

**Recommendations
regarding the
Implications of the IAS/IFRS Introduction for
the Prudential Supervision of
Insurance Undertakings**

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I. Introduction

Insurance accounting in the European Union

1. The introduction of IAS/IFRS in 2005 will significantly change financial statements of EU insurance undertakings. In principle, the use of international accounting standards represents a positive development that will increase convergence of financial reporting requirements.
2. For insurance undertakings, the introduction of such standards will come in two stages. During the first phase following 2005, there will be no comprehensive and final standard on insurance. The major rules will be found in IAS 39 ("Financial Instruments: Recognition and Measurement"), IAS 32 (Financial Instruments: Disclosure and Presentation) and in the interim standard IFRS 4 ("Insurance Contracts").
3. Phase 1 of the IASB insurance project is meant to be a "stepping stone" towards a final standard. The IASB Board has started its deliberations on a more permanent "Phase 2" standard, but it is expected that this will take some years before it is finalised.
4. Insurance accounting in the EU is currently harmonised under the Fourth, the Seventh and the Insurance Accounts Directives¹. The Directives contain a significant number of options that have been exercised differently in Member States². As a consequence, the current supervisory rules in the European Union are not based on a sole accounting regime.
5. The different exercise of the options may significantly impact the introduction of IAS/IFRS rules. This is particularly true for the options related to the use of a "historical cost" or a "market value" approach for the valuation of investments. Generally, the more the local GAAP are based on a market value system, the easier the move to IAS/IFRS will be. In fact, some of the current options in the Directives go a long way towards IAS/IFRS accounting.

Supervisory reporting for insurance undertakings following the introduction of IAS/IFRS

6. Since the IASB Framework and Standards have not been elaborated primarily for prudential purposes, it is crucial for regulators to be conscious of the changes that will take place.
7. In principle, the introduction of the new accounting regime should be neutral insofar as prudential supervision is concerned and it should not bring about non-intended modifications to the current solvency regime. Since the solvency regime is based on accounting definitions and practices, the adoption of new definitions and valuation rules may have involuntary solvency implications.
8. In any case, the change in the financial reporting criteria should not weaken the prudential regulation. If no supervisory adjustments take place, there is a risk that the

¹ Fourth Council Directive of 25 July 1978 (78/660/EEC), Seventh Council Directive of 13 June 1983 (83/349/EEC) and Council Directive of 19 December 1991 on the annual accounts and the consolidated accounts of insurance undertakings (91/674/EEC). For the purpose of this paper they are referred to as Accounting Directives.

² In some cases, the options might have been passed on to the insurance undertakings. See the KPMG survey "Options in EU insurance accounting rules" (January, 1999).

introduction of IAS/IFRS could lead to unintended increases or decreases in the amount of admissible assets, the Available Solvency Margin and/or the Required Solvency Margin. The magnitude of this risk may vary depending on the extent to which accounting data are used for solvency purposes within jurisdictions.

9. Therefore, CEIOPS asked its Expert Group on Pillar III and Accounting³ to develop a proposal on the possible introduction of "prudential filters" to process the IAS/IFRS accounting data, before their use for prudential purposes.

10. As stated above, the current situation in Member States is not the same; so that, the relevance of the "prudential filters" might vary from Member State to Member State.

Consequently, the proposal for "prudential filters" has been developed on the basis of the current level of accounting harmonisation in the EU as well as considering the temporary situation of the accounting rules for insurance (Phase 1 of the IASB insurance project).

11. It is worth underlining that a sort of prudential filters already exists in the current EU solvency regime. In fact, the main sources of accounting differences, such as asset valuation rules or discounting of liabilities, are clearly identified and explicit adjustments are foreseen in the solvency margin rules so as to reach a level playing field among market participants.

The same approach could be used concerning new divergences resulting from the introduction of IAS/IFRS: not each and every single source of divergence should be considered, but only those having a significant impact on the prudential supervision, with the purpose not to weaken the current level of prudence. Since these prudential filters are intended to preserve the level of prudence of the current solvency system, CEIOPS supports adequate control to be put in place on their application (e.g. internal control, assessment by external auditors).

12. The time horizon of the possible application of prudential filters to cope with IAS/IFRS should not be very long. The development of a new solvency regime (EU Solvency II project), which is expected to be "IAS compliant", could make the need for such filters unnecessary or, at least, very limited.

II. Purpose of the paper

13. The purpose of this paper is to **analyse the impact of the introduction of IAS/IFRS** accounting rules on supervisory returns in Member States⁴. The paper studies the impact on Member States systems where the reporting is based on the "historical cost approach" as well as on those using a "market value model".

