This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Financial stability and IFRS 17 – A preliminary view
Issues Paper

Objective

1 The objective of this paper is to consider the potential impacts of IFRS 17 *Insurance Contracts* on financial stability in Europe. Please note that these are only preliminary considerations and that the paper will be updated for inputs yet to be received, including the report from the economic consultants.

Description of the issue(s)

2 In the Request for Endorsement advice from the European Commission. EFRAG was requested to analyse the positive and negative impacts of IFRS 17 on financial stability and to the extent feasible and useful, the analysis should include sensitivity analysis as well as stress testing the impact on the financial statements.

3 This is mirrored in the Draft Motion for Resolution of the European Parliament with particular concerns around volatility.

Summary of ECB approach

4 In 2006, the European Central Bank ('ECB') published a report called 'Assessment of accounting standards from a financial stability perspective'[1]. The report focused on the introduction of IFRS in 2005 and the possible consequences for the banking sector predominantly, but also for other financial firms from the perspective of system-wide financial stability.

5 The report acknowledges the importance of accounting standards given that financial statements provide signals to the market which influences economic decisions. Furthermore, shareholders and analysts evaluate the quality of management 'largely on the basis of accounting figures'. It also notes that accounting can cause institutions to behave in a certain way which in turn may have an impact on financial stability.

6 The report identifies specific criteria with which accounting standards should be consistent from the perspective of financial stability. The ten criteria are as follows:

(a) Reliance on principles-based accounting standards;

(b) Use of reliable and relevant values;

(c) Recognition of the allocation and magnitude of risks;

(d) Provision of comparable financial statements;

(e) Provision of clear and understandable financial statements;

[1] https://www.ecb.europa.eu/pub/pdf/other/assessmentaccountingstandards2006en.pdf?a1415598edf0845669bc3b33248da0d3

(f) Portrayal of the financial situation of banks (solvency, profitability, liquidity);

(g) Alignment of accounting rules and sound risk management practices;

(h) Promotion of a forward-looking recognition of risks;

(i) Avoidance of negative and promotion of positive externalities, in particular regarding the behaviour of banks;

(j) Enhancement of market confidence and corporate governance

7 For more details on the ten criteria, please refer to Appendix 1.

8 The ECB report indicates that, "in principle, the introduction of IFRS should lead to a substantial increase in comparability and transparency, thus enhancing the level playing field between banking institutions and strengthening market discipline." The report notes that at time of publication, the implementation of IFRS appears to be rather diverse and comments on the diverse accounting treatment of insurance liabilities. The report states that IFRS (if appropriately implemented and applied) could provide useful insights and information about exposures or risks. Furthermore, it argues that accounting standards that correctly reflect economic substance of the transactions and related risks are likely to enhance control given the visibility of these in the published accounts.

Summary of the findings from EIOPA

9 EIOPA recently released a paper called "Failures and near misses in insurance – Overview of the causes and early identification"[2] to discuss the causes observed in 180 affected insurance undertakings in 31 European countries[3] between 1999 and 2016. Whilst not all of these would be IFRS preparers, given that IFRS 4 *Insurance Contracts* uses local GAAP for insurance contracts, the insights gathered remain relevant.

10 National competent authorities were asked to identify general causes of failures and near misses observed in their territories and accounting risk in and of itself is not a major risk (it is the only fifth primary cause for non-life failures and near misses). More details about the general causes as identified by the national competent authorities are as follows:

	Life	Non-life
Top 5 primary causes of failures and near misses for EU life and non-life undertakings		
1	Management & staff competence risk	Technical provisions - evaluation risk
2	Investment / Asset-liability management risk	Internal Governance & control risk
3	Market risk	Management & staff competence risk
4	Technical provisions - evaluation risk	Underwriting risk
5	Economic cycle / condition risk	Accounting risk

11 EIOPA also comments that the most commonly reported early identification signal is deteriorating capital strength and/or low solvency margin. Far less significant is evidence of poor management and thirdly, are high expenses and low profitability.

12 Given the low direct impact of accounting on these factors, it may therefore be important to consider any indirect impacts accounting may have in this context. For

[2] https://eiopa.europa.eu/Publications/Reports/EIOPA_Failures_and_near_misses_FINAL%20(1).pdf

[3] The 28 EU member states plus Iceland, Liechtenstein and Norway.

instance, accounting measurement and disclosures may improve identification and assessment of other risk factors.

13 Further extracts from the paper have been included in Appendix 2.

EFRAG Secretariat analysis

ECB criteria:

14 While the ECB report was clearly written with the banking sector being the predominant focus, almost all the criteria are relevant to the insurance industry even if for slightly different reasons.

15 IFRS 17 is chiefly principles-based (Criterion 1) which allows it to deal with a variety of products in a number of jurisdictions with widely varying legal systems. This should help to meet Criterion 1 to future proof the standard in this time of innovation as well as disruption from FinTech and other sources.

