

# Assistance to EFRAG for Impact Analysis of IFRS17 Insurance Contracts

Presentation of Final report to EFRAG Board  
20 September 2018



# Structure of the report

- **Executive Summary**
- **Chapter 1 Introduction**
- **Chapter 2 Research methodology**
- **Chapter 3 Competition from non-EU insurers faced by EU insurers in product and capital markets**
- **Chapter 4 Development of the EU insurance markets since 2005 – product mix and prices**
- **Chapter 5 Developments in the asset allocation of European insurers**
- **Chapter 6 Investors’ perception of the clarity of the financial reports of EU insurance undertakings**
- **Chapter 7 Recapitulation of key findings**

# Chapter 3 Competition from non-EU insurers faced by EU insurers in product markets – competition through branches



- Extent of competition of non-EEA insurance undertakings through branches in the EU
  - In the large majority of Member States (20), no insurance undertakings from outside the EEA were active in 2015
  - In the other Member States
    - only 1 non-EEA undertaking was active in AT, ES and NL
    - 2 were active in EL
    - 3 were active in IT
    - 4 were active in FR
    - 5 were active in DE
    - 22 were active in the UK, reflecting in large part the international business underwritten in the London market place.

# Chapter 3 Competition from non-EU insurers faced by EU insurers in product markets

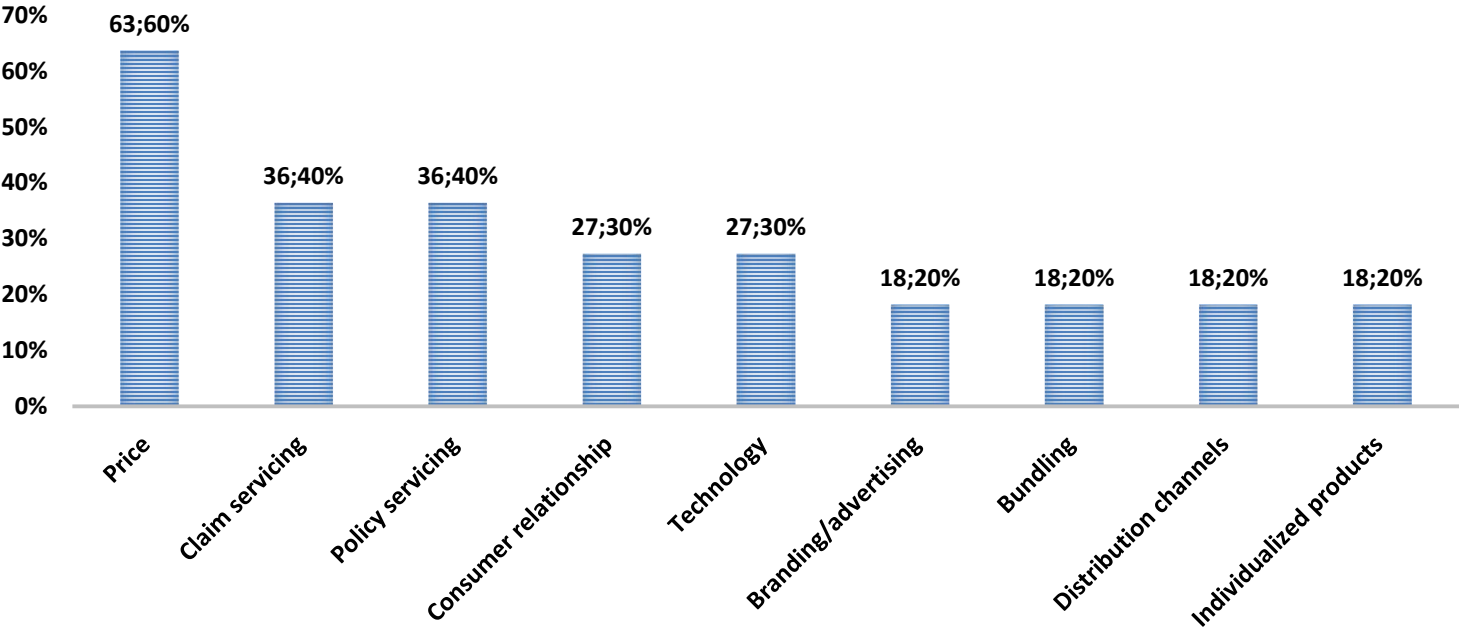


- Stakeholders noted that the **most intense competition** between EU and non-EU companies manifests mainly in **the business-focused segments**, such as “marine, aviation and transport”, “fire and other damage to property”, “credit and suretyship” and “reinsurance”.
  - **These segments are considered more global** and competition with US companies (and Bermuda companies for the maritime segment) is reported to have increased in the last years.
- In general, the majority of industry players and supervisory authorities commented that **Europe is not an attractive market to enter for a non-European insurance undertaking**, as there are high entry costs and most of the local markets are saturated with limited growth

# Chapter 3 Competition from non-EU insurers faced by EU insurers in product markets



Figure 2: Most important competition drivers



Source: VVA's elaboration of the online survey results – sample: 29 responses

# Chapter 3 Competition from non-EU insurers faced by EU insurers in product and capital markets



- **“Life”**: Insurers interviewed believe that the adoption of IFRS17 will **damage their competitive position against asset management companies** (not subject to the costs associated with IFRS17 compliance).
- **“Credit & Suretyship”**: the adoption of **current value accounting** under IFRS 17 will imply that the **volatility of the market will be reflected in the P&L**. Industry stakeholders are concerned that this volatility might be **even greater for segments where the frequency of claims is high**.
- A [Deloitte] survey, however, shows that this view on volatility is not supported by all insurers – some life insurers are more concerned about volatility than others, given the long duration of their liability (Deloitte, 2018).
- **Concerns about the competitiveness of operations outside Europe**: US companies that are subsidiaries of European holding companies will be obliged to report under IFRS for the purpose of the holding company consolidated financial statements.