³ The Expert Group is chaired by Fausto Parente (Italy) and is composed of Karl Proschofsky-Spindler (Austria), Giancarlo Pellizzari (Belgium), Iva Pluharova (Czech Republic), Flemming Petersen (Denmark), Priit Kask (Estonia), Pirjo Saarelainen (Finland), Sarah Bouquerel (France), Henning Goebel (Germany), Christine Pierrakou (Greece), Judit Gyongy (Hungary), Paul Fleming (Ireland), Dave Montgomery (Ireland), Lucilla Caterini Grossi (Italy), Elena Barra Caracciolo (Italy), Dace Vilne (Latvia), Agnese Joela (Latvia), Audrius Linartas (Lithuania), Claude Wirion (Luxembourg), Bernie Komduur (Netherlands), Siw-Mette Thomassen (Norway), Beata Baluta (Poland), Teresa Casado (Portugal), Ema Kokalj-Prelc (Slovenia), Luis Pasquau (Spain) and Teddy Nyahasha (UK). Ulf Linder and Susanne Rosenbaum are the EU Commission observers.

⁴ Reference is also made to the EU Commission Services' document MARKT/2527/03 dated 27 August 2003.

The paper indicates which **prudential filters** may be needed for jurisdictions using these two different approaches (i.e. the historical cost approach vs. the market value approach).

It furthermore elaborates to what extent IAS/IFRS reporting can be used for supervisory reporting consistent with the European Directives.

14. CEIOPS supports an early definition of Phase 2 permanent accounting rules enhancing comparability and a stable definition of the accounting framework. The paper takes its starting point in the fact that Phase 1 accounting rules will only be applicable for a short time, and that pragmatic prudential solutions could be used to preserve the prudence level of the current system in order to secure the interests of policyholders.

15. For the purpose of this paper, IAS/IFRS shall mean standards and interpretations endorsed for mandatory use in the EU by the Accounting Regulatory Committee in accordance with Regulation No. 1606/2002 of the European Parliament and of the Council⁵.

III. Factors influencing the analysis

16. CEIOPS acknowledged that the supervisory implications can widely vary among Member States, due to the following reasons:

- A. the scope of application of IAS/IFRS in Member States;
- B. the use of separate sets of accounts for financial reporting and supervisory purposes;
- C. the current accounting regime in Member States;
- D. the different choices regarding solo and adjusted solvency margin calculations in Member States.

A. The scope of application of IAS/IFRS in Member States

17. Regulation No. 1606/02 regards the consolidated accounts of EU listed entities and publicly traded entities. Consequently, the endorsed IAS will automatically be applicable only to the consolidated statements of listed insurance undertakings and those with listed debt instruments. However, Member States can require or permit the application of IAS to other types of undertakings as well as to individual accounts.

18. CEIOPS has carried out a survey regarding the choices made in different Member States regarding the scope of application of the Regulation (Annex 1).

⁵ CEIOPS started to perform the analysis on the current non-amended version of IAS 39. At the meeting of the Accounting Regulatory Committee on 1 October 2004 a majority of Member States voted in favour of the endorsement of IAS 39 with carve-outs for some parts relating to certain hedging rules and to the Fair Value Option. Such carve-outs have been explicitly mentioned in the paper, where relevant. However, an in-depth study of the impact of such carve-outs is still to be completed.

19. The survey generally shows that IAS/IFRS accounts will be used for the consolidated accounts of insurance undertakings, while – for the moment – this will generally not be the case for annual accounts. This means that the main impact of IAS/IFRS for solvency will be related to the calculation of the adjusted solvency margin when based on consolidated accounts⁶.

20. A number of jurisdictions however will not require, but allow the application of IAS/IFRS, both for consolidated and annual accounts. Consequently, in these countries the real impact will largely depend on the undertakings' choices.

B. The use of separate sets of accounts for financial reporting and supervisory purposes

21. In most Member States the financial statements are the basis for the supervisory returns. Certain Member States use the same set of accounts, whilst others perform more or less extensive adjustments to the financial information to make it appropriate for the supervisors' purposes. In certain Member States the extent of prudential adjustments is such that it can be considered a separate set of accounts.

22. This means that the introduction of IAS/IFRS may have a more relevant impact in the former Member States and a less significant one in the latter ones. In any case, the IAS/IFRS introduction may directly or indirectly have an impact also on supervisory returns and so, it may even lead each country to introduce more extensive adjustments to the accounting data.

