Solvency II: Reconciling IFRS reporting with regulatory filings

CFRR team

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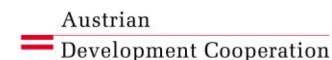
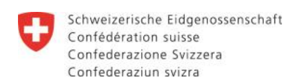




European Union

- Introduction.
- Starting premises.
- What is pillar 3 reporting in Solvency 2?
- Overlap between Solvency 2 and IFRS Phase 2: “The Engine Room”.
- Upstream v/s downstream.
- A reminder of overlap between Solvency 2 and IFRS Phase 2 in measurement and impact on reporting.
- Implications of overlaps and differences.

Introduction

- There are two major sets of new requirements and rules that would impact on insurance companies in the next few years.
  - Solvency 2-Prudential framework
  - IFRS Insurance contract phase 2 and IFRS 9-Accounting framework

- They have different dates of implementation.
- They need changes in IT systems.
- Their impact on **financial statements** and Solvency 2 **reporting requirements** will be different.

DIFFERENCES AND OVERLAP IN REPORTING
DUE TO
OPERATIONAL ISSUES AND VALUATIONS
ISSUES

- The IASB's standard objectives are to ensure high-quality, **understandable and enforceable to improve transparency** and comparability of insurers' financial statements regardless of sector, geography or products.
- Solvency II's goal is to establish a **single common regulatory framework to maintain capital adequacy and risk management standards** in the insurance industry.
- The aim under IFRS and Solvency II is to facilitate **comparability and transparency from a regulatory and accounting perspective to external stakeholders, in contrast to the current divergent practices and measures which characterise insurance reporting**.

- There are significant overlaps in both the measurement and disclosure requirements between the Phase II and Solvency II frameworks.
- Although timeline is different between Phase II and Solvency II, preparation for both frameworks has already started in the insurance companies as there are significant overlaps.
- The overlaps are both in the preparation and input of data as well as **in the output and reporting of data to the regulators and in the financial statements.**
- For insurance groups, the content and structure of data captured from business units to support group statutory and regulatory reporting will change significantly. This will require major changes to group financial consolidation and reporting systems. In addition, changes to the primary financial statements and disclosures will impact the general ledger and chart of accounts at both the group and business unit level.

» Why is IFRS reporting and Solvency 2 reporting different? (which statement(s) is correct)

A. Different objectives.
B. They are the same not different.
C. Solvency 2 reporting includes prudential reporting.
D. IFRS reporting is not about prudential reporting.
E. Solvency 2 reporting includes detailed disclosures about capital adequacy and solvency.
F. IFRS reporting includes detailed disclosures about capital adequacy and solvency.

» Pillar 3 reporting in Solvency 2 includes both reporting to the public and to supervisors only.

A. True.
B. False.
C. Partly true.
D. It depends on the insurer.
E. It depends on each regulator.

Question 3

- IFRS reporting and Pillar 3 reporting overlaps despite the differences in objectives.

A. Depends on a case by case basis.
B. False.
C. True.
D. Depends on the intentions of the insurers to be transparent or not.
E. Depends how regulators implement Pillar 3 in the EU.
F. Pillar 3 reporting is quite flexible so it depends.

» The Solvency II Pillar 3 regulatory reporting requirements came into force on 1 January 2016. Firms must produce **two key reports**:

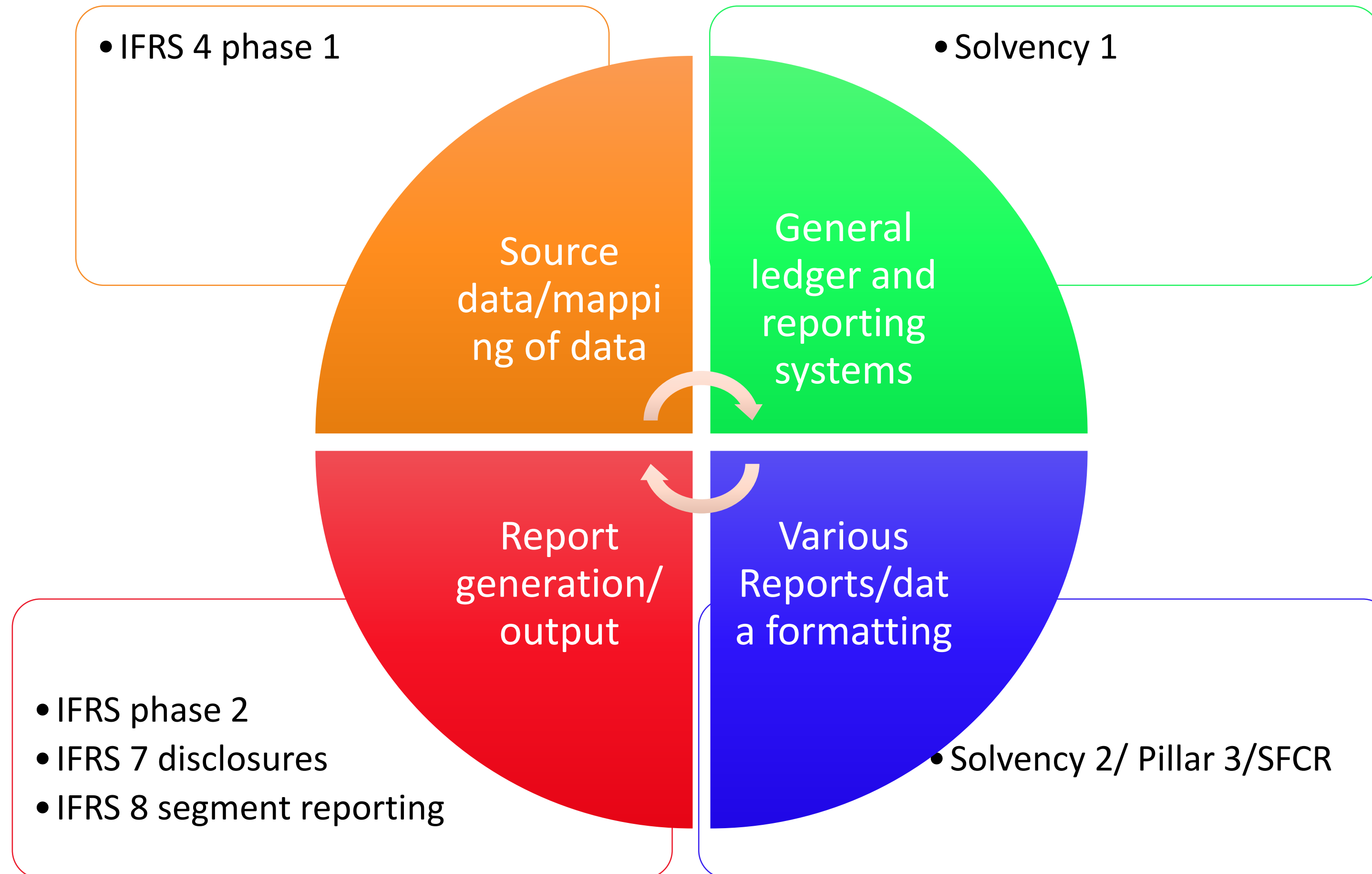
» i) the Solvency and Financial Condition Report (SFCR) – Firms are required to disclose this report publicly and to report it to the local National Competent Authority (NCA) on an annual basis. The SFCR includes both qualitative and quantitative information; and

» ii) the Regulatory Supervisory Report (RSR) – This is a private report to the supervisor and is not disclosed publicly. Firms submit this report to the NCA in full at least every three years and in summary every year. The RSR includes both qualitative and quantitative information.

Starting premises

Systems, Procedures and Internal Controls

Overlap between Solvency 2 and Phase 2: "Engine Room"



Upstream v/s downstream

- The procedures, processes and systems for both IFRS Phase 2 and Solvency 2 are the same and very much similar.
- The integrity, accuracy and completeness of data for Solvency 2 balance sheet and reports will depend on the source data used for Phase 2 and vice-versa.
- **Regulators and supervisors role starts at this point ("upstream"). Intervention by regulators further "downstream" could be too late.**
- Insurers will also need to define solutions to support parallel reporting of Phase I and Phase II results during the transitional period and provide Solvency II, local GAAP and local regulatory reporting on an ongoing basis as required.
- This will necessitate an assessment of the capability of corporate and business unit general ledgers to support multiple GAAP conversions and avoid business and regulatory compliance disruptions.