16 Some would question whether the application of IFRS 17 leads to reliable and relevant values (Criterion 2) given the extent to which it requires judgement and sophisticated estimation techniques. However, given that IFRS 17 updates the insurance liability for changes in expectations in both financial and non-financial (such as technical) aspects, this is an improvement for those jurisdictions where this is not currently the case. The main techniques such as discounting, actuarial estimates, risk adjustments are used either in other IFRS Standards (e.g. decommissioning obligations, pension plans, financial instruments) or by the industry itself.

17 One criterion as phrased by the ECB report, which is less relevant to the insurance industry in Europe due to the introduction of the Solvency II regime is the provision of comparable financial statements to facilitate consistent supervision (Criterion 4). However, it is arguably very important for users to compare and contrast business model, products and outcomes. Some criticise IFRS 17 for the various accounting options and different models implemented and that this will reduce comparability. These respond to the concerns raised by preparers over the years of standard-setting that such options and models are necessary to reflect the various business models and products in the industry. It follows that the options and models should present users with the information necessary to understand the financial position and performance of insurance entities.

18 Criteria 3, 5 and 6 will be met given the improved transparency in measurement and disclosures in IFRS 17 which will be on a significantly more comparable basis than is currently the case, although the extent to which the financial statements are understandable will depend on preparers and the knowledge of users.

19 Apart from reinsurance, IFRS 17 covers risk management (Criterion 7) only to a limited extent in that it deals with an adjustment for risk mitigation for contracts under the Variable Fee Approach (VFA) to ensure the CSM mechanism works as intended in these cases. Where this is not relevant, preparers will have to turn to the hedge accounting requirements in IFRS 9 *Financial Instruments* like other industries. The insurance industry is expected to consider extensive and in-depth involvement in the IASB's project on Dynamic Risk Management to ensure that it reflects their business models.

20 IFRS 17 incorporates extensive forward-looking information as envisaged in Criterion 8, but this requires judgement and estimates as mentioned earlier. The "Avoidance of negative and promotion of positive externalities" criterion (Criterion 9) will be considered in more detail in the Issues paper on Long term investment.

21 The extent to which IFRS 17 will discourage manipulation on its own is uncertain given the aforementioned estimates, judgements as well as sophisticated actuarial techniques required to measure the insurance liability. This is mitigated by the

disclosures that are intended to shine a light on these for users. Nevertheless, it will still require solid corporate governance, vigilant audits as well as market surveillance and discipline.

EIOPA paper:

22 As mentioned earlier, from the EIOPA paper it is clear that accounting risk in and of itself is not a major risk. However, the increased transparency and comparability of IFRS 17 may make it easier for users and supervisors to identify and assess other risk indicators such as competence risk, investment/asset-liability risk and market risk from an accounting perspective compared to the current position.

23 IFRS 17 also supplements the Solvency II requirements on technical provisions evaluation risk as it uses a similar (but not identical) approach when valuing the liabilities. This may enhance the understanding and insight of users and supervisors in the light of the specific Solvency II adjustments such as volatility, matching and transitional arrangements.

24 Furthermore, while Solvency II performs a vital role from a prudential perspective, it does not require performance measures and so has given rise to a variety of solvency performance KPIs. However, many of these currently lack comparability, similarly to embedded value previously used by many in the industry to overcome the lack in comparability in the current accounting requirements.

IFRS 17 from a theoretical perspective

25 EFRAG Secretariat has assessed whether IFRS 17 could have negative impact on financial stability as a consequence of leading to excessive accounting volatility (i.e. volatility that does not reflect underlying economic conditions). This assessment included an evaluation of how the results of applying IFRS 17 are affected by applying stress-case scenarios.

26 For the VFA, the impact of stress scenarios is expected to give rise to less profit or loss volatility compared to the General Model. This is a result of the fact that changes in interest rates as well as asset price risk impact CSM under the VFA rather than profit or loss directly. However, the CSM release in a stress year can still be significantly lower than in previous years, but as the impact of the stress (except for contracts that have become onerous) are recognised over time in profit or loss, this is less significant than for the General Model.

27 Given that the Premium Allocation Approach (PAA) largely carries forward current requirements for short term general insurance contracts, it is not expected that IFRS 17 would change the impact of a stress scenario on the accounting numbers. Similarly to IAS 39 *Financial Instruments Measurement and Recognition*, IFRS 9 may impact assets in a stress scenario. The actual impact would depend on the extent to which IFRS 9[4] results in changes to measurement and recognition compared to the current position and is very hard to predict.

28 Portfolios under the General Model are expected to be more significantly impacted as they are is not shielded from changes to financial inputs in the same way as contracts under the VFA is. The impact on profit or loss however will depend on various factors such as the following:

(a) the extent to which contracts become onerous as a result of the stress;

(b) whether changes in asset prices offset the change in the insurance liability as a result of interest rate changes; and

[4] This is also further discussed in the paper on the interaction between IFRS 9, 15 and 17.