23. CEIOPS acknowledges the interest of the insurance industry to deal with a single set of accounts as well as limit the amount of prudential adjustments to the financial statements. Even though it is generally recognised that adjustments to a basis set of IAS accounts are needed, such adjustments need to be motivated from a prudential point of view.

C. The current accounting regime in Member States

24. As stated in the introduction, the Accounting Directives contain a large number of options that have been exercised in different ways in Member States⁷. Some of these main options also have consequential alternatives in the Prudential Directives⁸ (as stated in the Introduction paragraph 11, these can be considered prudential filters for the valuation alternatives allowed today).

25. The options under the Accounting Directives to use historical cost values, current values and fair values for certain balance sheet items are of particular importance to the analysis of this paper⁹.

⁶ Directive 98/78/EC of 27 October 1998 on the supplementary supervision of insurance undertakings in an insurance group, Annex 1, method 3.

⁷ See footnote 1.

⁸ For the purpose of this paper, the following Directives are considered "Prudential":

- Directive 73/239/EEC on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance (with subsequent amendments);
- Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance.

⁹ The Fourth Directive normally mentions purchase price, market value and fair value. The Insurance Accounts Directive normally uses purchase price, current value and fair value. The fair value paragraphs in the Fourth Directive apply also to insurance undertakings.

Based on the different national application of the options in the Accounting Directives the accounting systems in Member States can be divided, for the sake of clarity of this analysis, in two groups:

historical cost-based

market value-based.

There is however a continuum possible for Member States between these two extremes.

26. The market value-like provisions of the different Directives seem to make it possible for Member States to apply most of the IAS/IFRS fair value requirements.

D. The different choices regarding solo and adjusted solvency margin calculation in Member States

27. The Insurance Groups Directive includes an option for Member States with regard to the calculation of the adjusted solvency margin¹⁰. The Prudential Directives also envisage some options related to the eligible elements for the solo solvency margin coverage. These options have an influence at group level, too.

28. As stated above (paragraph 19), IAS/IFRS will be mainly applied to the consolidated accounts. From a prudential point of view, the impact of the move towards IAS/IFRS is likely to be greater in jurisdictions which chose to apply the accounting consolidation method for the calculation of the adjusted solvency margin.

IV. List of issues

29. Against this background, CEIOPS has identified 11 issues arising from the application of IASB principles that may have an impact on prudential supervision. The issues are the following:

- Definition of insurance contract
- Valuation of financial assets
- Financial derivatives

Major options between market and historical valuations can e.g. be found in the

- **Fourth Directive:** Fixed assets (including investments of insurance undertakings) at purchase price or current value (Art. 35); Financial instruments at purchase price or fair value (Art. 39, 42a).
- **Insurance Accounts Directive:** Investments at purchase price or current value (Art. 46), but the Fair Value Option in the Fourth Directive applies; Land and buildings at purchase price or current value (Art. 49); Art. 62 (g) allows discounting under certain conditions.
- **Prudential Directives:** E.g. Art. 27.3 (d) of the consolidated Life Directive (2002/83/EEC) states that hidden reserves could be used to cover the solvency margin. Directive 2002/13 (“Solvency I”), Art. 16 (2c) requires adjustments to the eligible capital when undertakings have discounted their technical provisions to take account of investment income.

¹⁰ Annex 1 of the Insurance Groups Directive (Dir. 98/78/EC of the European Parliament and of the Council of 27 October 1998 on the supplementary supervision of insurance undertakings in an insurance group) contains three methods for the calculation of the group solvency margin: 1) the deduction and aggregation method, 2) the requirement deduction method and 3) the accounting consolidation-based method. The accounting consolidation-based method also allows Member State to choose between *i*) adding up Required Solvency Margins which are calculated at solo level; *ii*) calculating a Solvency Margin on the basis of the consolidated accounts.

- Valuation of property
- Valuation of insurance liabilities
- Equalisation provisions
- Valuation of financial liabilities
- Intangible assets
- Discretionary participation features
- Valuation of subsidiaries
- Valuation of pension commitments

V. Supervisory implications of IAS/IFRS introduction

30. CEIOPS has performed the analysis of the supervisory implications according to the following structure:

Prudential implications – i.e. analysis of the effectiveness of the current most important supervisory tools in the light of the new accounting regime:

measurement of technical provisions,

coverage of technical provisions by appropriate assets,

solvency margin.

Lack of homogeneity implications – i.e. analysis of the threat for supervision related to the possible lack of homogeneity of data arising from IAS/IFRS accounting treatment options.

