

ANNEX 3
Issues arising from the application of IAS/IFRS
in the light of prudential supervision

1 - Definition of an Insurance Contract (IFRS 4)

General description

IFRS 4 defines an insurance contract as *"a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain event (the insured event) adversely affects the policyholder"*.

According to the definition introduced by IFRS 4, a significant insurance risk is a main feature of an insurance contract, so that contracts that do not have a significant insurance risk are classified as financial instruments and recognised/measured according to IAS39¹.

Non-life insurance generally clearly falls within the definition, although there may be a question about some limited classes (such as credit insurance). On the life side, pure risk products are clearly covered and pure investment products are clearly not. It is likely that many "bundled" products will fall readily into one or other category.

However, despite the clarifications, it seems that, in the case of a number of life products and product structures, different interpretations of "significant" are currently being promoted by companies, auditors and consultants. It is not immediately clear how such differences will be resolved, other than through the emergence of uniformity of practice with experience.

Prudential implications

The IFRS definition will potentially have very significant effects on the financial accounts of insurance companies, specifically on the life assurance side, which apply IFRS. The application of IFRS 4 will be obligatory in the case of the consolidated accounts of listed companies in the EU from 2005. For insurance companies otherwise, either IFRS or local GAAP will, in general, be permitted. It is unclear, therefore, how extensive the use of IFRS will be, although it appears that companies are likely to continue to use local GAAP where permitted.

However, it is clear that different insurance company's accounts will be prepared on two different bases from 2005, posing problems of comparability for supervisors.

The IFRS definition is a definition for financial accounting purposes. For other purposes, insurance continues to be defined in accordance with EU Directives and

¹ The IASB has offered the following clarifications of "significant" insurance risk:

- (i) Risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, other than a scenario that lacks commercial substance. The obvious example is where a benefit paid on death is significantly larger than the benefits payable on surrender or maturity.
- (ii) To qualify as significant, the insurance risk should reflect a pre-existing risk for the policyholder, rather than having arisen from the terms of the contract.
- (iii) In considering the additional benefits under a contract, a requirement to pay benefits earlier if an insured benefit occurs could make a contract insurance.
- (iv) 101% unit linked contracts are unlikely to meet the definition.

local law. The current EU directives do not contain a definition of insurance contract, since they follow an entity approach rather than a contract approach.

In most cases supervisory returns are based on the financial accounts, and adjustments to the financial accounts will (in cases where IFRS applies) be required for supervisory purposes since, at least for accounting purposes, some of the contracts issued by an insurance company and currently treated as insurance contracts - both for supervisory and accounting purposes - will not be considered as such anymore, under the new international accounting regime.

So that contracts that today are classified as insurance could disappear from the insurance caption in the accounts, and will be classified and accounted for as financial instruments under IAS39.

Similar effects may arise from the unbundling of the financial components of an insurance contract, which are required by the IFRS 4 to be treated, under certain circumstances, in accordance with IAS39.

A) Measurement of technical provisions

Description: the ineligibility for certain contracts to be considered as insurance contracts has an influence on:

- i) the life technical provisions;
- ii) provision for unearned premiums measurement.

Countermeasures (prudential filters): To keep on the current entity-based approach to identify insurance contracts for supervisory purposes. Consequently, the supervisory amount of premiums will differ from the accounting one.

B) Coverage of technical provisions by appropriate assets

Description: Not applicable

Countermeasures (prudential filters): Not applicable

C) Solvency margin

Description: the variation in the amount of premiums and technical provisions has an influence on

- i) the minimum solvency margin required at solo level;
- ii) the minimum solvency margin required at a group level when it is calculated on the basis of consolidated accounts, that is option b) of the method n. 3 envisaged by the annex 1 of the directive 98/78.

Countermeasures (prudential filters): To keep on the current entity-based approach to identify insurance contracts for supervisory purposes. Consequently, the supervisory amount of premiums will differ from the accounting one.

Lack of homogeneity implications

Description: the lack of clarity in the definition of "significant" insurance risk may lead to a variety of behaviours in accounting treatment of the same contract, even within

the same jurisdiction. Actually it will depend on the evaluation made by the single insurer. There is a risk that supervisors will not be able to make an effective comparison of data.

Countermeasures (prudential filters): To keep on the current entity-based approach to identify insurance contracts for supervisory purposes. Consequently, the supervisory amount of premiums will differ from the accounting one.

2 - Valuation of financial assets (IAS 39)

2.1 – Valuation of Loans and Receivables

General description

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They shall be measured at amortised cost using the effective interest method.

Prudential implications

A) Measurement of technical provisions

Description: Not applicable

Countermeasures (prudential filters): Not applicable

B) Coverage of technical provisions by appropriate assets

Description: No impact for this class of financial assets.

Countermeasures (prudential filters): Not applicable

C) Solvency margin

Description: No impact for this class of financial assets besides the impact due to the classification in the AFS for some Loans & receivables.

Countermeasures (prudential filters): Not applicable

Lack of homogeneity implications

Description: Not applicable

Countermeasures (prudential filters): Not applicable

2.2 - Valuation of Held To Maturity financial assets

General description

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention

and ability to hold to maturity. The HTM shall be measured at amortised cost using the effective interest method.

Prudential implications

A) Measurement of technical provisions

Description: Not applicable

Countermeasures (prudential filters): Not applicable

B) Coverage of technical provisions by appropriate assets

Description: For jurisdictions using the historical cost valuation, no impact for this class of financial assets. Nevertheless, there should be very few assets classified as HTM because:

- They can be classified as AFS or HFT.
- They suffer from a very severe rule i.e. the tainting rule that will make the use of this class of assets almost impossible.

On the other hand, for jurisdictions where the valuation is based on mark to market, the impact can be a lower valuation of those assets because the use of amortised cost for this type of assets was forbidden. However, the use of this class of assets will probably be very limited.