» The data requirements for Phase II are similar to Solvency II and address many of the potential data gaps in Phase I (e.g., data to model future premiums, participation bene ts, options and guarantees). Solvency II also requires insurers to invest in data quality, control and management; however, there are differences in the detail, e.g., regarding the definition of a portfolio, contract boundaries and unbundling.

» Solvency 2 Pillar 3 and IFRS reporting are different because of:

A. The disclosure requirements are different.
B. The IT systems/platforms/templates to produce the disclosures may be different.
C. Source of data from the ledgers are different.
D. IFRS reporting and Pillar 3 require different mapping exercise.
E. The differences are minimal and for some insurers not material.
F. The valuation methodologies under Solvency 2 and IFRS are the same.
G. The valuation methodologies under Solvency 2 and IFRS are different.

Solvency 2 Balance sheet v/s IFRS phase 2 balance sheet

- The risk adjustment (RA) in IFRS 4 Phase II is the compensation that a company requires for bearing the uncertainty about the amount and timing of cash flows. IFRS 4 Phase II does not prescribe the method to calculate the RA, and therefore a company can apply its own specific view on insurance risk.
- A similar concept called the risk margin exists under Solvency II. The risk margin is defined as the amount, in addition to the present value of future cash flows, which would be required by another insurer to take over and meet the insurer's obligations.
- The risk margin is calculated as the cost of providing the capital required in respect of the liabilities over their lifetime; in other words, the cost of providing the required solvency capital requirement (SCR) over the lifetime of the liabilities
- A cost of capital (CoC) methodology is used to determine the risk margin. The CoC is the net present value of the cost of holding the solvency capital. The CoC rate is set to 6% of the non-hedgeable solvency capital.