31. The prudential implications analysis has been performed from the starting point of Member States using a historical cost approach as well as from the point of view of countries with a market value tradition.

32. The different perspectives may trigger different prudential filters. Those filters can largely be implemented without any change of the Directives since they aim to maintain the current standard of prudence of the supervisory system. In only one case, CEIOPS has identified issues that may need changes in the Directives. These issues should be brought to the attention of the Commission Services (Annex 2).

33. In addition to the prudential aspects, CEIOPS has also analysed each issue considering the lack of homogeneity implications. This is an important issue as it relates to reporting formats, collection of statistics as well as input figures for analytical models. However, it is mainly of interest at national level, since the options in the Directives already give rise to similar problems between Member States today¹¹.

34. CEIOPS believes that, in the long run, the transition to IAS/IFRS will increase harmonisation of accounts on a European level. However, the valuation options included in IAS/IFRS can potentially create additional problems to the current level of homogeneity - in terms of measurement criteria - within the same jurisdiction.

¹¹ One of the main issues (use of market values vs. historical values) has been dealt with in the Accounting Directives by requiring double disclosure.

Therefore each national supervisor should make an inventory of its data need and consequently make a decision on which issues adjusted figures should be required.

35. Annex 3 reflects the complete analysis performed according to the structure described in paragraph 30. The main results of the analysis however are indicated below. For each issue a synthesis of the main points of discussion is reported together with the supervisory implications and the prudential filters proposed under the two perspectives (market value approach vs. historical cost approach)¹².

Definition of Insurance Contract

36. *Discussion:* The current EU Directives do not contain a definition of insurance contract, since they follow an entity approach rather than a contract approach.

37. IFRS 4 provides a definition of insurance contract which is based on the "significance" of insurance risk accepted by the insurance undertaking. This definition may have significant effects on the financial statements of insurance companies, especially regarding the life assurance sector where a large part of the current insurance portfolio may not contain "significant" insurance risk.

38. *Implications (market/historical approach):* The ineligibility of certain contracts to be considered as insurance contracts may have effects on the level of technical provisions and Required Solvency Margin, especially in the life sector. Furthermore, the lack of guidance, regarding the definition of insurance risk and of its "significance", could potentially damage the comparability of financial statements and thus causes concern to supervisors.

39. As a consequence, CEIOPS agreed on the necessity to reverse the accounting definition of insurance contracts and to keep the current entity-based approach, for supervisory purposes.

Valuation of Financial Assets

40. *Discussion:* As mentioned above, the Accounting Directives provide Member States with the option to choose within a range of different evaluation methods which vary between "purchase cost", "current value" and "fair value" principles. Therefore, since each Member State chooses the system to be applied, different measurement systems may have been implemented throughout the EU.

41. IAS 39 provides for a mixed valuation system which depends on the classification of financial assets in four different categories, for which diverse measurement principles are to be used. Such a system is largely based on "fair value" principles, but it also includes amortised cost criteria for most financial liabilities and some financial assets. Financial instruments of the same kind may be valued at different bases depending on their classification, while in the Accounting Directives financial instruments of the same kind must be valued mainly in the same way. Under IAS 39, it is basically up to each insurance undertaking to select which valuation system to apply, even though this selection is guided to a certain extent by identified criteria;

¹² Whenever the implications and the prudential filters are the same under the two perspectives, they are outlined as "market/historical approach".

therefore it is possible that under an IAS/IFRS regime there will be less comparability even within the same jurisdiction.

42. The application of IAS 39 may create a mismatch between the valuation of assets and liabilities. The supervisory implications are discussed below under “Valuation of insurance liabilities” and “Valuation of financial liabilities”.

43. *Implications (historical approach)*: In Member States using “historical cost” criteria, fair value measurement implies the recognition of unrealised capital gains, which cannot be entirely accounted for under the current solvency regime.

44. For such jurisdictions prudential filters may basically rely on the maintenance of current valuation criteria for solvency purposes. This requires specific treatment for the unrealised capital gains and losses which arise in the financial statements drawn up under IASB principles. These jurisdictions may need to require that those unrealised capital gains and losses have the characteristics foreseen by the national solvency regime in order to be considered as eligible elements and, where applicable, as admissible assets for the coverage of technical provisions.

45. *Implications (market approach)*: In jurisdictions that today are more focussed on market values, IAS 39 will cause less concern. There is however a risk that financial assets which are today market valued could be subject to amortised cost treatment. A possible prudential filter is to require market valuation in supervisory reporting also in the future.

