Valuation of non-insurance contract in Solvency 2

CFRR team

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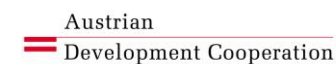

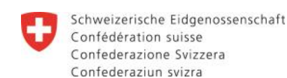

European Union

- » Introduction: what is the key issue we will consider in this session?
- » Some good news and some
- » Why are there differences?
- » Solvency 2 Directive: Article 75
- » Article 9 of the Delegated Acts (DA):Valuation methodology — general principles
- » EIOPA guidelines
- » Table: Consistency of IFRS Valuation with Article 75 of the Directive
- » Examples of accounting policies in notes from financial statements to show mix model

- Solvency 2 (S2) balance sheet is “based” on IFRS as a starting point.
- The aims of S2 are:
  - to ensure a uniform and enhanced level of policyholder protection across the EU providing policyholders greater confidence in the products of insurers, and
  - shift supervisors' focus from compliance monitoring to evaluating insurers' risk profiles and the quality of their risk management and governance systems.
- S2 valuation standards are compatible with IFRS where market consistent valuations are prescribed (IFRS give options that are not acceptable in line with article 75 of the Sovency 2 Directive)
- However, there are differences between Solvency 2 and IFRS requirements for the valuation of insurance liabilities, assets non-insurance liabilities, in the same manner as there are differences and adjustments for banks between IFRS and Basel III/CRR.
- These differences are to be expected.

- Solvency 2 is about a “realistic” balance sheet “trying” to avoid mismatch.
- IFRS is still a mix-based framework where “mismatch” is still present.
- Solvency 2 is a prudential framework for supervisors and adequacy of capital for the protection of policyholders.
- IFRS is “backward” looking and has a wider range of stakeholders and users of financial statements.
- Objectives of Solvency 2 reporting and IFRS reporting are different.

Regulators and supervisors should be fully aware of these differences.

Valuation of assets and liabilities

- Solvency 2 requires a specific balance sheet (i.e. not necessarily the accounting BS) with specific valuation criteria in line with art 75 of the Solvency 2 Directive: Member States shall ensure that, unless otherwise stated, insurance and reinsurance undertakings value assets and liabilities as follows:
  - assets shall be valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction;
  - Liabilities shall be valued at the amount for which they could be transferred, or settled, between knowledgeable willing parties in an arm's length transaction.
  - When valuing liabilities under point (b), no adjustment to take account of the own credit standing of the insurance or reinsurance undertaking shall be made.

Question 1

» Solvency 2 is based only on IFRS. Which statement(s) is correct?

A. True but only partly.

B. False.

C. Solvency 2 is based on local GAAP.

D. Solvency 2 is based on US GAAP.

E. Solvency 2 is based on realistic balance sheet approach.

F. Solvency 2 is based on cost accounting.

G. Solvency 2 is based on fair value.

» What is a realistic balance sheet approach which is used in Solvency 2?

A. Based on amortised costs.

B. Based on mixed valuation basis (historical cost and fair value)

C. Only Assets measured at fair value.

D. Only Liabilities measured at fair value.

E. Both Assets and Liabilities measured at fair value and the difference is the value of equity.

F. Based on historical costs.

» Are IFRS reporting and Solvency 2 reporting similar?

A. True
B. False
C. Partly True

- Why are there differences between IFRS reporting and Solvency 2 reporting?(which statement(s) below are correct)

A. Their objectives are different.

B. There are no differences at all.

C. IFRS reporting is for banks only.

D. Solvency 2 reporting is for banks only.

E. Neither IFRS reporting nor Solvency 2 reporting apply to insurers.

Article 9 of the Delegated Acts (DA):Valuation methodology — general principles

» On article 9 of the DA you've the general principles (the next articles clarify the valuation hierarchy (much in line with IFRS 13) and specific criteria for particular assets and liabilities other than Technical Provisions:

1.Insurance and reinsurance undertakings shall recognise assets and liabilities in conformity with the international accounting standards adopted by the Commission in accordance with Regulation (EC) No 1606/2002.

