may be necessary for the bottom up approach, but are not necessary when using the top down approach. As the starting point to determine the interest rate in a top-down perspective is a reference portfolio, which shall be selected in a way that matches the liquidity characteristics of the insurance liabilities, any further adjustments for liquidity may be arbitrary.

Solvency II uses a basic risk-free term structure, which resembles a bottom-up approach without liquidity adjustment. However, Solvency II also defines a volatility adjustment, which is a measure to ensure the appropriate treatment of insurance products with long-term guarantees under Solvency II. Applying the volatility adjustment, insurers are allowed to adjust the risk-free rate to mitigate the effect of short-term volatility of bond spreads on their solvency position. The volatility adjustments are derived from spreads of representative portfolios of assets.<sup>39</sup> Solvency II also allows for an entity-specific matching adjustment to consider asset spread volatility, which is closer to a top-down approach with liquidity adjustment. The overarching principles of the volatility adjustment and matching adjustment appear to be in line with the IFRS 17 guidance on calculating the appropriate discount rate. However, due to the slightly different requirements, the matching adjustment and volatility adjustment approaches may require adjustments when used in the implementation of the IFRS 17 discount rate, if the effects are considered material.

## 4.6. Risk adjustment

- The approach to determining the risk margin in Solvency II is conceptually different from the risk adjustment in IFRS 17 (transfer vs entity-specific).

<sup>37</sup> See Art. 43 of Delegated Regulation (EU) 2015/35.

<sup>38</sup> See Art. 47 of Delegated Regulation (EU) 2015/35.

<sup>39</sup> See Art. 49 of Delegated Regulation (EU) 2015/35.

- 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.

Both frameworks require an explicit risk margin/ risk adjustment for non-financial risk in order to reflect a risk-averse market-consistent valuation.

Solvency II describes the objective of the risk margin as follows: The risk margin shall be such as to ensure that the value of the technical provisions is equivalent to the amount that insurance and reinsurance undertakings would be expected to require in order to take over and meet the insurance and reinsurance obligations.<sup>40</sup> The risk margin shall be calculated by determining the cost of providing an amount of eligible own funds equal to the Solvency Capital Requirement necessary to support the insurance and reinsurance obligations over the lifetime thereof.

IFRS 17's definition of the risk adjustment's objective is: An entity shall adjust the estimate of the present value of the future cash flows to reflect the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk.<sup>41</sup>

IFRS 17 stays at a principle-based level and takes an entity-specific perspective. Compared to that, Solvency II regulates explicitly the inputs and assumptions of the calculation of the risk margin for all insurers, and with that introduces the perspective of a fictional receiving third-party 'reference undertaking' that takes over exactly the same assets, obligations and funding as the transferring insurer. Through that logic, the insurer implicitly values the risk margin taking into consideration entity-specific inputs, for example, future management actions.<sup>42</sup>

Examples of standardised elements of the SII risk margin are the cost of capital rate at 6%, the applicable confidence level (99.5% Value-at-Risk) and the recognition of diversification effects, which are generally allowed (other than between life and non-life liabilities). The SII solvency capital requirement covers different risk categories, where relevant: underwriting risk (non-life, life, health), market risk, credit risk and operational risk, which includes legal risks and excludes risks arising from strategic decisions or reputational risks.

The SII risk margin is calculated for the entire portfolio of contracts and is then allocated to the lines of business<sup>43</sup> to adequately reflect the contributions of the lines of business to the solvency capital requirement over the lifetime of the whole portfolio of the contracts.<sup>44</sup> SII requires to use entity-specific information where that information better reflects the characteristics of the portfolio than information that is not limited to the undertaking and where the calculation of the technical provision in a prudent, reliable and objective manner would not be possible without using such entity-specific information.<sup>45</sup>

IFRS 17 captures all non-financial risks, such as insurance risk and certain other risks (e.g. lapse and expense) in the risk margin, yet excludes any risks that do not arise from insurance contracts, such as general operational risk. It is a matter of practical

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<sup>40</sup> See Art. 77(3) of Directive 2009/138/EC.

<sup>41</sup> IFRS 17.37.

<sup>42</sup> See Art. 38 of Delegated Regulation (EU) 2015/35.