46. *Implications (market/historical approach)*: In order to accept fair valuation for solvency purposes, specific requirements may be retained or established by supervisors (rules, regularity, definition of fair value).

Financial Derivatives

47. *Discussion*: Under the Prudential Directives, derivatives 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 risk or facilitate efficient portfolio management. These instruments must, according to the Prudential Directives, be valued on a prudent basis and may be taken into account in the valuation of the underlying assets.

48. IAS 39 requires to measure 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. They may also be used for hedge purposes to eliminate changes in fair values or cash flows of a hedged instrument.

49. In most cases, IAS 39 will mean that more financial derivatives (certainly on the liabilities’ side) will be included in the balance sheet, and this transparency should normally benefit also insurance supervisors.

50. Derivatives may also be used for hedge purposes to eliminate changes in fair values or cash flows of a hedged instrument. Prudential implications of their use are mainly related to cash flow hedges¹³.

¹³ Where the insurance undertaking tries to hedge the value of its investments by using derivatives, the value of the derivative and the asset it is hedging would move in opposite directions, the result should be approximately neutral. This includes fair value hedges as defined in IAS 39.

51. *Implications (market/historical approach)*: Supervisors may find it appropriate to exclude cumulative gains and losses on cash flow hedges, that are recognised directly in equity, from the Available Solvency Margin.

Valuation of Property

52. *Discussion*: The current EU Directives provide Member States with the option to select between the purchase price and the market value criteria.

53. IAS 40 as well as IAS 16 foresee a valuation system under which insurance undertakings are allowed to choose between the adoption of a “cost model” or a “fair value model”.

54. *Implications (historical approach)*: In countries whose system is based on historical cost principles, unrealised gains are considered as an eligible element only under certain circumstances and with prior approval of the supervisor. In these Member States, the IAS allowance for fair value measurement may imply an automatic recognition in equity of unrealised gains.

55. Prudential filters basically rely on the maintenance of the current valuation criteria for solvency purposes. This requires specific treatment for the unrealised capital gains which arise in the financial statements, drawn up under IASB principles. Thus, jurisdictions may need to require that those unrealised gains have the same characteristics as foreseen by the national solvency regime in order to be included in the eligible elements and, where applicable, as admissible assets for the coverage of technical provisions.

56. *Implications (market approach)*: In countries whose system is based on market value principles, unrealised gains are already recognised in equity and are considered, totally or partially, eligible for solvency purposes. For these countries, the adoption of the fair value model in the measurement of investment property will have no impacts for solvency purposes.

57. However, there is a risk that property which is today market valued could be subject to amortised cost treatment if an insurance undertaking chooses this approach. A possible prudential filter is to require market valuation in supervisory reporting also in the future.

58. *Implications (market/historical approach)*: In order to accept market valuation of property for solvency purposes, specific requirements regarding valuers and valuation may be retained or established in certain jurisdictions.

Where the insurance undertaking 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 interest rate instrument), cash flows will be stable but fair value movements may occur. This refers to cash flow hedges as defined in IAS 39. Under IAS 39, the cumulative fair value gains and losses on cash flow hedges of financial instruments are recognised directly in equity, to the extent that the hedges are effective.

To solve the unwanted accounting volatility that may arise from derivative hedging, accounting solutions provided by IFRS 4 are: 1) shadow accounting, where the effect of fair value measurement on the asset side is equally applied to insurance liabilities; 2) using a current market interest rate along with other current assumptions regarding insurance liabilities. Provided that such accounting solutions are compliant with the Prudential Directives, supervisors may accept their use for solvency purposes, too.

Valuation of Insurance Liabilities

59. *Discussion:* Under the Prudential Directives, technical provisions are prudently calculated in order to be “adequate” or “sufficient” to fulfil the payments to policyholders¹⁴. There are no detailed instructions at EU level on how these provisions should be established. However, Member States normally have more defined rules, which ensure uniform measurement principles to be applied in each jurisdiction. This situation has led to significant differences in practice within Member States, both as concerns financial reporting and supervisory returns¹⁵.

60. 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 in preparing Phase 2¹⁶.

61. 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 provisions¹⁷. The IFRS 4 solutions to such a problem is the allowance for changing the current valuation 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 prudence¹⁸. 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.

62. *Implications (historical approach):* The 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.

¹⁴ Art. 15 of Directive 73/239/EEC and Art. 28 of Directive 91/674/EEC.

¹⁵ European Commission, Report of the Working Group on non-life technical provisions to the IC Solvency Subcommittee (MARKT/2529/02), September 2002.