Countermeasures (prudential filters): Not applicable for historical cost jurisdictions. There can be a need for countermeasures for market jurisdictions because of the mismatch risk in covering the technical provisions.

C) Solvency margin

Description: the impact of this class of financial assets is related to the classification in the Available For Sale for a lot of financial assets currently considered as Held To Maturity. On the other hand, for jurisdictions where the valuation is based on mark to market, the impact can be a risk of mismatch in the evaluation criteria for assets and liabilities.

Countermeasures (prudential filters): Not applicable

Lack of homogeneity implications

Description: Not applicable

Countermeasures (prudential filters): Not applicable

2.3 - Valuation of Available For Sale financial assets

General description

Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss. A gain or loss on an available-for-sale financial asset shall be recognised directly in

equity, through the statement of changes in equity until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in equity shall be recognised in profit or loss.

Prudential implications

A) Measurement of technical provisions

Description: Not applicable

Countermeasures (prudential filters): Not applicable

B) Coverage of technical provisions by appropriate assets

Description: some instruments that are currently classified in portfolios such as “loans and receivables”, “held to maturity” will be accounted for in the AFS portfolio, at fair value through equity. For the historical cost jurisdictions, the major impact will come from instruments currently accounted at historical cost that should be classified as HTM but, because of the tainting rule, will be classified as AFS.

The fair valuation generally implies higher values of financial assets in Member States which currently use historical cost accounting. Currently, under this practice, unrealised capital gains cannot be accounted for, whilst the unrealised capital loss generally must be.

Countermeasures (prudential filters): A specific treatment should be applied to specific instruments included in this portfolio for supervisory purposes. In order to accept fair valuation for solvency purposes, specific requirements may be retained or established by supervisors (rules, regularity, definition of fair value). To keep on with the existing evaluation rules can be a solution for historical cost countries.

C) Solvency margin

Description: the fair valuation through equity implies the recognition of unrealised capital gains, which in historical cost countries can just be considered as eligible elements under certain circumstances and only by prior approval of the supervisor. In some extreme circumstances, it is even possible to have a negative equity and a positive cash flow statement and income statement.

Countermeasures (prudential filters): The effects of IAS 39 may be (partially) neutralised through national adjustments, provided that these are in line with the EU Directives. In order to accept fair valuation for solvency purposes, specific requirements may be retained or established by supervisors (rules, regularity, definition of fair value).

Lack of homogeneity implications

Description: In this portfolio, the insurance companies can classify almost all types of financial instruments. This implies that some instruments that are currently classified in portfolios such as “loans and receivables”, “held to maturity” will be accounted in the AFS portfolio, at fair value through equity. The major impact will come from instruments currently accounted at historical cost that should be classified as HTM but, because of the tainting rule, will be classified as AFS. Because the companies can

choose what kind of instruments are to be included in that portfolio, it will lead to a loss of comparability between different insurance undertakings.

Countermeasures (prudential filters): Ask for sufficient information on the AFS portfolio to make it possible to compare the different insurance companies' portfolios on a basis of the use of the financial instrument (i.e. not on the basis of the accounting treatment).

2.4 - Valuation of financial assets measured at fair value through income statement (Held For Trading)

General description

A financial asset or financial liability is classified as held for trading if it is:

- (i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
- (ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
- (iii) a derivative (except for a derivative that is a designated and effective hedging instrument).

Those assets are accounted at fair value with changes in fair value through income statement.

Prudential implications

A) Measurement of technical provisions

Description: Not applicable

Countermeasures (prudential filters): Not applicable

B) Coverage of technical provisions by appropriate assets

Description: the fair valuation generally implies higher values of financial assets in Member States which currently use historical cost accounting. Currently, under this practice, unrealised capital gains cannot be accounted for in the financial statements, whilst the unrealised capital loss generally must be shown in the account. In the jurisdiction using a mix-model - i.e. mix of historical cost accounting and mark to market accounting - as well as for jurisdictions using the fair value model, there won't be any impact because those assets are already recognised as trading instrument and measured at mark to market.

Countermeasures (prudential filters): A specific treatment should be applied to specific instruments included in this portfolio for supervisory purposes. In order to accept fair valuation for solvency purposes, specific requirements may be retained or established by supervisors (rules, regularity, definition of fair value). To keep on with the existing evaluation rules can be a solution for historical cost countries.

C) Solvency margin

Description: in the historical cost jurisdictions, there can be an indirect impact on the available solvency margin due to the fact that the changes in fair value through income statement can increase the level of eligible elements (retained earnings).

Countermeasures (prudential filters): In order to accept fair valuation for solvency purposes, specific requirements may be retained or established by supervisors (rules, regularity, definition of fair value). To keep on with the existing evaluation rules could be a solution for historical cost countries.

Lack of homogeneity implications

Description: Not applicable

Countermeasures (prudential filters): Not applicable

2.5 - Valuation of other financial assets measured at fair value through income statement (Fair Value Option)²

General description

Upon initial recognition it is designated by the entity as at fair value through profit or loss. If elected, such designation shall be used only for a financial asset that meets certain conditions.

Those assets are accounted at fair value with changes in fair value through income statement.

Prudential implications

A) Measurement of technical provisions

Description: Not applicable.

Countermeasures (prudential filters): Not applicable

B) Coverage of technical provisions by appropriate assets

Description: the fair valuation generally implies higher values of financial assets in Member States which currently use historical cost criteria. Currently, under this practice, unrealised capital gains cannot be accounted for in the financial statements, whilst the unrealised capital loss generally must be shown in the account.

Countermeasures (prudential filters): The valuation can be adjusted to neutralise the impact of IAS 39. The use for the Fair Value Option can be also restricted for prudential reporting. In order to accept fair valuation for solvency purposes, specific requirements may be retained or established by supervisors (rules, regularity, definition of fair value).