# Chapter 3 Competition from non-EU insurers faced by EU insurers in capital markets

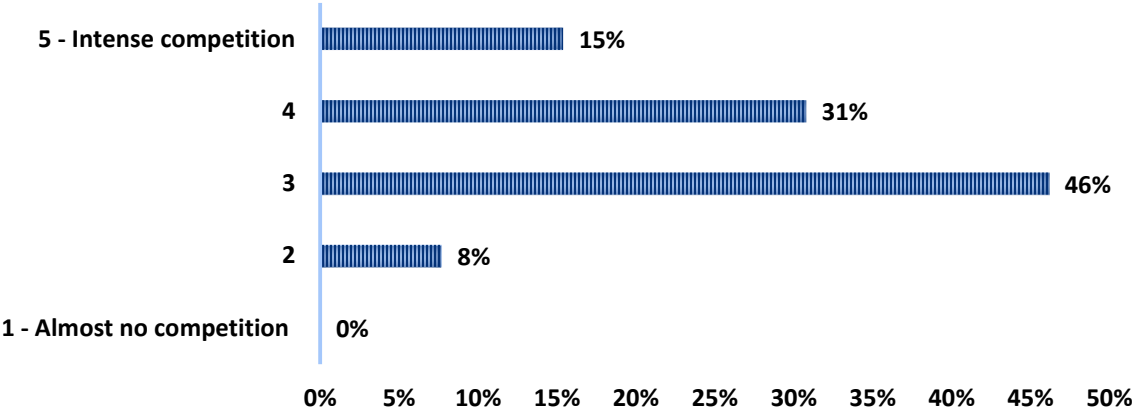


- The available data on EU loan and bond markets suggest that **EU insurers face relatively limited competition from non-European insurers in national debt capital markets in EU Member States**
- The competition for debt funding posed by non-EU insurers seems more pronounced in international bond markets
- Very little capital is raised through IPOs/FPOs by non-EEA insurance undertakings in EU equity markets
- Stakeholders also confirm that competition faced in raising capital from non-EU insurers is limited

# Chapter 3 Competition from non-EU insurers faced by EU insurers in capital markets

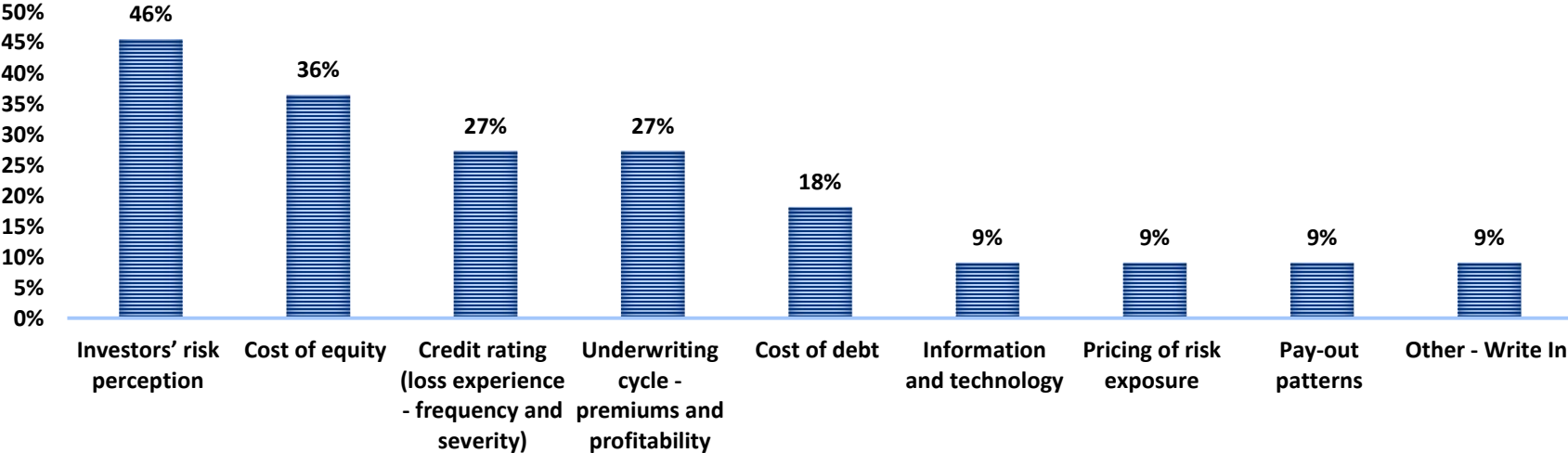


Figure 4: Perceived level of competition for funds between EU and non-EU insurers – stakeholders’ assessment