¹⁶ Particularly, insurance undertakings may measure designated liabilities to reflect the 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.

¹⁷ A less relevant mismatch issue may arise in market value-based jurisdictions in relation to the assets which should be measured at amortised cost under IAS 39.

¹⁸ E.g.: the option to remeasure designated insurance liabilities by introducing current market-based discount rate does not prescribe a comparison of this market rate to the expected future earning rate of assets backing the considered liabilities.

63. *Implications (market approach)*: The prudential issue can be addressed by posing limits to the use of IFRS 4 options for prudential purposes or by providing guidance related to measurement changes. This may especially be related 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.

Caution must be taken that the options are exercised in conformity with the Prudential Directives, as the options in financial reporting do not override the valuations rules of these Directives for prudential purposes.

Equalisation Provisions

64. *Discussion*: Under the Prudential Directives the establishment of equalisation provisions for credit insurance business is required. These are shown as liabilities in the balance sheet. Moreover, in some Member States further provisions are allowed or required to be set up.

65. IFRS 4 prohibits insurance undertakings from recognising catastrophe provisions or equalisation provisions relating to future possible claims as liabilities under future insurance contracts. Thus equalisation provisions and catastrophe provisions, today accounted for as liabilities, will be shown as equity.

66. The effect of the introduction of IAS in this respect may be a reduction in the robustness of the provisions.

67. Due to the links between the Insurance Accounts Directive and the third Non-Life Directive¹⁹, minor revisions to these Directives may be needed. The major reason of the proposed amendments is to create legal certainty.

68. *Implications (market/historical approach)*: A prudential filter consists in keeping the current national rules for solvency purposes, requiring that an equal amount of reserves (namely the former equalisation provisions) is included as a restricted, segmented part of equity, and is deducted from the eligible elements for solvency purposes. Supervisors should be allowed to accept the equalisation reserves - other than required by Prudential Directives - as an eligible element for solvency purposes on an individual basis, provided that no prudential concerns arise on the suitability and adequacy of the entity's reserve level.

On the other hand, the amount deducted from the eligible elements should be added to the technical provisions to be covered by appropriate assets.

¹⁹ Council Directive 92/49/EEC of 18 June 1992 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance and amending Directives 73/239/EEC and 88/357/EEC

Valuation of Financial Liabilities

Financial liabilities and the supervisory treatment of own credit risk

69. *Discussion:* The Prudential Directive requirements contain some prudential margins for the measurement of liabilities related to all the contracts issued by an insurance undertaking (see Dir. 2002/83, Art. 20 and Dir. 91/674, Art. 56 to 60).

70. CEIOPS started its analysis considering the whole non-amended current version of IAS 39. Under this standard financial liabilities should normally be measured at amortised cost or, by means of the "Fair Value Option", subject to specific designation by each insurance undertaking, at fair value through profit and loss.

71. The Fair Value Option has however not been endorsed in the EU with regard to the financial liabilities²⁰. An in-depth study of the possible impacts of such carve-out has not yet been developed; however, the possible consequential mismatch issue regarding the unit-linked contracts accounting treatment has already been clarified by the Commission Services²¹.

Therefore, in the following the full version of the Standard is considered.

72. The application of IAS 39 to financial liabilities may create concerns for:

- a) insurance contracts falling outside the IFRS 4 definition. They will be accounted for under IAS 39 and this will generate financial liabilities instead of insurance liabilities.

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. The fair value measurement of financial liabilities may result in being less prudent than the current EU regime under the Prudential Directives.

The amortised cost method envisaged by 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.

- b) financial liabilities that do not derive from the reclassification of the current insurance contracts.

²⁰ At the Accounting Regulatory Committee meeting (1 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.

²¹ Liabilities stemming from such contracts are today normally market valued as are the related assets. The carve-out of the Fair Value Option might lead to an asymmetrical treatment of assets and liabilities.

The Commission Services have stated in an Explanatory Memorandum dated 24 September 2004 that such contracts can continue to be market valued due to rules in the Insurance Accounts Directive. The legal reasoning behind this conclusion is the following:

The rules in the Insurance Accounts Directive are applicable, and would enable Member States to permit or require companies reporting under IAS/IFRS to value liabilities - where the policyholders bear the investment risk or where benefits are determined according to an index - according to the value of the underlying units, assets, share index or reference value. It is however important to carefully analyse the product features in each case to determine whether the criteria in the Insurance Accounts Directive would be fulfilled. The recent amendments to the Fourth Council Directive following the Fair Value Directive (2001/65/EC) provided a further valuation option (Art. 42a), but did not replace the valuation rules in the Insurance Accounts Directive.