² See also chapter no. 7 “Valuation of Financial Liabilities” with regard to the endorsement of the Fair Value Option.

C) Solvency margin

Description: in the historical cost jurisdictions, there can be an indirect impact on the available solvency margin due to the fact that the changes in fair value through income statement can increase the level of eligible elements (retained earnings).

Countermeasures (prudential filters): In order to accept fair valuation for solvency purposes, specific requirements may be retained or established by supervisors (rules, regularity, definition of fair value). To keep on with the existing evaluation rules could be a solution for historical cost countries.

Lack of homogeneity implications

Description: In this portfolio and under the current draft's version, the insurance companies can classify almost all types of financial instruments, because of the embedded derivative condition. This implies that some instruments that are currently classified in portfolios such as "loans and receivables", "held to maturity" or "AFS" will be measured at fair value through income statement. Because the companies can choose what kind of instruments are to be included in that portfolio, it will lead to a loss of comparability between different insurance companies. It will, in some circumstances, lead to financial instruments' manipulation to create some embedded derivative in order to be eligible for the Fair Value Option (like it can be also done for some insurance contracts that do not fall into the IFRS 4's scope).

Countermeasures (prudential filters): The classification of the financial instruments (assets and liabilities) included in this portfolio can be based on supervisory definitions for the prudential control and not on accounting definitions in historical cost jurisdictions.

3 - Financial derivatives – IAS 39 (including cash flow hedges)³

General description

Treatment under IAS/IFRS

Under IAS 39 an insurer is required to value derivatives on a fair value basis. This includes stand alone financial derivatives as well as derivatives embedded in a financial instrument or in an insurance contract. Financial derivatives may therefore occur on the asset side as well as on the liability side of the balance sheet. In most cases, IAS 39 will mean that more financial derivatives (certainly on the liabilities' side) are included in the balance sheet, and this transparency should normally benefit also insurance supervisors.

Relating to solvency effects special attention is addressed to cash flow hedges. Cash flow hedging gives rise to recognition of a gain or loss directly into equity.

EU Directives

Derivative instruments such as options, futures and swaps in connection with assets covering technical provisions may be used in so far as they contribute to a reduction of investment risks or facilitate efficient portfolio management. They must be valued

³ In this note it is assumed that the effect of measuring derivatives in accordance with IAS39 on technical provisions relating to investments on behalf of the policyholders will be limited as both positions are fair valued already.

on a prudent basis and may be taken into account in the valuation of the underlying assets.

Prudential implications

A) Measurement of technical provisions

Description: Insurance contracts included in technical provisions may contain written options/derivatives. This will potentially concern all contracts issued by an insurer. However if the embedded derivative qualifies as an insurance contract the insurer may continue measuring the contract under existing accounting practice. Furthermore IFRS 4 states that an insurer need not separate, and measure at fair value, a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate).

In general embedded financial derivatives in insurance contracts can be classified as written options. Measurement at fair value of these options therefore may lead to an increase in technical provisions.

Countermeasures (prudential filters):

As technical provisions will probably be increased, from a supervisory point of view no measures are necessary.

B) Coverage of technical provisions by appropriate assets

Description: An insurer may enter into different types of derivative contracts. The goals an insurer has in entering into a derivative contract will be various. Derivatives may relate to written options or guarantees contained in the technical provisions. Changes in the value of the derivatives on the asset side should in these cases be in line with changes in the value on the liability side of the balance sheet.

There may also be derivatives in the investments of the insurer to cover for the risks associated with these investments⁴. These derivatives may relate to different forms of market risk (interest, foreign exchange, commodity and equity risk) and to credit risk attached to the investments of the insurer.

Where the insurer tries to hedge the value of the investments by using derivatives, the value of the derivative and the asset would move in opposite directions, the result should be approximately neutral. This includes fair value hedges as defined in IAS 39.

Where the insurer tries to hedge a stream of cash flows, for example in an interest rate swap paying floating and receiving fixed (the underlying instrument being a floating rate loan), cash flows will be stable but fair value movements may occur. This includes cash flow hedges as defined in IAS 39.

The following situations can be recognised:

- ♦ If assets and corresponding liabilities are not measured on a fair value basis, accounting volatility may arise with regard to equity. This also concerns the effect of cash flow hedges.

⁴ It is assumed that the insurer will use these derivatives in line with the EU directives i.e. relating to risk management.

- ♦ If assets and corresponding liabilities are measured on a fair value basis no significant effect is to be expected, to the extent that positions are matched (assets and liabilities) and/or to the extent investments are effectively hedged.

Countermeasures (prudential filters): Some measures are already provided by IFRS 4, such as:

- ♦ shadow accounting where the effect of fair value measurement on the asset side is equally applied to the technical provisions;
- ♦ introducing a realistic measurement basis for technical provisions.

On the other hand, problems may arise where assets and liabilities are not fair valued in case of cash flow hedges. In this case, a supervisory countermeasure could be the elimination of the effect of cash flow hedge in equity.

C) Solvency margin

Description: The effect of measuring derivatives on the asset side on a fair value basis - e.g. cash flow hedges - may imply the recognition of unrealised capital gains and losses. However if sufficient countermeasures relating to technical provisions are applied - i.e. shadow accounting, fair valuing technical provisions or eliminating the fair value effect in equity - no further measures relating to the solvency margin will be required.

Countermeasures (prudential filters): See comments under letter B.

Lack of homogeneity implications

Description: Not applicable

Countermeasures (prudential filters): Not applicable.

4 - Valuation of property -Valuation of investment property (IAS 40) and valuation of owner-occupied property (IAS 16)

General description

An insurer will be required to evaluate property according to IAS 40/IAS 16, which allows the adoption of a "fair value model", under which property is measured after initial measurement and at each reporting date at fair value with changes in fair value recognised in profit or loss, or, of a "cost model", under which property is measured after initial measurement at depreciated cost (less any accumulated impairment losses).