2. Insurance and reinsurance undertakings shall value assets and liabilities in accordance with international accounting standards adopted by the Commission pursuant to Regulation (EC) No 1606/2002 **provided that those standards include valuation methods that are consistent with the valuation approach set out in Article 75 of Directive 2009/138/EC**. Where those standards allow for the use of more than one valuation method, insurance and reinsurance undertakings shall only use valuation methods that are consistent with Article 75 of Directive 2009/138/EC. 3.

3. Where the valuation methods included in international accounting standards adopted by the Commission in accordance with Regulation (EC) No 1606/2002 are not consistent either temporarily or permanently with the valuation approach set out in Article 75 of Directive 2009/138/EC, insurance and reinsurance undertakings shall use other valuation methods that are deemed to be consistent with Article 75 of Directive 2009/138/EC.

Article 9 of the Delegated Acts (DA):Valuation methodology — general principles

4.By way of derogation from paragraphs 1 and 2, and in particular by respecting the principle of proportionality laid down in paragraphs 3 and 4 of Article 29 of Directive 2009/138/EC, insurance and reinsurance undertakings may recognise and value an asset or a liability based on the valuation method it uses for preparing its annual or consolidated financial statements provided that:

(a) the valuation method is consistent with Article 75 of Directive 2009/138/EC;

(b) the valuation method is proportionate with respect to the nature, scale and complexity of the risks inherent in the business of the undertaking;

(c) the undertaking does not value that asset or liability using international accounting standards adopted by the Commission in accordance with Regulation (EC) No 1606/2002 in its financial statements;

(d) valuing assets and liabilities using international accounting standards would impose costs on the undertaking that would be disproportionate with respect to the total administrative expenses.

5.Insurance and reinsurance undertakings shall value individual assets separately.

6.Insurance and reinsurance undertakings shall value individual liabilities separately.

Question 5

» Can insurers apply IFRS methods of valuation for fair value to comply with Article 75 of Solvency 2?

A. Maybe
B. Not sure.
C. Yes.
D. No.
E. The fair value in Solvency 2 is different from the fair value in IFRS.

Question 6

» To determine fair value in Solvency 2, an insurer can use the fair value used for the preparations of the financial statements.

A. No.

B. Sometimes.

C. Yes.

D. Only if the IFRS fair value is the same as the fair value in Solvency 2.

» The differences between IFRS reporting and Solvency 2 reporting is because…

A. Solvency 2 requires historical cost.

B. IFRS requires historical cost in all cases.

C. Solvency 2 requires amortised cost.

D. IFRS requires amortised cost in all cases.

E. Solvency 2 requires fair value in all cases and IFRS requires historical cost or fair value in specific circumstances.

EIOPA Guidelines

- EIOPA-BoS-15/113 EN: Guidelines on recognition and valuation of assets and liabilities other than technical provisions
  - Delegated Regulation (EU) 2015/35 clearly defines in which cases the valuation methods are not consistent with the valuation approach set out in Article 75 of the Solvency II Directive, and therefore, other valuation principles or adjustments than IFRS shall be applied.
  - These Guidelines are addressed to supervisory authorities under the Solvency II Directive.
  - These Guidelines are intended to facilitate convergence of professional practice across Member States and support undertakings in recognizing and valuing assets and liabilities other than technical provisions.

» EIOPA has intentionally not assessed which local accounting principles, used in annual or consolidated financial statements, would be consistent with Article 75 of the Solvency II Directive. EIOPA has, however, provided information on the principles laid down in the Accounting Directives.

Guideline 2: Consistency and relevant info

- Undertakings should apply valuation techniques consistently. Undertakings should also consider if as a result of a change in circumstances, including those listed below, a change in valuation techniques or their application is required on the basis that such change would result in a more appropriate measurement in accordance with Article 75 of the Solvency II Directive.
- Such changes may include the following:
  - new market developments that change market conditions;
  - new information becomes available;
  - information previously used is no longer available;
  - Valuation techniques improve.