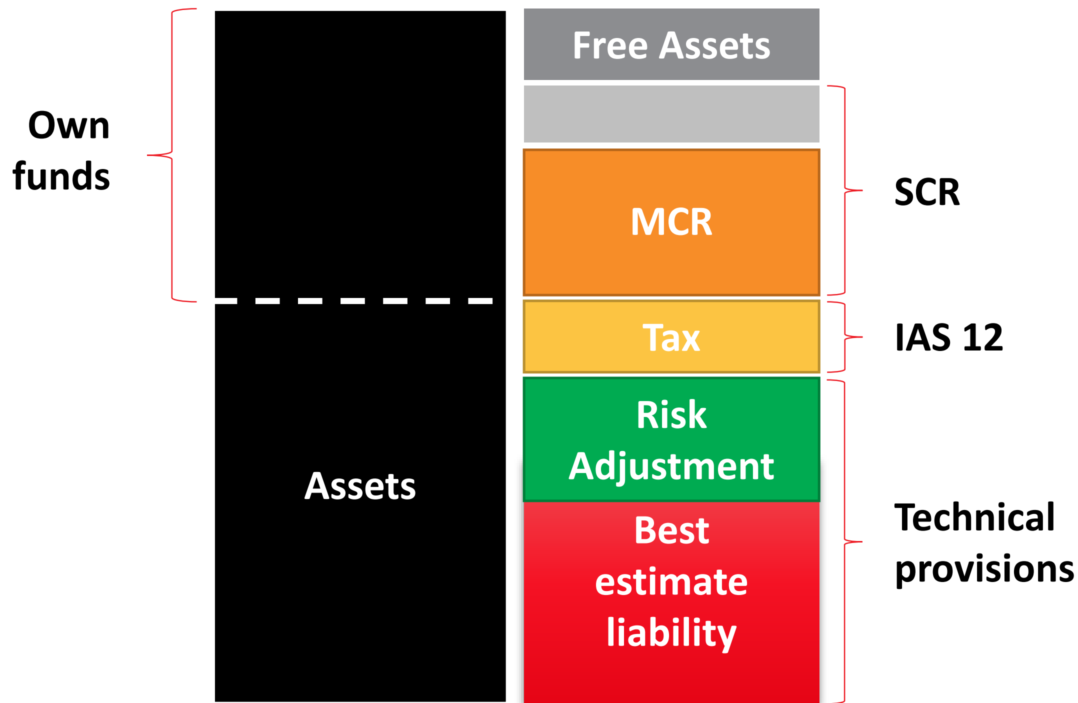
Risk Adjustment v/s Risk Margin

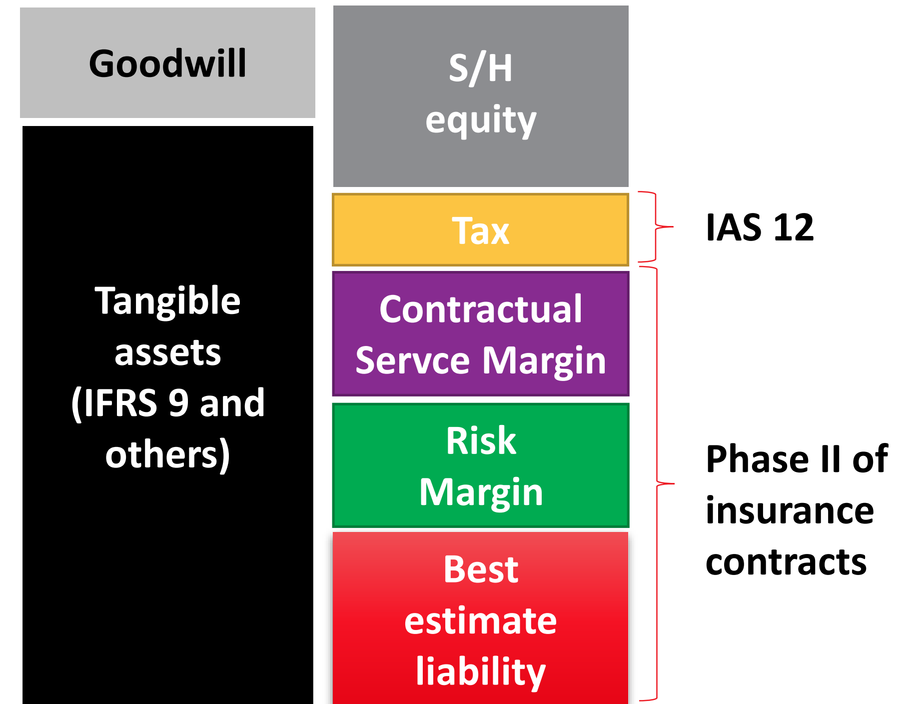
- Differences can occur applying IFRS at group level (larger diversification) and at legal entity or sub-group level (smaller diversification).
- Higher risk aversion results into higher risk adjustment and decreases comparability between different insurance companies (for instance if the entity applies a higher confidence level). Nevertheless additional disclosures are introduced.
- Unit of account = entity level: implies similar or higher diversification benefits compared to Solvency II.
- In principle, to calculate the Risk Adjustment is by determining the SCR in each future year, multiplying each SCR by the cost of capital and discounting them to the valuation date.

- The methodology to determine the risk adjustment is not prescribed under IFRS 4 Phase II. The IFRS methodology used should reflect the companies' perception of risk. One possibility is that companies would use a cost of capital methodology to allow for comparability with Solvency II.
- However, the disclosure of the confidence level corresponding to the RA is mandatory in order to enhance comparability between companies. The RA can be determined at a portfolio level and can incorporate diversification benefits that may exist.

- One of the first key difference between Solvency 2 and Phase 2 is the CSM.
- Solvency 2 is based on an exit value model whereas Phase 2 is based on the fulfilment cash-flows model.
- Hence, the CSM in Phase 2.
- The CSM would act as an buffer to absorb any profit at inception and profit would be released over time. This buffer does not exist in Solvency 2.
- The CSM may result in different P&L numbers and profitability ratios between Solvency 2 and Phase 2.
- The Solvency 2 balance sheet could be more volatile.

Overlaps between Solvency 2 and Phase 2





Overlaps between Solvency 2 and Phase 2

- At the heart of both models is the requirement to use current unbiased estimates for all future cash flows. This reflects the time value of money and the inclusion of a risk margin to deal with the uncertainty around those cash flow estimates – the three building block approach. These components are re-measured each reporting period to reflect changes in assumptions and estimates of the cash flows, as well as the uncertainty associated with those cash flows.
- Differences in the level of expenses and the level at which diversification for the risk margin can be considered will lead insurers to build additional flexibility into their actuarial models to simultaneously calculate the differing measures. Additional systems, over and above those being developed for Solvency II, will be required to address the Contractual Service Margin (CSM) and level of diversification benefits whether at portfolio or legal entity levels or expenses for example.