In result, the adoption of the "fair value model" for property can lead to a possible mismatch due to the liability evaluation principles until phase II.

By other hand, in countries that already valued property at a fair value model (whether or not liabilities are valued at fair value or amortised cost), the choice of the

“cost model”, allowed only to give preparers and users time to gain experience with using a fair value model, represents a loss of comparability and relevance on the financial reporting.

Regarding the requirements established to support fair value measurement considering solvency implications, most of these countries have defined requirements of independency, professional qualification and recent experience of the valuers, which are stricter than IAS/IFRS rules requirements.

Prudential implications

A) Measurement of technical provisions

Description: Not applicable

Countermeasures (prudential filters): Not applicable

B) Coverage of technical provisions by appropriate assets

Description: The choice by insurers of the “fair value model” in countries where property is valued at historical cost, as also as the choice of the “cost model” in countries where property is valued at market value, can implicate significant changes in the amounts of property covering technical provisions.

Regarding fair value measurement, the acceptance of the (re)evaluations in the measurement of property covering technical provisions has to rely on the fulfilment of a set of requirements regarding valuers and valuations, established for prudential proposes.

Countermeasures (prudential filters): The effects of IAS/IFRS should be (partially) neutralise through national adjustments, provided that these are in line with the EU Directives. Regarding valuations, specific prudential requirements could be established.

C) Solvency margin

Description: The choice of the fair value model implies the recognition of unrealised gains and losses, which in countries where property measurement is based on an historical cost principle, are considered as an eligible element just under certain circumstances and by prior approval of the supervisor.

In countries where property measurement is based on a market value principle, unrealised gains and losses are already recognised in equity and are considered total or partially eligible for solvency purposes. For these countries, the adoption of the fair value model in the measurement of property, in opposite to a choice of a cost model, will have no impact for solvency purposes, if prudential requirements regarding valuers and valuations are established.

Countermeasures (prudential filters): The effects of IAS 40/IAS 16 may be (partially) neutralised through national adjustments, provided that these are in line with the EU Directives. Regarding valuations, specific prudential requirements must be established.

Lack of homogeneity implications

Description: Under IAS/IFRS, two different measurement criteria are allowed: the “fair value model” and the “cost model”. Considering that choice is up to the single insurer, this can lead to a loss of comparability between insurers.

Also, the lack of requirements regarding valuations and valuers, can imply different levels of reliability regarding valuations since insurers are just encouraged but not required to determine fair value on the basis of valuation by an independent valuer who holds a recognised and relevant professional qualification and experience.

Countermeasures (prudential filters): To avoid lack of comparability, supervisors can for solvency purposes establish the measurement criteria, as also as, specific requirements for valuations and valuers.

5- Valuation of insurance liabilities (IFRS 4)

General description

Under the Prudential Directives, technical provisions are prudently calculated in order to be “adequate” or “sufficient” to fulfil the payments to policyholders. There are no detailed instructions at EU level on how these provisions should be established. However, individual Member States normally have more defined rules, which ensure uniform measurement principles to be applied in the jurisdiction. This situation has led to significant differences in practice within Member States, both as concerns financial reporting and supervisory returns.

IFRS 4 allows insurance undertakings to keep their current valuation principles for insurance liabilities. It also allows insurance undertakings to change their accounting policies provided that this will lead to more relevant and no less reliable methods. The purpose is to allow some steps towards – in the view of the IASB – better accounting solutions preparing phase II.

Main point of discussion is the lack of any methodology and next data comparison difficulties and possible arbitrage, potential manipulation in the amount of the most important class of insurance business. Particular methodology and assumption rules could be set to decrease possible above mentioned difficulties and especially to be able to practise real insurance supervision.

Prudential implications

A) Measurement of technical provisions

Description:

Under current directives, technical provisions are prudently calculated (e.g. art. 20, par. 1, lett. b of the 2002/83 EU Directive defines the interest rate to be used in the evaluation of Life technical provisions; art. 15, par 1 of 73/239 EU Directive states that undertakings have to establish sufficient technical provisions; art. 56 of 91/674 EU Directive states that the amount of technical provisions must at all times be such that an undertaking can meet any liabilities arising out of insurance contracts as far as can reasonably be foreseen; art. 31 of 78/660 EU Directive states that valuation must be made on a prudent basis).

Under IAS/IFRS, insurance companies will have considerable room for manoeuvre in key area. IFRS 4 permits to use new accounting bases for insurance contract – shadow accounting, floating interest rates – to achieve certain level of matching assets and liabilities.

Insurers can change their accounting policies so that they measure designated liabilities to reflect current interest rate, bringing them into line with movements in valuation of interest rate sensitive assets. The technique does not need to be applied across all categories of insurance liabilities.. Insurers can adopt a form of shadow accounting that would allow them to adjust their liabilities for changes that would have arisen if any unrealised gains or losses on securities had been realised.

IFRS 4 imposes minimum requirements for a liability adequacy test that insurers have to apply in order to assess at each reporting date whether their insurance liabilities are adequate or not. However, these requirements seem to be already covered by the current directives.

Therefore, the application of IFRS 4 may create two different supervisory concerns:

- a) a mismatch issue, i.e. the problem of asymmetry in the valuation of assets and liabilities arising mainly in historical cost-based jurisdictions from the application of IAS 39 on financial instruments covering technical provision⁵. The IFRS 4 solutions to such a problem is the abovementioned allowance for changing the current evaluation principles (for example shadow accounting and change of discount rate);
- b) a prudential issue, since the allowed changes may not comply with the Prudential Directives requirements regarding prudence⁶. The fact that the options in the standard are given directly to the undertaking can create problems for supervisors. There is a fear that the options may lead to financial statements that are less robust and prudent than before. Moreover, the lack of guidance in the choice of methodology and assumptions might hinder the measurement verifiability.