Guideline 3 – Investment property and other properties: alternative valuation methods

» For the purposes of Article 10 of Delegated Regulation (EU) 2015/35 when valuing investment property and other properties, undertakings should select the method in accordance with Article 10(7) thereof that provides the most representative estimate of the amount for which the assets could be exchanged between knowledgeable willing parties in an arm´s length transaction. In accordance with Article 10(6) of that regulation these methods should be based on the following:

a) current prices in an active market for properties of a different nature, condition or location, or subject to different lease or other contractual terms, adjusted to reflect those differences;

b) recent prices of similar properties on less active markets, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those prices;

Guideline 3 – Investment property and other properties: alternative valuation methods

c) discounted cash flow projections based on reliable estimates of future cash flows, supported by the terms of any existing lease and other contracts and, when possible, by external evidence such as current market rents for similar properties in the same location and condition and using discount rates that reflect current market assessments of the uncertainty in the amount and timing of the cash flows.

Guideline 3 – Investment property and other properties: alternative valuation methods

- In some cases, the various inputs listed above may suggest different valuations of a property. An undertaking should consider the reasons for those differences, in order to determine the most representative valuation estimate within the range of estimates.
- When undertakings determine the valuation of the property they should take into account a market participant’s ability to generate economic benefits by using the property to its highest and best use, or by selling it to another market participant that would use the asset in its highest and best use.

- According to IFRS, preparers for the IFRS balance sheet can use either fair value or cost for the valuation.
- In case the the cost option is used by the insurance entity, then there will be a difference between the IFRS balance sheet and the regulatory balance sheet.
- However, this “current-value” or “market-value” Solvency 2 requirement was agreed by all stakeholders to support the “realistic balance sheet” approach of Solvency 2.

- Some EU countries, already require fair value for investment property and other properties for the regulatory balance sheet.
- So this is not a totally “new” approach or concept.
- There are also some “other” consistencies with IFRS on:
  - Frequency of valuation.
  - Variables and input to use for valuation.

There is no requirement to re-value every year-same approach as in IFRS.

- If the balance sheet valuation is based on a formal appraisal, or other information, prior to the balance sheet date, undertakings should be able to demonstrate to their supervisory authority that all necessary adjustments have been made to reflect changes in the value between the date of a formal appraisal or other information and the balance sheet date.

» Emphasis on IFRS:

» When undertakings value a related undertaking’s assets and liabilities using the IFRS equity method in accordance with Article 13(5) of Delegated Regulation (EU) 2015/35, and if those related undertakings use an accounting framework other than IFRS, the undertakings should make adjustments where needed to recognise and value that related undertaking’s assets and liabilities in accordance with IFRS.

» Under Solvency 2, insurers do not need to calculate fair value in a consistent manner.

A. False, as consistency in the methodology used does not mean the highest fair value for assets.
B. Correct, as consistency ensures that there is no “cherry-picking’.
C. It depends, consistency can be used only when measuring historical cost.
D. It depends, as consistency is not accepted by external auditors but can be accepted by regulators.
E. It depends, as consistency is not accepted by regulators but required by external auditors.

- Under Solvency 2, insurers can use historical cost if they cannot determine or calculate the fair value.

A. True.

B. False.

C. Correct.

D. Maybe.

E. Only if the external auditors agree with the insurers.

F. Only if required by shareholders.

» To determine fair value in Solvency 2, which one of the following techniques can be used by the insurer?

A. Market price.

B. Valuation techniques allowed in IFRS.

C. Valuation decided and agreed by the CFO and the CEO.

D. The amortised cost model with a 50% premium.

E. A market price but only after a discount of at least 20%.

F. Always the highest price certified by the CEO.

Table: Consistency of IFRS Valuation with Article 75 of the Directive

IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
IAS 1 Presentation of financial statements	IAS 1 sets overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content.		no	IAS 1 does not prescribe valuation methodologies for balance sheet items.

Table: Consistency of IFRS Valuation with Article 75 of the Directive

IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
IAS 2 Inventories	IAS 2 prescribes the accounting treatment for inventories. Following IAS 2, inventories shall be measured at the lower of cost and net realisable value (IAS 2.9). Solvency II framework: In many cases the estimated cost of completion and the estimated costs necessary to make the sale are not material. This means the net realisable value is option consistent with Article 75 of Directive 2009/138/EC if the estimated costs of completion and the estimated costs necessary to make the sales are not material.	Net realisable value is a consistent option. Adjustment may be needed where estimated cost are material.	Yes	Undertakings shall apply the IAS 2 net realisable value for inventories if the estimated cost of completion and the estimated costs necessary to make the sale are not material.