Expenses in Solvency 2

- Solvency II's aim is to protect policyholders and fully reflect in the measurement of the liability costs which the insurer is expected to incur.
- Under Solvency II technical provisions are required to include claims-handling expenses (both allocated and unallocated) and other expenses incurred in running the business.
- Currently, most reserves estimated by actuaries would implicitly include allocated claims-handling expenses. Additionally, in some cases, actuaries would consider unallocated claims-handling expenses. However, it is far less common for actuaries to analyse other expenses. Consequently, the new regime will require many actuaries and supervisors to develop a deeper understanding of the expense elements of the balance sheet than they have now.

Expenses in IFRS

- The objective of IFRS is to provide information on the performance of the company. Overhead expenses represent the cost of managing the business and are expected to be covered by profits as they emerge. Phase II, therefore, requires only the costs related to managing the insurance contracts to be included within the liability measurement.
- This treatment of expenses will impact actuarial models, expense management and identification, as well as future profitability. Separate cash flows will be required within the underlying actuarial models to concurrently identify and measure maintenance expenses and overheads. Appropriate systems will also be needed to identify the maintenance expenses within the general ledger to ensure these are not included in the income statement.

- From the UK Prudential Regulatory Authority (PRA) :
  - “In the UK a comprehensive motor insurance policy provides property damage cover for an insured’s own vehicle along with third party liability cover. Third party liability cover would indemnify the insured against claims from third parties in respect of both bodily injury and property damage. The PRA would expect these policies and claims to be unbundled into the appropriate Solvency II lines of business. This impacts both reporting and also standard formula calculations.
  - Specifically, third party liability claims, both property and bodily injury, should be allocated to line of business 4 “Motor Vehicle Liability” or 26 “Non-proportional Casualty” and own property damage should be allocated to line of business 5 “Other Motor” or 28 “Non-proportional property”. Where only one of the risks is considered material, the technical provisions guidelines1 state that the unbundling of the obligations is not required. Where the risks within “Other Motor” cannot be shown to be immaterial, and to ensure that motor business is treated consistently, firms should be unbundling their motor business into the appropriate Solvency II lines of business.”

- The implications are that models may need to be enhanced to:
  - Provide flexibility to accommodate changes between Solvency II and Phase II.
  - Ensure capacity to update assumptions more frequently.
  - Handle varying cash flows for different reporting bases.
- It also implies that internal controls are effective at the right level to ensure that the flexibility provides accurate and up to date data for both IFRS reporting and Solvency 2.

Implications of overlaps and differences

- These overlaps and differences will crystalize and become visible at the Pillar 3 and IFRS reporting levels in various Pillar 3 reporting and in the IFRS financial statements.
- The disclosures and explanations would lead to different numbers and may add another layer of complexity that would need:
  - Better understanding.
  - Better communication.
  - More clarification.

Question 5

» Valuation of insurance liabilities in Solvency 2 is different from IFRS because of:

A. Different types of margins.
B. Margins used for different purposes.
C. Assumptions to calculate diversification benefits may be different but business lines are not different.
D. Assumptions to calculate diversification benefits may be different.
E. Business lines are different.
F. Margins are different because of names only.
G. Valuation of insurance liabilities between Solvency 2 and phase 2 not different.

- The differences between Pillar 3 and IFRS mean that insurers should:

A. Disclose IFRS and Pillar 3 data and information and do nothing afterwards.

B. Explain clearly in their public disclosures the differences to avoid confusion.

C. Let users understand the differences by themselves.

D. Assume that the differences are simple to understand by all users.

E. Align IFRS reporting on Pillar 3 to remove the differences.

Pillar 3 reporting and IFRS phase 2 reporting

Solvency 2 Pillar 3 reporting

» Pillar III will be the public and private reporting face of the technical provisions and capital requirements required under Pillar I and will provide the evidence of the own risk and solvency assessment (ORSA) and the insurers' risk governance framework under Pillar II.