⁵ A less relevant mismatch issue may arise in market value-based jurisdiction in relation to the assets which should be measured at amortised cost under IAS 39.

⁶ As an example, the option, for insurance companies, to re-measure designated insurance liabilities by introducing current market-based discount rate, without comparing this market rate to the expected future earning rate of assets backing the considered liabilities.

Countermeasures (prudential filters):

In the historical cost countries, both issues can be addressed by retaining the current calculation rules for prudential purposes.

Some jurisdictions may want to allow the use of certain elements of the accounting methods envisaged by IFRS 4 (e.g. shadow accounting and change of discount rate). In this case it could be necessary to pose limits to the use of IFRS 4 options for prudential purposes: caution must be taken that the options are exercised in conformity with the Prudential Directives.

In the market-value countries, the prudential issue can be addressed by posing limits to the use of IFRS4 options for prudential purposes or by providing guidance related to measurement changes. This may especially relate to the possible use of current interest rates and other current measurement estimates in calculating insurance liabilities as well as regarding the application of shadow accounting.

B) Coverage of technical provisions by appropriate assets

Description: Not applicable

Countermeasures (prudential filters): Not applicable

C) Solvency margin

Description: since the minimum margin required is based to a certain extent on the amount of technical provisions (especially in Life business classes), the option for the insurers to change their accounting criteria in this field has an impact for supervisory purposes.

Countermeasures (prudential filters): to keep on the existing evaluation methods for solvency purposes.

Lack of homogeneity implications

Description: the lack of clarity in the methodologies and assumptions in the fair valuation may lead to a variety of behaviours in accounting treatment of the same insurance liability even within the same jurisdiction. There is a risk that supervisors will not be able to make efficient comparison of data.

Countermeasures (prudential filters): to keep on the existing evaluation methods for solvency purposes.

6 - Equalisation provisions (IFRS 4)

General description

IFRS 4 prohibits insurance companies from recognising any catastrophic provisions or equalisation provision relating to future possible claims as liability under future insurance contracts. Thus equalisation provision and catastrophic provision amounts today accounted for as liabilities will be shown up as equity.

The practice in the Member States is not common in this respect. In some countries it is permitted or required to set up equalisation provisions in certain classes of insurance to cover random fluctuations of claim expenses around the expected value of claims (e.g. hail, credit, guarantee and fidelity insurance) using a formula based on experience over a number of years. In the case of catastrophic provisions in some countries it is permitted or required to set aside part of the premiums to cover severe losses with low frequency (e.g. earthquakes, floods etc.). In other Member States there is no such requirement over and above the rules stated in the third non-life directive (requiring equalisation provisions for credit insurance).

If the treatment of equalisation amounts is not clarified, consequences as the following could occur:

- ✓ The coverage of risks concerned, now expressed in these provisions, will be put into equity.
 - ◆ This means in accounting that the company can recognise a significant strengthening of its financial position in the year of first application of this standard.
 - ◆ Significant amounts could be subject to tax, unless particular amendments to the rules are made.
 - ◆ This means that part of the – formerly required – cover can be paid out as tax, reducing the available coverage for the risks concerned.
 - ◆ After transition if there will be no tax release for this purpose, coverage (within the equity) could be built up only from profit after tax, which can reduce the recognisable amount of this cover.
- ✓ The change in equity will be significant, which can have a(n) – positive – effect on the solvency of the company concerned.

Prudential implications

A) Measurement of technical provisions

Description: Under the current directives, the establishment of equalisation provisions for credit insurance business is required and shown as liabilities in the balance sheet.

Countermeasures (prudential filters): Some amendments of the current directives might be necessary to solve the question, such as:

- 1) Modification of the 3rd non-life directive
 - Clarifying in the prudential directives that is a part of technical provisions that should be covered by assets
- 2) Modification of the IAD
 - Modification of the layout of balance sheet and P&L due to the change from “equalisation provisions” to “equalisation reserves”:

B) Coverage of technical provisions by appropriate assets

Description: Change in the provisions will affect the asset portfolio as well. Taking into account that technical provisions should be covered by assets specified by Article 21 of the third non-life directive (and Article 23 of Directive 2002/83/EC on life

assurance). There is no similar requirement for authorised assets for the coverage of equity or solvency margin of the insurers.

The consequence can be that the assets formerly covering these provisions are added to the free assets of the company and treated accordingly.

Countermeasures (prudential filters): See above

C) Solvency margin

Description: Article 15a of Directive 73/239/EEC states that equalisation reserves shall be disregarded for the purpose of calculating the solvency margin.

It is important to ensure that equalisation reserve amounts classified as a segregated part of equity for accounting purposes cannot be used for covering the solvency margin.

Countermeasures (prudential filters): Amounts (equalisation and catastrophic provisions for accounting purposes included in Equity) should not be taken into account as eligible element for calculation of available solvency capital. However, for the equalisation reserves other than those required by Prudential Directives, supervisors should be allowed to accept the equalisation reserves eligible elements for solvency purposes on an individual basis, provided that no prudential concerns arise on the suitability and adequacy of the entity's reserve level.

Lack of homogeneity implications

Description: Not applicable

Countermeasures (prudential filters): Not applicable

7 - Valuation of financial liabilities

General description

The introduction of IAS/IFRS influences the valuation of financial liabilities with reference to

- a) investment contracts, that is insurance contracts falling outside the IFRS 4 definition will be accounted for under IAS 39;
- b) financial liabilities that do not derive from the re-classification of the current insurance contracts.

In addition, prudential concerns may arise in relation to the reclassification between liabilities and equities envisaged by IAS 32.

Prudential implications

A) Measurement of technical provisions

Description: Under IAS 39, investment contracts could be valued at amortised cost or at fair value⁷. Although the general valuation approach in IAS seems to be in line with the Prudential Directives, there is a need for supervisors to verify that the valuation criteria fulfil the prudential purpose.