Source: VVA’s elaboration of the online survey results – sample: 13 responses

Figure 5: Most relevant competition drivers in capital markets



8 Source: VVA’s elaboration of the online survey results – sample: 21 responses



# Chapter 3 Competition from non-EU insurers faced by EU insurers in capital markets



- After the implementation of IFRS 17, most insurers believe that their **competitive position in capital markets will erode**, especially in the short term, because the volatility of the P&L will increase:
  - IFRS 17 requires that a company update the estimated insurance obligations at each reporting date, using current estimates of the amount, timing and uncertainty of cash flows and of discount rates (the magnitude of the changes will depend upon current practices).
- **Accounting mismatches may arise** following the adoption of IFRS 17, especially for those companies not reporting using current value principles. **This, in turn, may distort a company's financial position and performance.**

# Chapter 3 Competition from non-EU insurers faced by EU insurers in capital markets



- Most insurers having expressed a view on the potential impact of IFRS 17 (especially those from the **life insurance sector**) believe that IFRS 17 introduces **too many complexities and assumptions** into the valuation basis which will **reduce comparability against US peers** (which won't report under IFRS17 but under US GAAP).
- There are concerns that this will put the European industry at **disadvantage in the eyes of global investors**.
- Although companies claim future distortion, **there are different practices today and many investors do not understand** (Chapter 6).
- The current standard allows insurers to use their local GAAP (IFRS 4), **IFRS 17 defines rules that will markedly increase the comparability of financial statements of insurance undertakings**.

# Chapter 3 Costs of IFRS 17



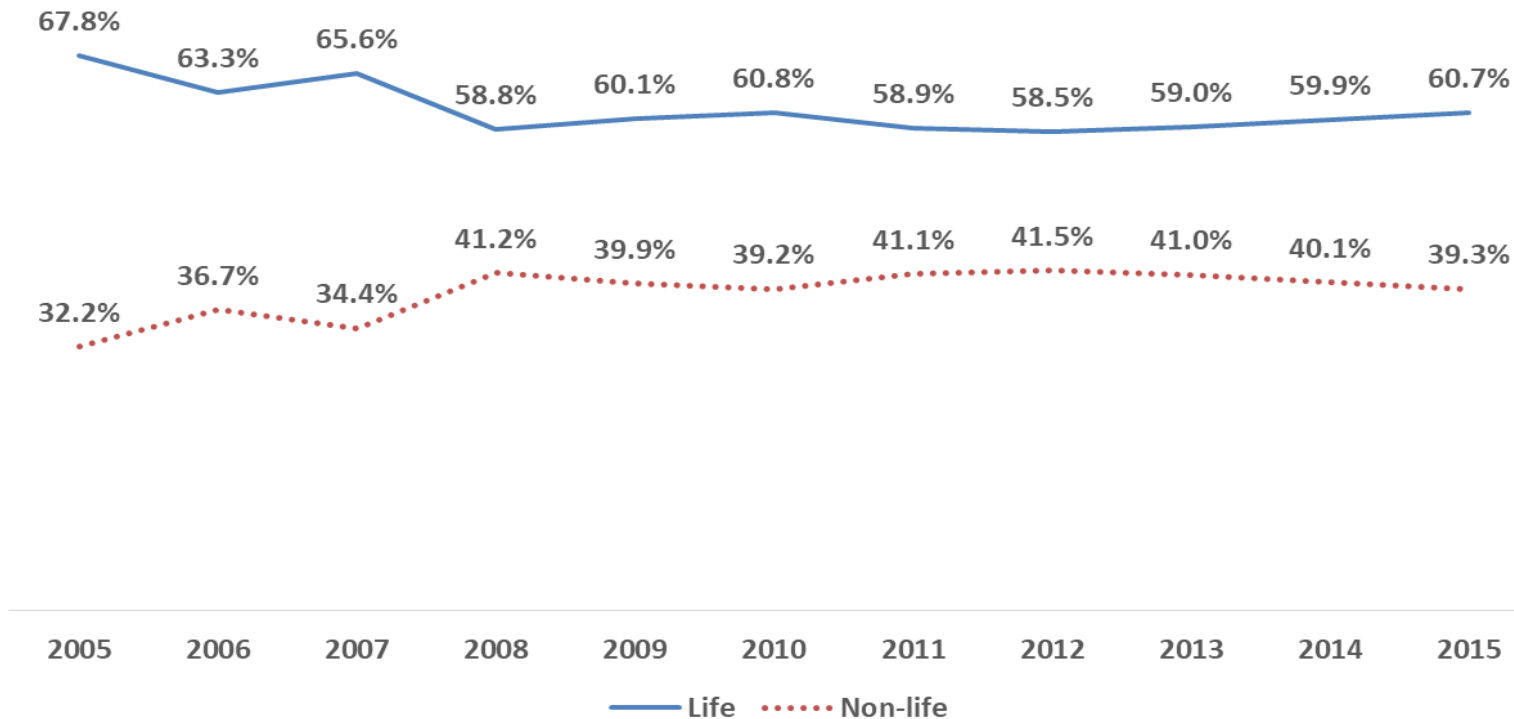
- The difference between the cost of capital faced by insurance companies and the other sectors was in 2017 still greater than the difference in 2005
- Lower and upper range of one-off costs: 0.13% and 1.24% of gross annual premiums
  - very early, ex-ante Solvency II estimates of 0.4% to 0.6% but have grown since. More recent UK estimate of 1.6%
- Much lower recurring costs: 0.01% to 0.2% of gross premiums

=> Recurring costs unlikely to have market impact, in contrast of one-off cost in the period(s) they are incurred

# Development of the EU insurance markets since 2005 – product mix and prices



Figure 6: Market share of life and non-life insurance premiums in total insurance premiums in the EU 2005 - 2015



Note: Insurance undertakings subject to Solvency I reporting requirements.