SFCR AND RSR

» The Solvency and Financial Condition Report (SFCR) – Firms are required to disclose this report publicly and to report it to the local National Competent Authority (NCA) on an annual basis. The SFCR includes both qualitative and quantitative information; and

» The Regulatory Supervisory Report (RSR) – This is a private report to the supervisor and is not disclosed publicly. Firms submit this report to the NCA in full at least every three years and in summary every year. The RSR includes both qualitative and quantitative information.

SFCR

TEMPLATES	NARRATIVE
Balance Sheet Premium claims and expenses Own funds SCR and MCR Technical provisions Group reporting	Business and performance System of governance Risk profile Valuation for solvency purposes Capital management

QRT

TEMPLATES	NARRATIVE
Balance Sheet Premium/claims/expenses Own funds Variation analysis SCR and MCR Assets Technical provisions Reinsurance Group reporting	N/A

RSR

TEMPLATES	NARRATIVE
N/A	Business and performance System of governance Risk profile Valuation for solvency purposes Capital management Group specific information

QRT

» Quantitative ReportingTemplates(QRTs) are templates for quantitative analysis that will form part of the RSR; some templates will also be part of the SFCR. Some templates will be required on an annual basis, while a smaller subset will be required quarterly.

» The templates are likely to cover the market consistent balance sheet, with a comparison to the current statutory balances, as well as an analysis of available capital (own funds).

» Underwriting risk
» Market risk
» Credit risk
» Liquidity risk
» Operational risk
» Other risks
» Material risk concentration
» Risk mitigation techniques
» Stress and scenario testing– internal model/ SCR

Risk Profile disclosures in Pillar 3	Overlap with IFRS
Underwriting risk Market risk Credit risk Liquidity risk Operational risk Other risks Material risk concentration Risk mitigation techniques Stress and scenario testing– internal model/ SCR	IFRS 7/IFRS 4

Qualitative information in RSR and SFCR: Valuation

Valuation disclosures in Pillar 3	Overlap with IFRS
Description of the bases and methods used for the valuation of: Assets Technical provisions Other assets and liabilities Explanation of any major differences for the valuation in financial statements	IFRS 7/IAS 1

Capital management disclosures in Pillar 3	Overlap with IFRS
Ownfunds MCR and SCR Methods used for the calculation of its SCR Differences between the standard formula and internal models used Internal model Non-compliance with MCR and SCR	IFRS 7/IAS 1

Why is Pillar 3 reporting relevant?

- Business and regulators will need to take full account of Pillar 3 reporting and disclosure in line with the requirement to build the risk and solvency evaluations into business and regulatory decision making. The binding capital constraints imposed by Solvency II will also have a decisive impact on how much money is available for dividends and investment, which are a key focus for, regulators analysts and investors.
- Pillar 3 could provide a useful catalyst for a review and rethink of reporting and disclosure aimed at understanding and communicating the risks, strength and performance of the insurance company.

- Solvency II will change how companies within the insurance sector think about their businesses and how supervisors assess the insurance company and its risk profile/capital adequacy. This might include how performance, risk and capital are evaluated, communicated and understood.
- Those insurers that are looking to use Solvency II to help bridge the information void both internally and with investors will need to be able to build from solo level to group-level analysis and to help provide clarity on the different sources of earnings that drive results on a Solvency II basis, as well as how group capital structures work in practice.

Why is it important for regulators to compare Pillar 3 and IFRS reporting?

» A market-consistent approach in Solvency 2 also introduces much greater volatility into both capital available and capital requirements, which even with buffers in place may exacerbate pro-cyclical pressures.

» There will be more volatility in available capital than under the relatively static existing regimes of Solvency I and IFRS phase I. Current approaches are therefore likely to be redundant and will need to give way to a more dynamic and frequent analysis under a comprehensive range of scenarios based on Solvency 2 and IFRS 4 phase 2 metrics.

Solvency 2 and Phase 2 metrics will feed into the volatility and availability of Capital and Dividend payments.

Why is it important for regulators to compare Pillar 3 and IFRS reporting?

- This volatility and availability of capital and dividend payments may not be only at the group level but also within a group based on different entities of the group or at existing **(or new?)** business lines levels.
- What is profitable now may not be in the future under Solvency 2 and Phase 2?
- Business lines and products that require *more* or *less* capital now may not be the same in the future under Solvency 2 and Phase 2?
- What is payable as dividend now may not be the case in the future under Solvency 2 and Phase 2?
- Business lines and products that are considered *more* or *less* risky now may not be the same in the future under Solvency 2 and Phase 2.