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IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
IAS 7 Statement of cash flows	IAS 7 requires disclosures about historical changes in cash and cash equivalents of an entity by means of a statement of cash flows.		no	IAS 7 does not prescribe valuation methodologies for balance sheet items.

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IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
IAS 8 Accounting policies, changes in accounting estimates and errors	IAS 8 specifies criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors.		no	IAS 8 does not prescribe valuation methodologies for balance sheet items.

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IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
IAS 10 Events after the Reporting Period	IAS 10 prescribes when an entity should adjust its financial statements for events after the reporting period and the complementing disclosure requirements.		no	IAS 10 does not prescribe valuation methodologies for balance sheet items.

Table: Consistency of IFRS Valuation with Article 75 of the Directive

IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
IAS 16 Property, plant and equipment	IAS 16 prescribes the accounting treatment for property, plant and equipment. After initial recognition an entity shall choose either the cost model in paragraph 30 or the revaluation model in paragraph 31 as its accounting policy and shall apply that policy to an	Revaluation model is a consistent option.	yes	Undertakings shall apply the fair value model and the revaluation model of IAS 40 and IAS 16 respectively when valuing property, including investment property, plant and equipment.

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IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
IAS 16	entire class of property, plant and equipment (IAS 16.29). Cost model: After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses (IAS 16.30)	Revaluation model is a consistent option.	Yes	The cost model permitted by IAS 40 or IAS 16, whereby investment property and property, plant and equipment is valued at cost less depreciation and impairment shall not be applied.

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IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
IAS 16	Revaluation model: After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.	Revaluation model is a consistent option.	Yes	

Table: Consistency of IFRS Valuation with Article 75 of the Directive

IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
IAS 16	Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period (IAS 16.31). Solvency II framework: The revaluation model is an option consistent with Article 75 of Directive 2009/138/EC.	Revaluation model is a consistent option.	Yes	

Table: Consistency of IFRS Valuation with Article 75 of the Directive

IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
IAS 21 The effects of changes in foreign exchange rates	IAS 21 prescribes how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.	Translation in reporting currency is consistent with Article 75 of Directive 2009/138/EC.	Yes	

Table: Consistency of IFRS Valuation with Article 75 of the Directive

IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
IAS 21 The effects of changes in foreign exchange rates	Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognised in profit or loss in the period in which they arise, except as described in paragraph 32 (IAS 21.28).	Translation in reporting currency is consistent with Article 75 of Directive 2009/138/EC.	Yes	

Table: Consistency of IFRS Valuation with Article 75 of the Directive

IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
IAS 21 The effects of changes in foreign exchange rates	Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognised in profit or loss in the period in which they arise, except as described in paragraph 32 (IAS 21.28).	Translation in reporting currency is consistent with Article 75 of Directive 2009/138/EC.	Yes	

Table: Consistency of IFRS Valuation with Article 75 of the Directive

IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
IAS 28 Investments in Associates and Joint Ventures	IAS 28 prescribes the accounting for investments in associates and to set out the requirements for the application of the equity method when accounting for investments in associates and joint ventures. Associates are accounted for using the equity method. The equity method is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets.	Applicable equity method measurement principles.	Yes	Limited application to the equity method.

Table: Consistency of IFRS Valuation with Article 75 of the Directive

IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
	The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income. The investor's share of the profit or loss of the investee is recognised in the investor's profit or loss. Distributions received from an investee reduce the carrying amount of the investment.			

Table: Consistency of IFRS Valuation with Article 75 of the Directive

IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
	Adjustments to the carrying amount may also be necessary for a change in the investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income. Such changes include those arising from the revaluation of property, plant and equipment and from foreign exchange translation differences. The investor's share of those changes is recognised in other comprehensive income of the investor (see IAS 1 Presentation of Financial			

Table: Consistency of IFRS Valuation with Article 75 of the Directive

IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
	Statements (as revised in 2007)). (IAS 28.11). The entity's financial statements shall be prepared using uniform accounting policies for like transactions and events in similar circumstances (IAS 28.26). If an associate or joint venture uses accounting policies other than those of the entity for like transactions and events in similar circumstances, adjustments shall be made to conform the associate's or joint venture's accounting policies to those of the entity when the associate's financial statements are used by the entity in applying the equity method (IAS 28.36).			