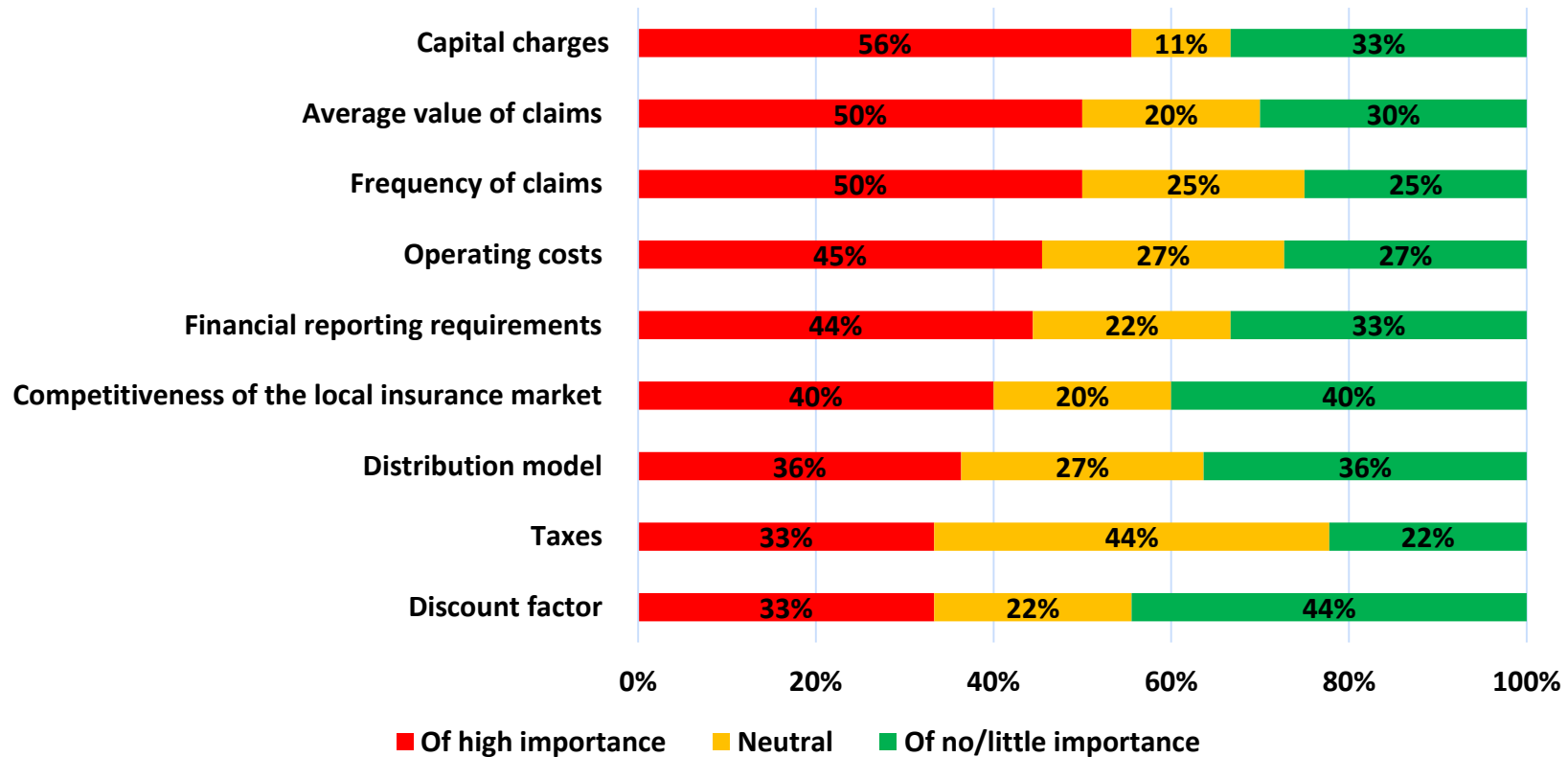
Source: EIOPA insurance statistics Solvency I Table 3.1 Breakdown of the main items of the gross technical account in non-life insurance (direct business only, in million euro) and Table 4 Breakdown of the gross direct premiums written and gross technical provisions in life insurance (in million euro)

# Chapter 4 Development of the EU insurance markets since 2005 – product mix and prices



Solvency II has brought **significant disruption** due to additional capital requirements - insurers pay even **more attention to capital costs** and the risk involved when developing products

Figure 9: How the indicated factors impacted your product mix & pricing strategies in past the 5 years?