» Regulators should

A. Try to understand and reconcile the differences between Pillar 3 and IFRS reporting to obtain greater clarity of the insurer.

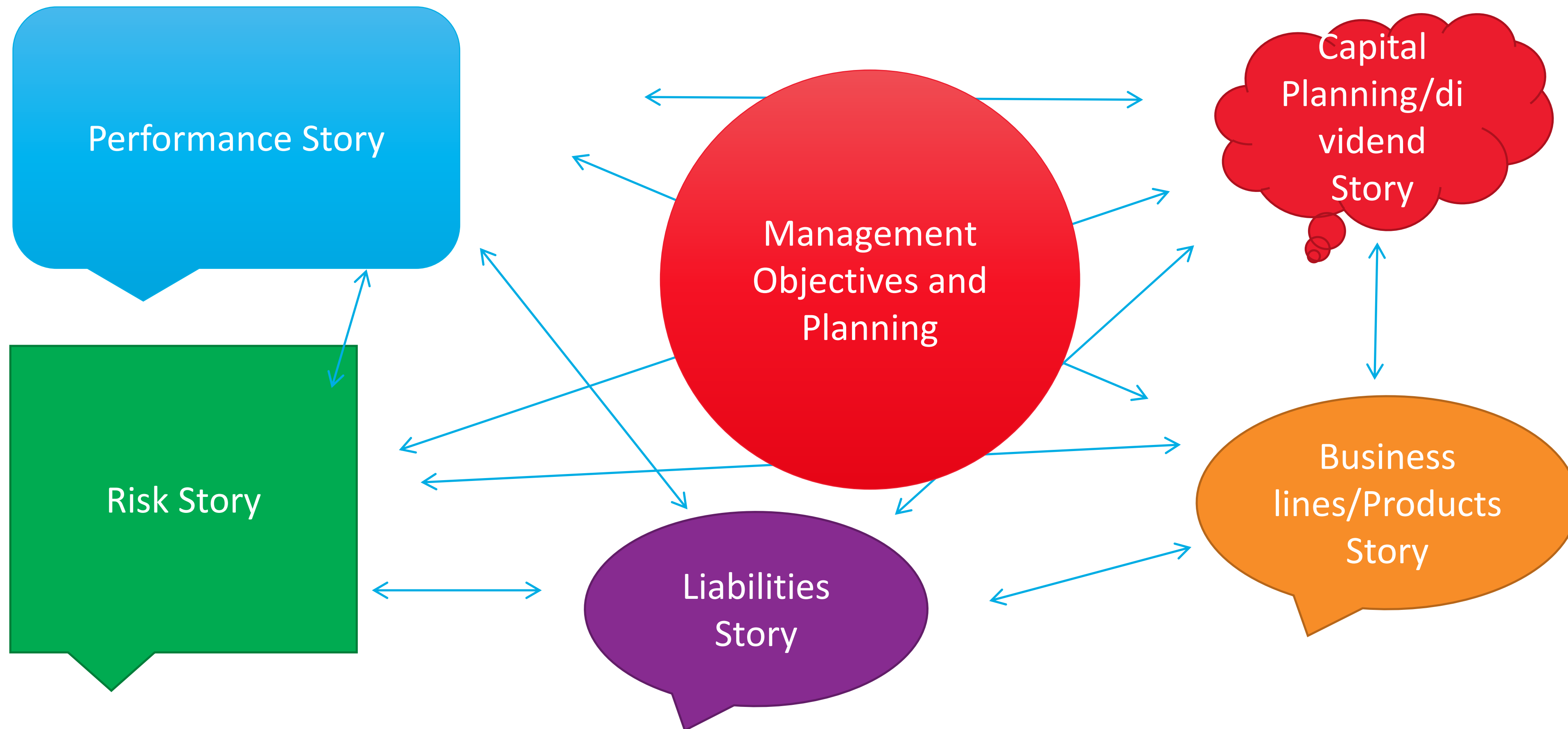
B. Not read IFRS disclosures as Pillar 3 reporting is sufficient.