Generally speaking, the fair value measurement of financial liabilities may result to be less prudent than the current EU regime under the Prudential Directives whereas the amortised cost method envisaged by the IAS 39 seems compatible with EU requirements, insofar as all future cash flows should be taken into account, including all future premiums, benefits, options available to the policyholder and all future expenses, including commissions.

In the following, some considerations on the prudential implications of the adoption of each method are detailed.

(i) The amortised cost method seems compatible with European requirements (see directive 2002/83 concerning life insurance, Art. 20 and directive 91/674 concerning non-life insurance, Art. 56 to 60) insofar as all future cash flows should be taken into account, including all future premiums, benefits, options available to the policyholder⁸ and all future expenses, including commissions.

However, some concerns remain, as amortised cost valuation does not take into account any prudential requirement and as there is no guidance relating to valuation of such liabilities⁹:

- ♦ Future streams of cash flows could be measured using various model (determinist models vs. stochastic models);
- ♦ in case where future benefits of an investment contract would be valued through time using an interest rate higher than the maximum prudential discount rate authorised by current European regulation, measurement at amortised cost could be less than the current prudential technical provisions;
- ♦ depending under which assumptions the amortised cost is calculated (e.g. modelling surrender rate, renewal rate, scope of the expenses taken into account), the amortised cost of an investment contract liability could happen to be less than the surrender value of this contract (for instance, if the assumption is made that policyholders do not act rationally).
- ♦ it not allow for the situation where the entity's assets would be insufficient to cover the interest-rate commitments towards policyholders

⁷ The Fair Value Option has however not been endorsed in the EU with regard to the financial liabilities: at the Accounting Regulatory Committee meeting (1st October 2004), a majority of Member States voted in favour of a partial endorsement of IAS 39, with carve-outs for some parts relating to certain hedging rules and to the Fair Value Option.

⁸ unless these options are derivatives which should be unbundled and measured separately at fair value (see issue # 3)

⁹ All the examples provided by the IASB in the IAS 39 Implementation Guidance are related to debt instruments (B.24 *Definition of amortised cost: perpetual debt instrument with fixed or market-based variable rate*, B.25 *Definition of amortised cost: perpetual debt instrument with decreasing interest rate*, B.26 *Example of calculating amortised cost: financial asset*, B.27 *Example of calculating amortised cost: debt instruments with stepped interest payments*)

and as such, is in contradiction with European regulation (see Directive 2003/83 concerning life-insurance, Art. 20 B¹⁰)

(ii) As stated above, the concerns relating to the measurement of contracts at fair value are related to its compliance with Prudential Directives with reference to measurement of insurance/investment contracts.

It should also be outlined that:

- Fair value measurement is not compatible with the practice of differing acquisition costs
- The fact that, under IAS 39, investment contract liabilities cannot be less than the surrender value of the contract, can be considered as a sort of prudential guarantee.
- On the other hand, as the own credit risk of the entity must be taken into account, a deterioration in an entity's financial statements and perspectives would cut down the fair value of a technical liability in the balance sheet, whereas the contract binding the policyholder to the issuer would stay unchanged. (own creditworthiness issue)

Countermeasures (prudential filters): Problems may arise where the fair value of the liabilities is lower than amortised cost. In these situations a supervisory countermeasure is the maintenance of the current EU rules for supervisory reporting of such financial liabilities.

In jurisdictions that are fair value orientated, supervisors may require valuation of financial liabilities on a fair value basis, provided that such requirements respect the rules laid down in the Prudential Directives. So that no countermeasures are needed in this respect.

B) Coverage of technical provisions by appropriate assets

Description: Not applicable

Countermeasures (prudential filters): Not applicable

C) Solvency margin

Description: Changes in measurement of financial liabilities would have consequences both on the required and on the available solvency margin of an insurance undertaking:

- ♦ the required solvency margin is calculated using various aggregates, including technical liabilities (Concerning life insurance, see Directive 2002/83, Art. 28). As a consequence, impact on the required solvency margin would be of the same kind as those relating to the measurement of technical provisions: if a technical liability measured under IAS 39 requirements appears to be underestimated, compared to a "prudential value", minimum required solvency margin would also be underestimated. (see also point A))

¹⁰ Directive 2002/83, Art. 20 B. (d): "The member state shall require an insurance undertaking to set aside in its accounts a provision to meet interest-rate commitments vis-à-vis policyholders if the present or foreseeable yield on the undertaking's assets is insufficient to cover those commitments".

- ♦ in accordance with European regulation requirements, the available solvency margin shall consist of *subordinated loan capital*, up to a determined proportion, and to the extent that it fulfils appropriate conditions (Concerning life insurance, see 2002/83 Directive, Art. 27, 3. (a) ; concerning non-life insurance, see 2002/13 Directive, Art. 16, 3. (a)). Regarding subordinated debt, supervisors' concerns are related to an "overestimation" – compared to current local GAAP – of these aggregates, when measured at fair value or at amortised cost, as required by IAS 39. This is related to the own creditworthiness issue mentioned above, as a consequence of the fair valuation of financial liabilities.
- ♦ The available solvency margin might also be affected by the fact that some instruments classified as capital under the Accounting Directives will be reclassified as liabilities under IAS 32. Shares in co-operative entities (such as some Mutual Insurance Undertakings) and certain preferred shares are likely to be affected.

On the other hand, some liabilities with embedded derivatives that are not classified as capital today, may contain equity-type embedded derivatives which will be automatically classified as equity under IAS standards. This would for example relate to the conversion option in a convertible bond.

Countermeasures (prudential filters): Problem may arise from the requirement in IAS 39 to take into account own creditworthiness. The potential inclusion of gains and losses related to changes in own creditworthiness would not be in line with the current EU solvency regime. Accordingly, it would be appropriate for supervisors not to recognise these gains and losses in regulatory capital.