Source: VVA's elaboration of the online survey results – sample: 9-12 responses

# Chapter 4 Development of the EU insurance markets since 2005 – product mix and prices



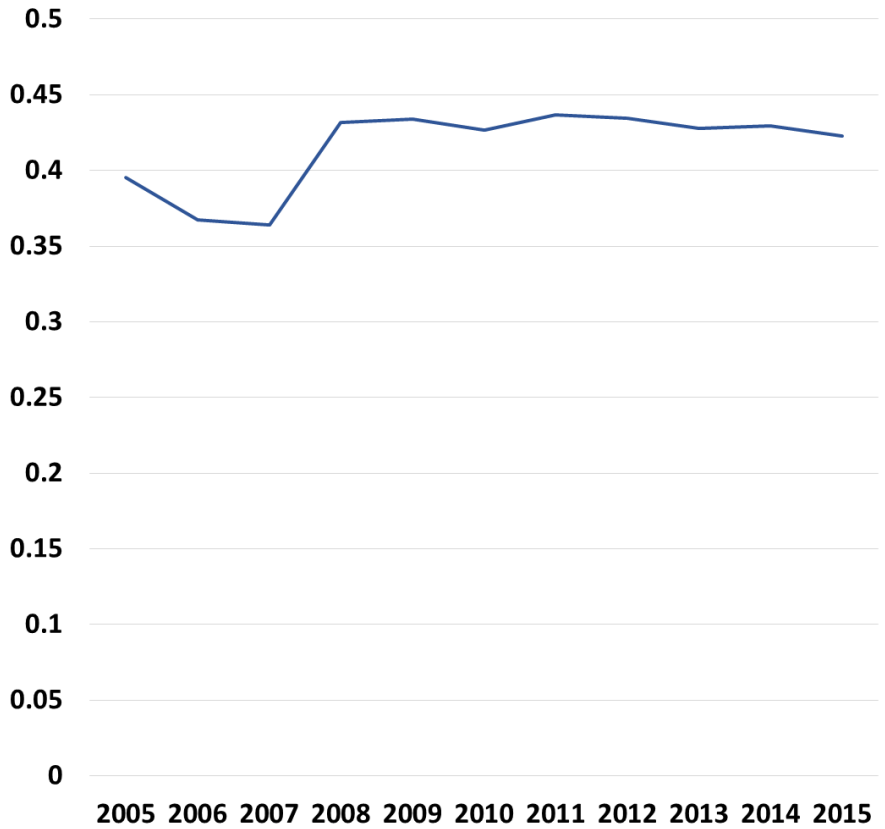
- Insurers reported that, in general, **financial reporting does not play a big role** in product mix and pricing. Thus, IFRS 17 is not expected to have a noticeable impact on the product mix
- IFRS 17 is **not expected to have significant impacts on short-term insurance contracts** measured using the *premium allocation approach*, the **main changes** for short-term insurance contracts will **depend upon companies' existing insurance accounting practices**.
- However, **long-duration contracts** (such as life insurance) or product features which expose the P&L to market fluctuations (such as **participating contracts evaluated using the general model**) **might be affected** by the adoption of the new standard.



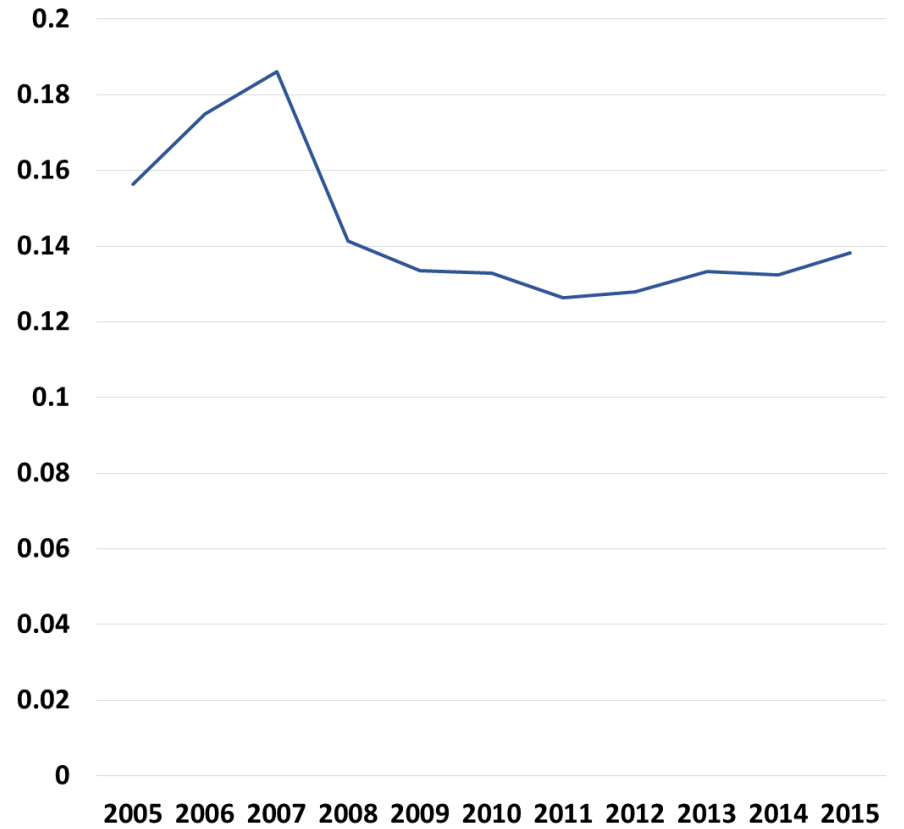
# Chapter 5 Developments in the asset allocation of European insurers