C. Adopt a box ticking approach to Pillar 3 reporting because there are many disclosures in Pillar 3 reports.

D. Analyse both IFRS and Pillar 3 reporting to understand the performance, risks, business models of the insurer.

E. Not understand the public disclosures in Pillar 3 as they are intended for the public only.

The Pillar 3 and Phase 2 "stories"



- Audit of Solvency II regulatory returns
  - EIOPA issued a statement supportive of the external audit of Solvency II reporting
  - The PRA anticipates that, to some extent, there will be an audit requirement of firms' public regulatory reporting for solos and groups. Audit opinion would be 'properly prepared in all material respects, in accordance with the Solvency II regulatory framework.'

- PRA's **proposal** for a policy to require the external audit of elements of Pillar 3 disclosure under Solvency II:
- Under Pillar 3, firms in scope of Solvency II are required to disclose publicly a SFCR. The proposed policy would require external audit of quantitative and qualitative information included in the 'Valuation for solvency purposes' and 'Capital management' sections of the SFCR (relevant elements of the SFCR) of insurers prepared at the solo, group and sub group level.
  - Subject to two exemptions: First, the Solvency Capital Requirement (SCR) would be exempt if calculated using an approved full or partial internal model (internal model). Secondly, where Solvency II requires information in the SFCR to be produced using sectoral rules, that information would not be subject to external audit.

Auditability of Pillar 3 reporting

» Objectives of audit: intended to give users of the SFCR, including investors, policyholders and the PRA, greater confidence in the quality of the disclosure. Investors may need this information to make informed investment decisions, which should contribute to market discipline and the PRA’s objectives of promoting the safety and soundness of firms and securing an appropriate degree of protection for policyholders.

- Auditors would be expected to provide a reasonable assurance opinion that the 'Valuation for solvency purposes' and 'Capital management' sections of the SFCR have been properly prepared, in all material respects, in accordance with Solvency II, subject to the exemptions noted above.
- The requirements for external audit would be implemented from 30 June 2016, for those firms reporting under Solvency II. Therefore it would first affect insurers for accounting years ending on or after 30 June 2016.
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- Though there is no requirement under Solvency II for external audit of the public or private disclosure under Pillar 3, the European Insurance and Occupational Pension Authority (EIOPA) ‘believes that to ensure high quality public disclosure for Solvency II purposes, external audit of that information can ... be a powerful tool.
- In order to make best use of external audit in the context of the SFCR, EIOPA is of the view that at individual and group level, the main elements of the SFCR (balance sheet, own funds and capital requirements) of all insurance and reinsurance undertakings could fall within the scope of an external audit.’

- One of the main elements investors analyse is the insurer’s solvency and financial condition. At present, insurance accounting under UK GAAP and IFRS allows a variety of practices. The new IFRS accounting standard, IFRS 4 Insurance Contracts, has not yet been completed and may not be effective until at least 2019, whereas under Solvency II, the SFCR will be presented by insurers on a consistent basis. It is expected that the SFCR will, therefore, continue to be used by investors and others for a number of years.
- The PRA’s discussions with investors have indicated that market consistent public solvency disclosure is likely to be an important source of information for analysis and decision-making.

- In addition, the PRA will use the SFCR to assist it in its supervision of insurers and in meeting its objective of policy holder protection. External audit can enhance the reliability of insurer reporting and disclosure. The insights that auditors obtain in undertaking an external audit of the Solvency II disclosure may also contribute to an effective auditor-supervisor dialogue.

» On Pillar 3 and IFRS reporting:

A. Not be audited by external auditors.
B. Be audited by external auditors.
C. Only IFRS financial statements are audited.
D. There are no requirements for Pillar 3 Solvency 2 to be audited.
E. It depends on the insurers, they can require the Pillar 3 reports to be audited.

» The key elements of Pillar 3 Solvency 2 reporting are:

A. The business model of the insurer.
B. The risk profile of the insurer.
C. The performance of the insurer.
D. Management's objectives.
E. The internal control and governance of the insurer.
F. Capital management and planning of the insurer.
G. Valuations of the assets and liabilities of the insurer.

» Capital management and planning disclosures in Pillar 3 reports should be:

A. Only backward looking.
B. Focus on the current year of reporting only.
C. Current year and forward looking.
D. Forward looking only.

THANK YOU