<sup>43</sup> As defined in Art. 80 of Directive 2009/138/EC.

<sup>44</sup> See Art. 37 of Delegated Regulation (EU) 2015/35.

<sup>45</sup> See Art. 22(1) of Delegated Regulation (EU) 2015/35.

implementation, if that difference regarding operational risks is material between both frameworks. Diversification effects are taken into consideration.

For insurers applying Solvency II, the SII risk margin can be considered for the purposes of IFRS 17, as it reflects on the actual capital it has to hold for regulatory purposes, insofar as it also reflects on the entity's own view on its exposures. Of course, IFRS 17 also allows for very different approaches.

#### 4.7. Reinsurance

- There are different approach as to considering effects from reinsurance held: 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.

Both frameworks set out that reinsurance contracts issued are generally<sup>46</sup> 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.

Solvency II expects technical provisions for reinsurance contracts held by the insurer to be calculated using essentially the same approach as is used for the insurer's underlying contracts. SII further specifies that the amounts recoverable from reinsurance contracts should be calculated consistently with the boundaries of the underlying contract.

The amounts and cash flows to be included in the SII best estimate shall only relate to compensation of insurance events and unsettled insurance claims. Other payments shall be recorded separately.<sup>47</sup>

IFRS 17 expects reinsurance contracts held to be accounted for under the IFRS 17 general model (or the premium allocation approach if applicable), subject to certain reinsurance-specific modifications. IFRS 17 treats reinsurance contracts held and the underlying contracts as separate legal agreements, which are accounted for separately.

As IFRS 17 treats reinsurance contracts held and underlying contracts separately, this permits differences to arise between the value of the reinsurance recoverable and the ceded insurance liability. That is not the case under SII where reinsurance contract held and underlying contracts are generally treated on a consistent basis. The impact is perhaps most evident with respect to contract boundaries. However, it also feeds into other areas, such as risk adjustment, as the recognition of different sets of cash flows can lead to further differences between the IFRS and SII balance sheet valuations.

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<sup>46</sup> Under IFRS 17 the variable fee approach model is not available for reinsurance contracts issued (or held). See IFRS 17, paragraph B109.

<sup>47</sup> See Art. 41 of Delegated Regulation (EU) 2015/35.

## **Contract boundary for reinsurance contracts held**

Under Solvency II, the amount recoverable from reinsurance contracts held is calculated consistently with the boundaries of the insurance or reinsurance contracts to which those amounts relate.<sup>48</sup>

If the reinsurance contract expires or can be terminated before the end of the underlying contract boundary, insurance and reinsurance undertakings can nevertheless recognise future cash flows arising from future reinsurance contracts in relation to obligations already recognised in the balance sheet. In order to do so, SII requires that the following set of conditions are met in respect of future reinsurance contracts that replace an expiring reinsurance arrangement:

- (a) the insurance or reinsurance undertaking has a written policy on the replacement of the reinsurance arrangement;
- (b) the replacement of the reinsurance arrangement does not take place more regularly than every 3 months;
- (c) the replacement of the reinsurance arrangement is not conditional on any future event which is outside of the control of the insurance or reinsurance undertaking. Where the replacement of the reinsurance arrangement is conditional on any future event, that is within the control of the insurance or reinsurance undertaking, then the conditions should be clearly documented in the written policy referred to in point (a);
- (d) the replacement of the reinsurance arrangement shall be realistic and consistent with the insurance or reinsurance undertaking's current business practice and business strategy. The insurance or reinsurance undertaking shall be able to verify that the replacement is realistic through a comparison of the assumed replacement with replacements taken previously by the insurance or reinsurance undertaking;
- (e) the risk that the reinsurance arrangement cannot be replaced due to capacity constraints is immaterial;
- (f) an appropriate estimate of the future reinsurance premium to be charged is made which reflects the risk that the cost of replacing existing reinsurance arrangements may increase;
- (g) the replacement of the reinsurance arrangement is not contrary to the requirements that apply to future management actions.<sup>49</sup>

Hereunder Solvency II expenses in respect of reinsurance contracts, shall be projected on the assumption that the undertaking will write new business in the future.<sup>50</sup>

IFRS 17.63 sets out that the measurement of reinsurance contracts held generally follows the underlying contracts, so that consistent assumptions are used to measure the estimates of the present value of the future cash flows for the group of reinsurance contracts held and the estimates of the present value of the future cash flows for the group of underlying insurance contracts. Further, 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 shall be included, which covers the effects of collateral and losses from disputes. Therewith, the determination of the reinsurance contracts' boundaries generally follow those of the underlying contracts with regards to assumptions, estimates and future cash flows (other than participating contracts that fall under the variable fee approach).