Share of debt securities and other fixed income securities in total investment portfolios of EU insurers



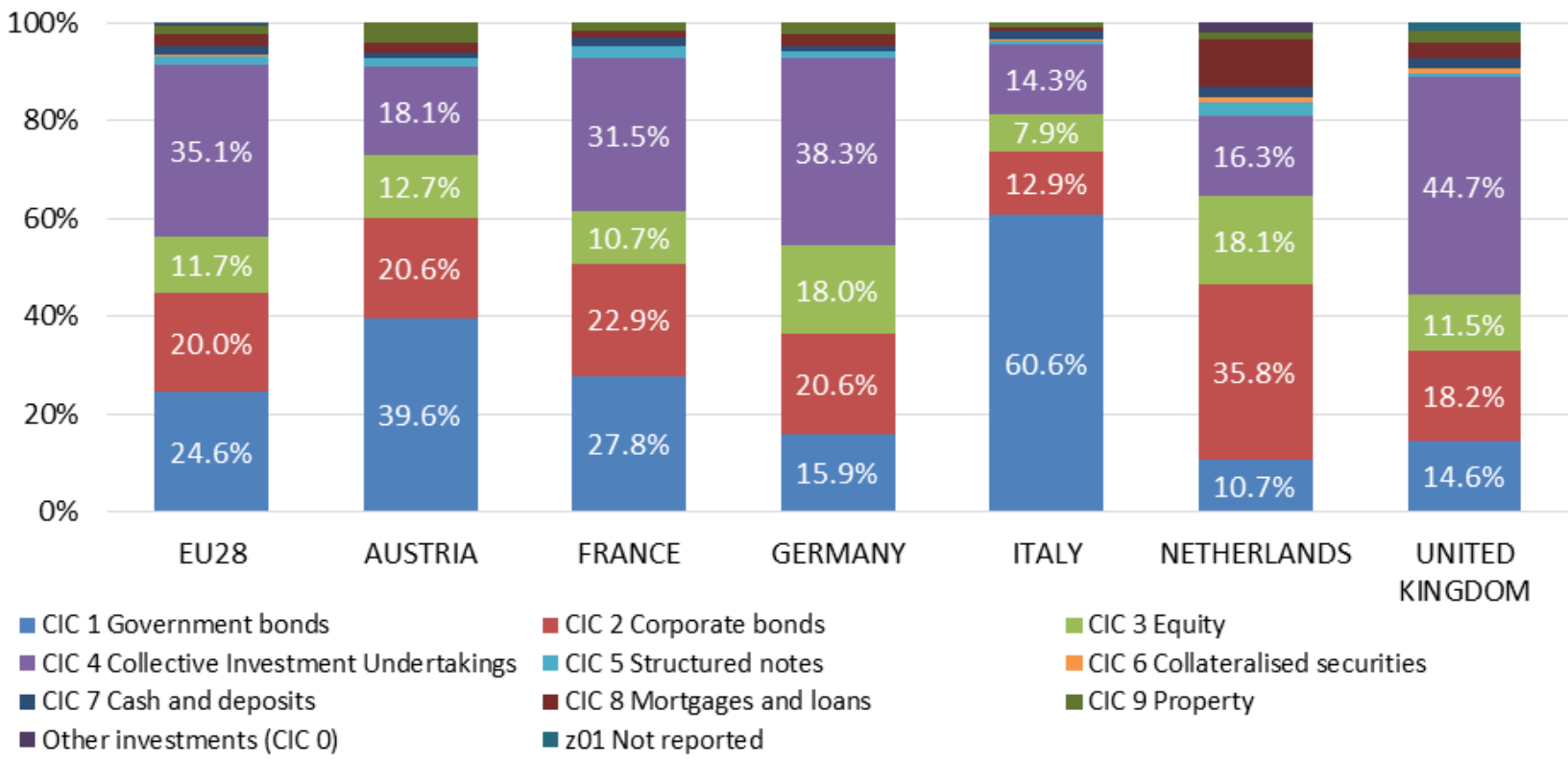
Share of equities and other variable-yield securities and units in unit trusts in total investment portfolios of EU insurers



# Chapter 5 Developments in the asset allocation of European insurers



Figure 10: Asset exposure (by country), Q4 2017



Source: London Economics figure based on EIOPA (2018 b)

# Chapter 5 Developments in the asset allocation of European insurers



- Considerable **discussion about insurers moving away from debt securities towards new asset classes and /or equity**. But, the aggregate **data** from EIOPA on the investments of EU insurers **do not show a significant movement** out of the debt securities at the EU wide level.
- The majority of stakeholders interviewed (i.e. supervisory authorities, insurers and external investors) agree that **IFRS 17 alone will not impact the asset allocation** of insurance undertakings, as this activity is more driven by risk management and/or asset/liability management.
- However, insurers expressed the view that the effect of applying **IFRS 17 in conjunction with IFRS 9 may have an impact on asset allocation**. This is because a company is required to account for: insurance contracts issued applying IFRS 17 and financial assets held applying IFRS 9.