This is the case with subordinated debts, which are eligible to be included in the available solvency margin. Under IAS 39, in fact, the valuation method for these instruments (“fair value” or “amortised cost”) could overestimate the global amount compared with the current system.

73. *Implications (historical approach)*: In both cases, problems may arise where the fair value of the liabilities is lower than the amortised cost. In these situations a prudential filter is the maintenance of the current EU valuation rules for supervisory reporting of such financial liabilities.

74. *Implications (market approach)*: 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. Thus, no filters are needed in this respect. Nonetheless, a 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.

Distinction between liabilities and equity

75. *Discussion*: 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. This would for example relate to the conversion option in a convertible bond.

76. *Implications (market/historical approach)*: 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.

Intangible Assets

77. *Discussion*: Under the Prudential Directives, all intangible assets recognised in the balance sheet are deducted from the available solvency margin.

78. IAS 38 allows the recognition of intangible assets that meet specific requirements and envisages that, after initial recognition, intangible assets are carried at cost or at revalued amount.

79. The amount of intangible assets in the balance sheet might increase since some purchased intangibles (such as trademarks and customer lists) that are not currently recognised on the balance sheet will be recognised under IAS 38 and since, under certain conditions, revaluations of intangible assets will be allowed.

80. *Implications (market/historical approach)*: The possible increase in the amount of intangible assets has no specific prudential implication, since intangible assets are deducted from the available solvency margin. Thus, no filters are necessary and supervisors may continue to deduct all intangible assets from the eligible elements.

Discretionary Participation Features

81. *Discussion:* Under the Accounting Directives bonuses intended for policyholders but not yet credited to individual policyholders should be accounted for as liabilities. As an alternative, Member States can allow that such amounts are accounted for as an item in the balance sheet neither belonging to liabilities nor to equity (fund for future appropriations).

Under the Prudential Directives, Member States may allow unallocated bonuses to be used to cover the solvency margin.

82. IFRS 4 envisages that Discretionary Participation Features (DPF) cannot be classified as an intermediate category that is neither liability nor equity. IFRS 4 allows the DPF to be recognised together with the guaranteed element to which it is associated; in this case the whole contract is classified as a liability. Otherwise, the DPF being separately recognised, it shall be classified as either a liability or a separate component of equity or it might be split into liability and equity components. IFRS 4 provides guidance neither for this classification nor for this split, nor for the accounting treatment of DPF itself.

83. *Implications (market/historical approach):* The amount of DPF classified as a component of equity influences the Available Solvency Margin as well as it may decrease the amount of technical provisions. Supervisors may want to maintain the current national regime, by reallocating amounts from equity to liabilities, to the extent in which they are assessed to be allocated to policyholders as bonuses in the future.

Consequently, the Available Solvency Margin may be reduced by the part assessed to be allocated to policyholders in the future. On the other hand, such amounts may be added to the technical provisions to be covered by appropriate assets.

Valuation of Subsidiaries

84. *Discussion:* The Accounting Directives allow the use of cost method, equity method (minus goodwill) or prudent estimated sales for the evaluation of subsidiaries.

85. IAS 27 requires the use of the cost method or, under certain circumstances, the use of the fair value method in the individual accounts of an entity. In the consolidated financial statement the equity method is preferred.

86. *Implications (market approach):* Supervisory concerns may arise especially for Member States whose current system is not based on the cost method. A prudential filter is to keep the current method for solvency purposes, i.e. to apply the equity method in the individual accounts as well.

Valuation of Pension Commitments

87. *Discussion:* Although current pension approaches vary widely across Europe, it is commonly accepted that the new rules will better describe the full future cost of pension payments than the current systems in the EU. The pension liabilities will in

most cases be increased, and volatility may be introduced as a result of the use of market values.

88. *Implications (market/historical approach)*: Given the common acceptance of the new regime and the better notice of the full future cost of pension payments over the existing regimes, no prudential filters may be needed.

Supervisors, however, should pay attention that a net asset resulting from the valuation of pension assets and liabilities is deducted from the available solvency margin to the extent that it does not entitle to a reimbursement from the pension regime or to a reduction of future contributions.

In any case, supervisors will need to take into account the need for any transitional arrangements for the first time adoption of the Standard.

VI. Financial Statement Formats

89. The Insurance Accounting Directive provides for specified formats for the balance sheet and the profit and loss account to be adopted by an insurance undertaking.

90. Contrarily, under IASB accounting rules each insurance undertaking will be allowed to determine suitable formats for the financial statements to represent its own business.