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<sup>48</sup> See Art. 41 of Delegated Regulation (EU) 2015/35.

<sup>49</sup> See Guideline 78 of EIOPA Guidelines on Valuation of Technical Provisions.

<sup>50</sup> See Art. 31(4) of Delegated Regulation (EU) 2015/35.



IFRS 17's provisions for contract boundaries refer to the 'substantive rights and obligation that exist during the reporting period'. Arguably, the substantive right to receive services from the reinsurer ends when the reinsurer has the practical ability to reassess the risks transferred to itself and can set a price or level of benefits for the contract to fully reflect the reassessed risk, or the reinsurer has a substantive right to terminate the coverage. That means the contract boundary of the reinsurance contract held does not need to be consistent with the contract boundary of the underlying insurance contract.

Consequently, the contract boundary of a reinsurance contract held may be longer than the contract boundary of the underlying insurance contracts. In such a case, the fulfilment cash flows of the reinsurance contract held could include cash flows relating to benefits received in respect of underlying insurance contracts that have not yet been written (or cash flows from beyond the boundary of underlying insurance contracts with short contract boundaries).

The reinsurance contract boundary could also be short relative to the underlying direct insurance, for example, where the reinsurer can terminate the coverage at any time with a three months' notice period.

Under Solvency II, as the amounts recoverable from the reinsurance contract held are calculated consistently with the contract boundaries of the underlying insurance contract, insurers may recognise cash flows arising from future, as yet unpurchased, reinsurance contracts that cover obligations recognised on the balance sheet (subject to certain conditions, see above). In the case of a multi-year reinsurance contract, the contract boundary of the reinsurance contract would not extend beyond the contract boundary of the underlying contracts written before the reporting date. However, the part of the reinsurance contract held that is outside of the underlying contracts' contract boundaries or that does not refer to an existing underlying insurance contract, is not be recognised, unless it is a determined commitment, for example general commissions to be paid.

In the case where the reinsurance contract has a shorter boundary compared to the underlying insurance contracts under IFRS 17, the outcome may be different under SII as cash flows relating to reinsurance not yet purchased can be within the contract boundary of the underlying contracts under SII.

### **Risk margin for reinsurance contracts held**

Due to the net presentation of reinsurance held, the Solvency II risk margin of the underlying contracts is reduced for the effects of reinsurance. Under Solvency II a single risk margin is calculated for the firm based on the 'net of reinsurance position'.<sup>51</sup> Therefore, a risk margin for reinsurance contracts held is not separately identified on the SII balance sheet, instead the recognition of the risk mitigating effect of the reinsurance contracts held are reflected in the risk margin calculation and results in a lower risk margin for the firm.

Whereas IFRS 17's gross presentation the risk margin of the reinsurance asset is determined by the risk transferred from the underlying insurance contracts. There is also a conceptual difference in that the IFRS 17 risk adjustment reflects the recognition of risk transferred to the reinsurer, whereas under SII, the risk margin is reflective of the value required for another undertaking to take over and meet the insurance and reinsurance obligations.

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<sup>51</sup> Unless the entity is a composite, in which case, a life and non-life risk margin would be calculated.

Both approaches have a conceptually similar adjustments for the credit risk of the reinsurer and to the reinsurance recoverable asset. The Solvency II approach is marginally more prescriptive: the reinsurance recoverable is adjusted to take account of expected losses due to counterparty default. Solvency II sets out that this calculation is to be based on assessment of the probability of default and average loss resulting therefrom. IFRS 17 sets out that the valuation of reinsurance contracts held is adjusted to reflect the effect of any risk of non-performance by the issuer of that group of reinsurance contracts.

The net effect on equity is expected to be the same under both frameworks, all other factors being equal.