# Chapter 5 Developments in the asset allocation of European insurers



- Insurance companies typically seek to match the characteristics of their assets with their liabilities to minimise economic mismatches between the two (IASB, 2017). **If an insurer's liabilities and assets are not matched, the economic mismatch will be apparent as a result of the changes introduced by IFRS 17 and IFRS 9.**
- Existing insurance accounting practices in parts of Continental Europe (e.g. Italy) do not tend to include current value accounting.
- In contrast, in Denmark, and in the United Kingdom, existing accounting practices tend to measure insurance contract liabilities on a current value basis - IFRS 17 and IFRS 9 are not expected to involve significant changes in accounting and investment practices in these two jurisdictions.

# Chapter 5 Developments in the asset allocation of European insurers

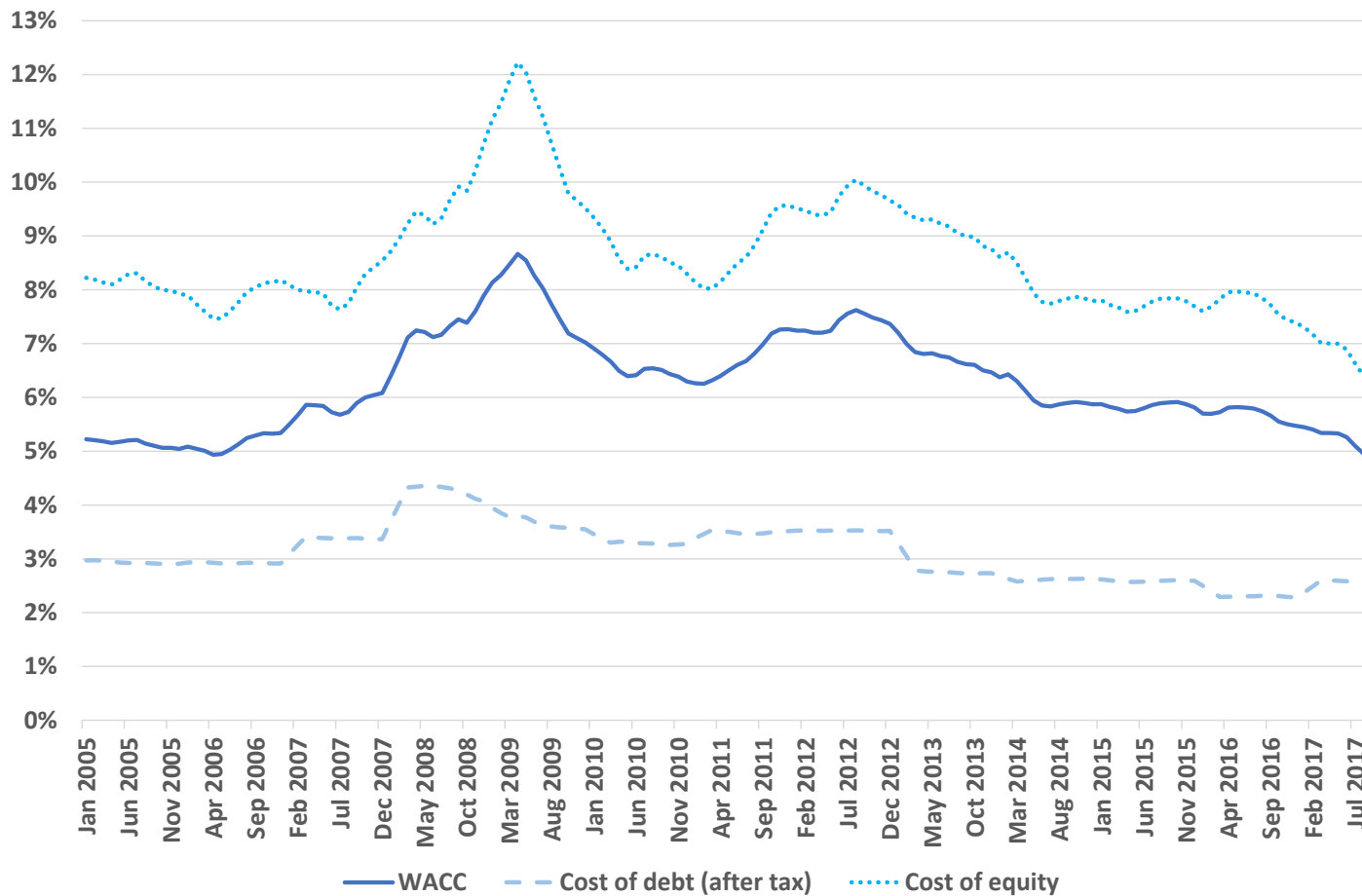


- Other stakeholders interviewed for this study (i.e. supervisory authorities and some non-life insurance undertakings) believe that **changes in accounting will not have any impact** or will not be significant enough to change the asset allocation of insurance undertakings:
  - This is because the asset-liability management risks are related to the extent to which asset and liability values respond differently to changes in economic conditions.
- Nevertheless, some insurance undertakings reported that **investments in equity and structured funds will become less attractive** following the adoption of IFRS 17 and IFRS 9, as assets characterised by higher volatility will expose a company's P&L to market fluctuations.