Table: Consistency of IFRS Valuation with Article 75 of the Directive

IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
	Solvency II framework: When calculating the excess of assets over liabilities for related undertakings, other than related insurance and reinsurance undertakings, the participating undertaking shall value the related undertaking's assets and liabilities in accordance with the equity method as prescribed in international accounting standards, as endorsed by the…			

Table: Consistency of IFRS Valuation with Article 75 of the Directive

IFRS	Summary of IFRS treatment: Measurement principles or options consistent with Article 75 of Directive 2009/138/EC?	Fully consistent? Consistent option with adjustments?	Applicable ?	Other comments
	Commission in accordance with Regulation (EC) No 1606/2002, where valuation in accordance with Articles 75 to 86 of Directive 2009/138/EC is not practicable. In such cases the value of goodwill and other intangible assets valued at zero shall be deducted from the value of the related undertaking.			

- AXA financial statements (notes to the financial statements)
- Investments include investment in real estate properties and financial instruments including equity instruments, debt instruments and loans.
- **1.8.1. Investment in real estate properties**
- Investment in real estate properties (excluding investment in real estate properties totally or partially backing liabilities arising from contracts where the financial risk is borne by policyholders) is recognized at cost. The properties components are depreciated over their estimated useful lives, also considering their residual value if it may be reliably estimated.
- In case of unrealized loss over 15%, an impairment is recognized for the difference between the net book value of the investment property and the fair value of the asset based on an independent valuation. Furthermore, at the level of each reporting entity, if the cumulated amount of unrealized losses under 15% (without offsetting with unrealized gains) represents more than 10% of the cumulated net cost of real estate assets, additional impairment are booked on a line-by-line approach until the 10% threshold is reached.

- AXA financial statements (notes to the financial statements)
- **ASSETS BACKING LIABILITIES ARISING FROM CONTRACTS WHERE THE FINANCIAL RISK IS BORNE BY POLICYHOLDERS**
- Assets backing liabilities arising from insurance or investment contracts where the financial risk is borne by policyholders are presented in a separate aggregate of the balance sheet so that they are shown in a symmetrical manner to the corresponding liabilities. This presentation is considered more relevant for the users and consistent with the liquidity order recommended by IAS 1 for financial institutions, since the risks are borne by policyholders, whatever the type of assets backing liabilities (investment in real estate properties, debt instruments or equity instruments, etc.). Details of these assets are provided in the notes.

- **Property and equipment (Aviva)**
- Owner-occupied properties are carried at their revalued amounts, and movements are recognised in other comprehensive income and taken to a separate reserve within equity. When such properties are sold, the accumulated revaluation surpluses are transferred from this reserve to retained earnings. These properties are depreciated down to their estimated residual values over their useful lives.
- All other items classed as property and equipment within the statement of financial position are carried at historical cost less accumulated depreciation.

- **Loans (Aviva)**
- Loans with fixed maturities, including policyholder loans, mortgage loans on investment property, securitised mortgages and collateral loans, are recognised when cash is advanced to borrowers. Certain loans are carried at their unpaid principal balances and adjusted for amortisation of premium or discount, non-refundable loan fees and related direct costs. These amounts are deferred and amortised over the life of the loan as an adjustment to loan yield using the effective interest rate method. Loans with indefinite future lives are carried at unpaid principal balances or cost.
- However, for the majority of mortgage loans, the Group has taken advantage of the fair value option under IAS 39 to present the mortgages, associated borrowings and derivative financial instruments at fair value, since they are managed as a portfolio on a fair value basis. This presentation provides more relevant information and eliminates any accounting mismatch that would otherwise arise from using different measurement bases for these three items. The fair values of these mortgages are estimated using discounted cash flow models, based on a risk-adjusted discount rate which reflects the risks associated with these products. They are revalued at each period end, with movements in their fair values being taken to the income statement.

THANK YOU