91. This freedom to choose a format, even though it has no direct impact on recognition and measurement issues, may create lack of homogeneity in the collection of IAS/IFRS accounting data, both among different Member States and within the same jurisdiction.

92. CEIOPS is currently considering whether to analyse and propose specific formats for supervisory purposes. Such work should be made in close coordination with other organisations involved in these issues (IAIS, IASB, EFRAG, CEBS, etc.).

VII. Conclusions

Long-term convergence goals

93. The evolution in accounting and financial reporting is taking place within a context of convergence among Member States regimes. The convergence towards a unique accounting system is an extraordinary opportunity to enhance the level of harmonisation throughout the European Union and it will surely have positive effects in increasing the convergence of national solvency regimes.

94. However, some further steps are necessary to reach a degree of convergence, such as

- i.* a final International Accounting Standard on Insurance Contracts,
- ii.* a wider mandatory scope of application of the International Accounting Standards,
- iii.* the development of an EU "IAS compliant" solvency system.

95. On the basis of the analysis carried out and taking into account all the differences among the national systems, CEIOPS acknowledged that a wider degree of convergence among supervisory systems can be reached only at a later stage.

Temporary solutions during Phase 1

96. In the meantime, there is a strong call for closely monitoring the accounting changes in order to ascertain that the move towards the new accounting regime would not have undesired effects on the Available Solvency Margin and/or the Required Solvency Margin. CEIOPS acknowledges that it is a reasonable starting point to put in place some supervisory actions to revert the changes resulting from the introduction of IAS/IFRS, which have a relevant impact on prudential supervision.

97. Those supervisory actions, so-called “prudential filters”, constitute a means to avoid that the move towards the new accounting regime may have undesired effects on the current solvency system. They aim to neutralise the non-intended effects of the application of IAS/IFRS on such a system. Since there are differences among the present national solvency systems, those prudential filters may differ between Member States to reflect their peculiarities.

98. CEIOPS acknowledges the interest of the insurance industry in dealing with a single set of accounts as well as the need to limit the amount of prudential adjustments to the financial statements. Therefore, the adjustments would have to be motivated from a prudential point of view.

99. As a result of the analysis, CEIOPS proposes the following prudential filters to be adopted.

Prudential filters for all jurisdictions

100. The prudential filters may be needed

- a) to reverse the accounting definition of insurance contracts and to keep on with the current entity-based approach;
- b) to establish or retain specific requirements for solvency purposes to accept fair valuation of financial instruments as well as of property (rules, regularity, valuers requirements, etc.);
- c) to exclude cumulative gains and losses on cash flow hedges that are recognised directly in equity from the available solvency margin;
- d) to deduct from the equity elements an amount of reserves equal to the current equalisation provisions as well as to add it to technical provisions to be covered by appropriate assets;
- e) to maintain the current definition of equity and liability components;
- f) to reduce the Available Solvency Margin by the part of Discretionary Participation Features assessed to be allocated to policyholders in the future as well as to add it to technical provisions to be covered by appropriate assets.

Prudential filters primarily for historical cost jurisdictions

101. In Member States which are used to a historical cost-based accounting tradition, prudential filters may be needed

- a) to require specific treatment for unrealised capital gains and losses related to financial instrument as well as property valuation;
- b) to maintain the current national rules for the measurement of insurance liabilities;
- c) to retain the current EU valuation rules for supervisory reporting on financial liabilities. This could also be the case for qualifying subordinated debts as eligible elements.

Prudential filters primarily for market value jurisdictions

102. In Member States using a market value-based approach, prudential filters may be needed

- a) to require market valuation in supervisory reporting for the valuation of all financial instruments as well as property;
- b) to limit the use of IFRS 4 options (or to provide guidance) to change the measurement of insurance liabilities. Caution must be taken that the insurance liabilities are measured in conformity with the Prudential Directives;
- c) to require that gains and losses arising in the valuation of financial liabilities on a fair value basis in relation to own creditworthiness are deducted from the Available Solvency Margin;
- d) to keep the current valuation method of subsidiaries.

Amendments to the Directives

103. In the analysis, only one point has arisen where changes to Directives seem necessary. This relates to the **equalisation provisions**, which are generally regarded as provisions in the EU and are normally covered by assets as are other technical provisions.

Possibly the following adjustments would be needed:

- i. Clarify in the Prudential Directives that "equalisation reserve" is a technical provision.
- ii. Remove the caption "equalisation provision" in the IAD and create a new sub-caption "equalisation reserve"