Concerning the reclassification between equity and liabilities, supervisors may find it appropriate to continue the current treatment of equity and liability components, particularly in the case of equity being recognised as a liability within the IFRS rules.

Lack of homogeneity implications

Description: Regarding the measurement of technical provisions, the lack of homogeneity of financial statements is with no doubt one of the major issues.

- (i) There is an high uncertainty on the criteria that an insurance liability – in accordance with local regulation – should meet to fall within the scope either of IAS 39 or IFRS 4:
 - The definition of a "significant insurance risk" remains unclear (see issue 1);
 - Regarding investment contracts, the issue of the definition of a "discretionary participation feature" causes the same concerns (see issue 9);
- (ii) Given the fact that most investment contracts liabilities¹¹ would potentially be eligible for the "Fair Value Option", entities could designate such liabilities – on a discretionary basis - as being measured either at fair value through profit and loss or at amortised cost.
- (iii) As there is a lack of guidance, regarding measurement of investment contract at amortised cost, and currently no consensus on the fair value of such contracts, future homogeneity problems, regarding the calculation methods to be used should be expected.

¹¹ Which have been clearly designated as falling within the scope of IAS 39 !

Countermeasures (prudential filters): to keep on the current practice for supervisory purposes.

8 – Intangible assets

General description

IAS 38 allows the recognition in the balance sheet of intangible assets meeting predefined requirements of identifiability, control over a resource and existence of future economic benefit. Under IAS 38, an intangible asset is measured initially at cost while, for the subsequent measurement, entities may choose either the cost model or the revaluation model. The revaluation model is based on fair value determined by reference to an active market.

Therefore, certain purchased intangibles (such as trademarks and customer lists) that are not currently recognised on the balance sheet will be recognised under IAS/IFRS. Some of these assets will be separable, i.e. they could be sold separately from the business, but many will not. Of those that are separable in principle, some will have active markets in certain jurisdictions but others will not. Even where there are active markets, the value of a particular asset may depend on cash flows that are not independent of the financial condition and reputation of the insurer that currently holds it.

If the revaluation model is adopted, revalued amounts will be recognised in the balance sheet. Contrarily, for the time being, intangible asset are valued at purchase price or production cost and these amounts are reduced by value adjustments in order to take into account the limited economic lives of the assets and reductions of value which are expected to be permanent.

Prudential implications

A) Measurement of technical provisions

Description: Not applicable

Countermeasures (supervisory filters): Not applicable

B) Coverage of technical provisions by appropriate assets

Description: Not applicable

Countermeasures (supervisory filters): Not applicable

C) Solvency margin

Description: The amount of intangible assets in the balance sheet is likely to increase due to the recognition of other and to the possible utilisation of the revaluation model. Since intangible assets are deducted from the eligible elements of the coverage, this might not pose specific prudential implications.

Countermeasures (supervisory filters): Supervisors may choose to continue the current treatment which, in most EU jurisdictions, is to treat all intangible assets in the same way as goodwill and deduct them from capital.

Lack of homogeneity implications

Description: Prudential implications might be related to different treatment

Countermeasures (supervisory filters): Supervisors may choose to continue the current treatment which, in most EU jurisdictions, is to treat all intangible assets in the same way as goodwill and deduct them from capital.

9 – Discretionary participation features (DPF)

General description

Under the European accounting directive, bonuses intended for policyholders but not yet credited to individual policyholders should be accounted for as a liability. As an alternative Member States rules can allow that such amounts are accounted for as an item in the balance sheet not belonging neither to liabilities nor to equity (fund for future appropriations).

IFRS 4 makes it optional whether unallocated surplus arising from discretionary participation features on insurance contracts or on investment contracts with such features is accounted for as a liability or as part of equity.

In some jurisdictions, the allocation of bonuses to policyholders is connected with the realisation of gains. If the cost principle is used for assets no unallocated surplus will arise. With the transition to IAS/IFRS fair value measurement on investments will be more common in countries with accounting systems based on the cost principle. In those countries it is likely that unallocated surpluses related to participation contracts will arise to a greater extent.

Under IFRS 4 it is not allowed to show an item between equity and liabilities. Unallocated surpluses should either be accounted for as part of equity or as a liability. In Phase 1 insurers are free to choose to what extent unallocated surplus is part of equity or part of liabilities.

Under current European directives Member States can permit unallocated bonuses to be used to cover the solvency margin.

Prudential implications

A) Measurement of technical provisions

Description: Depending on the choice of the insurer to show unallocated bonuses as liabilities or as equity and depending on the measurement basis used for the investments under present rules, the transition to IAS/IFRS could increase or decrease provisions for bonuses.

Countermeasures (supervisory filters): Member States may want to reallocate amounts from equity to technical provisions (bonus provisions) to the extent they are assessed to be allocated to policyholders as bonuses in the future.

B) Coverage of technical provisions by appropriate assets

Description: Not applicable

Countermeasures (supervisory filters): Not applicable

C) Solvency margin

Description: The Available Solvency Margin (equity) can be increased with the amount of the DPF classified as a component of equity. In certain jurisdictions the increase can be determined as the part of unrealised gains that would be allocated to policyholders if they were realised.

Countermeasures (supervisory filters): Member States may want to reduce the Available Solvency Margin (equity) for the part of the distributable surplus classified as equity.

Lack of homogeneity implications

Description: The choice for insurers to show unallocated surplus related to participation contracts either as a liability or as equity may lead to less comparability between accounts, even in the same jurisdiction.

10 - Valuation of subsidiaries

General description

IAS 27 Consolidated and Separate Financial Statements apply to the consolidated and separate statement for subsidiaries. When the enterprise reports the consolidated statement (i.e. if there is a subsidiary) IAS 27 applies to associates and joint ventures as well. The choices between different valuation methods made in the consolidated statement must be used consistently when drawing up the single financial reporting as well, even for associates and joint ventures.