# Chapter 6 Cost of capital and investors' perception of the clarity of the financial reports of EU insurance undertakings



Figure 11: Cost of capital faced by European insurers



Source: London Economics WACC model based on Datastream and IMF data

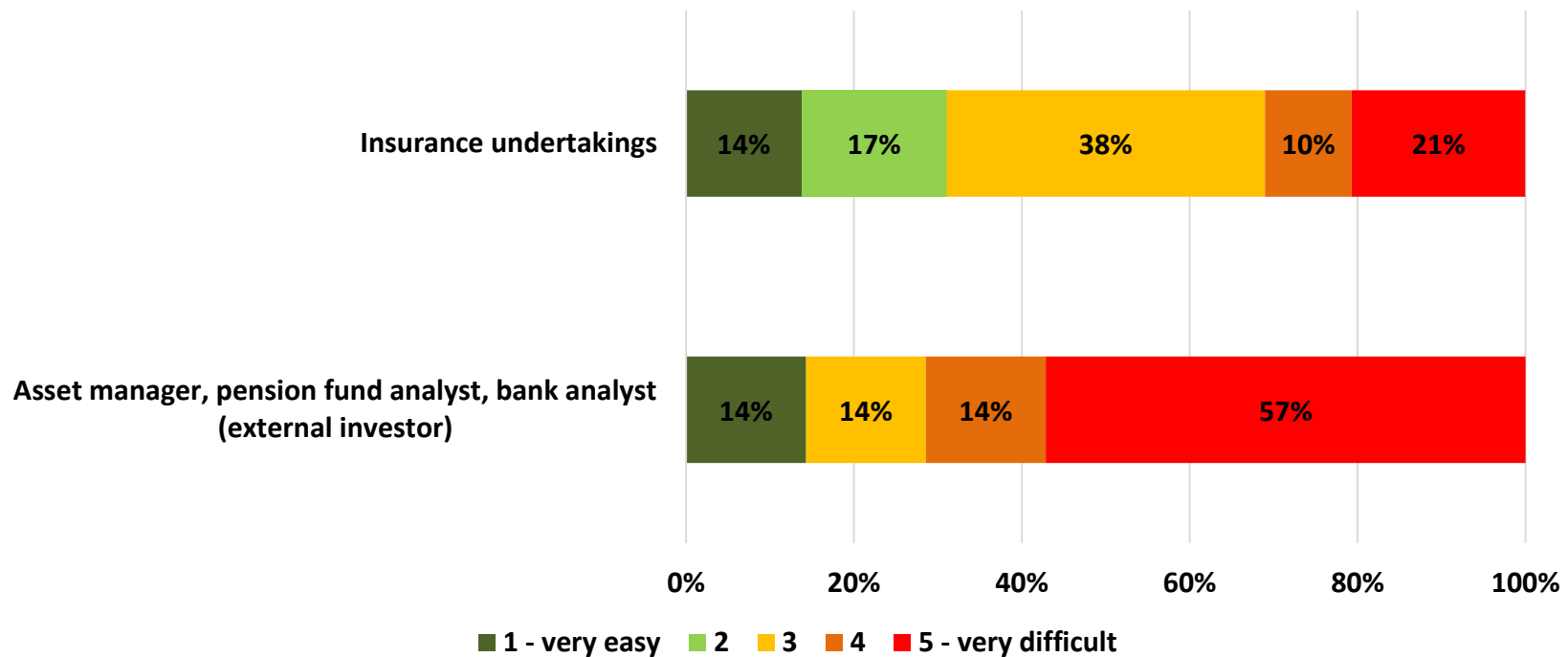


# Chapter 6: Cost of capital and investors' perception of the clarity of the financial reports of EU insurance undertakings



Among the stakeholders interviewed and surveyed, there was a **general agreement about the difficulties that analysts face when evaluating the financial report of an insurance companies**:

Figure 13: Comparing the financial performance of insurance undertakings with the performance of non-insurance companies – stakeholders view



Source: VVA's elaboration of the online survey results – sample: 36 responses

# Chapter 6 Cost of capital and investors' perception of the clarity of the financial reports of EU insurance undertakings



- There are differing views on the potential impact of IFRS 17 on the cost of capital for EU insurance undertakings:
- **The majority of supervisory authorities and some insurance undertakings** agreed on the fact that **in the long run**:
  - The new accounting standards will bring **increased transparency** on the financial report practises of European insurance companies;
  - IFRS 17 will improve European insurance companies' **ability to raise capital** on the market;
  - IFRS 17 could make the insurance industry **more attractive to a generalist investors**, which would **reduce the cost of equity**.
- The majority of **life insurance undertakings** interviewed stressed that IFRS 17 implementation will **negatively affect the life insurance industry**

# Chapter 6 Cost of capital and investors' perception of the clarity of the financial reports of EU insurance undertakings



- The **education of external investors** and analysts is a **major concern** for insurers interviewed (both life and non-life) - challenge to explain the balance sheets and underlying financial assumptions to the external investors
- It is possible that IFRS 17 could lead to a **perceived weakening of the financial strength of companies** due to lower perceived retained earnings.
- IFRS 17 could (at least **temporarily**) **increase the cost of capital for European insurers** while investors familiarise themselves with the new standard.
- In terms of **rating**, two major rating agencies (FITCH and S&P) commented that IFRS 17 is **unlikely to directly affect insurers' ratings** because the economic substance of their balance sheets will not change.