If the parent holds no subsidiaries, hence will not report on a consolidated level, IAS 28 will apply for investments in associates and IAS 31 will apply for investments in joint ventures. Since the IAS regulation must be used for all groups in their consolidated financial reporting, IAS 27 may be more relevant than IAS 28 and 31. (This may differ from country to country depending on the national implantation of the Insurance Accounting Directive)

To day the cost method, the equity method or a prudent estimated sales price are used in European GAAP. IAS 27 allows the cost method and the use of fair value in accordance with IAS 39. As mentioned above, the method used in the consolidated statement must be used in the separate statement as well.

Prudential implications

A) Measurement of technical provisions

Description: Not applicable

Countermeasures (prudential filters): Not applicable

B) Coverage of technical provisions by appropriate assets

Description: Not applicable

Countermeasures (prudential filters): Not applicable

C) Solvency margin

Description: In some countries the mandatory use of cost method for individual account may create a mismatch issue.

Countermeasures (prudential filters): It may be manageable by reversing the "unwanted" accounting method. It can however be difficult to reverse any goodwill component in a subsidiary, associates or joint ventures that thru fair value measurement will be a part of the parents financial reporting on a both consolidated and single level.

Lack of homogeneity implications

Description: The lack of homogeneity may cause implications for reporting both to prudential supervisors and to EuroStat (or any other national statistical office).

Countermeasures (prudential filters): It could be overcome by separate prudential (and for statistical purposes) reporting. This is the case already in some member states but may not be a preferred solution in other member states.

11 - Valuation of pension commitments (IAS 19)

General description

The standard distinguishes between two types of post-employment benefit plans: the defined contribution plan where the enterprise pays fixed contributions into a fund but has no legal or constructive obligation to make further payments if the fund does not have sufficient assets to pay all of the employees' entitlements to post-employment benefits and the defined benefit plans which are all the other plans.

Whereas for defined contribution plans only the contributions paid are recognised as expenses and no obligation exists in the balance sheet, for defined benefit plans more complex actuarial assumptions are required to measure the obligation in the balance sheet and the expense to be recorded in the income statement.

The amount recognised on the balance sheet shall be equal to the present value of the defined benefit obligation (that is the present value of expected future payments required to settle the obligation resulting from employee service in the current and prior periods) reduced by the fair value of plan assets and adjusted for unrecognised actuarial gains and losses and unrecognised past service cost. The present value of the defined benefit obligation is determined using the Projected Unit Credit Method which takes account *inter alia* of inflation, future salary increases, expected plan asset return, staff turnover, etc.

Regarding actuarial assumptions, those will correspond to the company's best estimate, therefore the company will use its judgement to define the actuarial assumptions according to the features of the pension plan, the economical environment and the principles defined in IAS 19.

Non recognition for actuarial gains and losses is allowed up to 10% of the greater of the defined benefit obligation and the fair value of plan assets (corridor approach).

As an alternative, the company may choose to adopt any systematic method that results in faster recognition of actuarial gains and losses, provided that the same basis is applied to both gains and losses and the basis is applied consistently from period to period. In this context, the company may recognise in full the actuarial gains and losses as they occur outside profit or loss in a statement of changes in equity titled 'statement of recognised income and expense', without any subsequent recycling in profit or loss (this option in accordance with April 2004 proposed amendments to IAS 19).

The charge to the income statement is largely disconnected from the actual contribution paid and is made of:

- ♦ Current service cost, i.e. the actuarial estimate of the benefits earned by employee service during the period
- ♦ Interest cost
- ♦ Expected return on plan assets
- ♦ Actuarial gains and losses to the extent recognised
- ♦ Past service costs to the extent recognised
- ♦ The effect of any plan curtailments or settlements

Although current pension approaches vary widely across Europe, it is commonly accepted that the new rules will show increased pension liabilities for many companies and more volatile pension costs.

Prudential implications

A) Measurement of technical provisions

Description: Not applicable

Countermeasures (prudential filters): Not applicable

B) Coverage of technical provisions by appropriate assets

Description: Not applicable

Countermeasures (prudential filters): Not applicable

C) Solvency margin

Description: In countries where the pension commitments are not reflected in the accounts or in the solvency position, increased pension charges in the income statement and pension liabilities on the balance sheet will reduce the surplus capital available for solvency purposes.

Countermeasures (prudential filters): In countries where the new regime is more prudent than the existing one no special supervisory measures are needed. On the other hand, in certain cases where the company recognises an asset, it may be applied a specific treatment for supervisory purposes. The asset portion referring to a net actuarial loss not recognised because of the deferring treatment may be deducted for solvency purposes. If the portion is a net actuarial gain reflected in the profit or loss of the period or in retained earnings, a uniform countermeasure may be applied.

Taking into account a prudential point of view, some supervisors may feel the need to prescribe additional solvency requirements based on the calculation of the present value of the defined benefit obligation using more conservative assumptions.

Lack of homogeneity implications

Description: no level playing field between companies using IAS19 and companies subject to less stringent requirements, or companies subjected to more prudent requirements.

On the other hand, among companies using IAS19, they may choose to either recognise actuarial gains and losses immediately in profit or loss, in retained earnings (proposed amendment) or to defer the recognition of part of their actuarial gains and losses using the 'corridor'. So, because the choice is up to the companies, it may lead to a loss of comparability between them.

The use of different actuarial assumptions among companies may also lead to a lack of comparability.

Countermeasures (prudential filters): none; in the past, in spite of largely differing national practices regarding accounting for pension commitments, level playing field has never been an issue considered by insurance supervisors.

Regarding actuarial assumptions, some supervisors may feel the need, for solvency purposes, to establish a set of assumptions considered adequate for the calculation of the present value of the defined benefit obligation.