(c) whether the entity is recognising changes relating to interest rate changes in OCI or profit or loss as well as the classification and measurement of the related assets.

Case study[5]

29 Per the ECB framework, for purposes of financial stability, volatility per se is neither negative nor positive if it reflects the underlying economics. However, where the volatility is solely or primarily caused by accounting, this may be viewed as not conducive to financial stability. Still, the cause of the results observed may not always be easy to untangle.

30 In this context, the case study has provided some material to test these theoretical considerations in the form of sensitivity analyses as well as application of the 2016 EIOPA double-hit stress scenario to IFRS 17 numbers.

Sensitivity analyses

31 Metrics[6] that showed the highest sensitivity in a number of portfolios were the financial risk metrics such as equity price risk, the sensitivity to an increase or decrease of the interest yield curves and the increase of the corporate bond spreads. In few portfolios the impact of insurance risk was important.

32 There are questions to respondents outstanding about the sensitivity to equity price risk given the low investment in equities overall as well as sensitivity to yield curve risk in the light of reported jurisdictional mismatches.

33 *Sensitivity to corporate spread:* Many of the annuity portfolios accounted for in accordance with the General Model were highly sensitive to a change in corporate bond spreads, with either a positive or negative impact on profit.

34 Views may differ as to whether the combination of the requirements of IFRS 17 and IFRS 9 appropriately reflect the economics given that the two standards address the assets and liabilities independently. However, the EFRAG Secretariat agrees that the approach taken in these two standards reflect the economic reality. Some stakeholders may disagree with this assessment. IFRS 17 and IFRS 9 also allow for the volatility relating to interest rate changes to be recognised through OCI.

35 *Sensitivity to insurance risk*: Considering that not all sensitivities requested in the case study were addressed, few of the portfolios submitted were highly sensitive to one of the insurance risks that were reported upon. Exceptions include policyholder lapses for one of the savings portfolios and death risk for one of the credit insurance portfolios.

Stress testing[7]

36 Under the stress impacts reported, the initial negative impact of the stress on profit before tax compared to the base case varied between 0% impact on a unit-linked portfolio accounted for under the VFA and 400% impact on annuities under the General Model. Most of the impacts resulted in a negative impact on profit before

[5] It is important to note the significant impediments that participants struggled with during completion of the case study as accounting policy choices, interpretations and models were still under development.

[6] Respondents did not apply sensitivities to all portfolios included in the case study and for those selected not all sensitivities were necessarily applied. The feedback therefore has been based on the most prominently used sensitivities.

[7] Six respondents completed the stress testing questions for IFRS 17 but not for current GAAP, with one completing it for both. Stress testing was completed for 13 portfolios.

tax as compared to the base case on the result between 20% and 30% for portfolios under the VFA. For general insurance the impacts reflect the changes in asset prices and reflected a similar range to those under the VFA and under current GAAP.

Conclusion

37 The information from the ECB and EIOPA confirms the importance of transparency also in the sphere of financial stability. The results in the case study for those portfolios that were subjected to sensitivity analysis and the stress test confirmed that the portfolios under the General Model are the most likely to be subject to volatility. Portfolios under the VFA may have significant decreases in profits but it seems not as severely as those under the General Model. Portfolios under the PAA seems likely to behave similarly to the current position.

38 During the user outreach it was clear that users are not concerned about volatility *per se*, as long as it has an understandable basis, such as significant economic stress, which is clearly explained. As one interviewee said, the concern is that users would like to be able to model results and predict results in a variety of scenarios. Therefore, EFRAG Secretariat assesses that the potential significant negative profit or loss impact of both the General Model and the PAA in periods of stress would not be a problem if the causes and impact are clearly communicated to the market. If the stress reflects significant new information about asset and liability matching or quality of assets, this may provoke a strong reaction, but it would not necessarily be the problem of IFRS 17.

Question for EFRAG TEG

39 Does EFRAG TEG have any questions or comments on this analysis?

Appendix 1: Further detail on ECB criteria

Introduction

1 The appendix includes more details on the ten criteria established by the ECB to consider financial stability implications of IFRS on predominantly the banking sector. However, many of the same consideration will be relevant to the insurance sectors or parts of it.

The details

2 **Criterion 1 - Reliance on principles-based accounting standards**: The report states that it is important from a financial stability perspective that financial statements effectively capture the underlying economics. It continues that for a dynamic and innovative field such as banking, principle-based standards are better placed to do so than rule-based standards. However, it also notes that it is critical for this to be complemented by "corporate governance, compliance and vigilant external audits".

3 **Criterion 2 - Use of reliable and relevant values:** As accounting numbers form the basis for economic decisions, the report emphasise that they should provide the correct signals to users and supervisors. Therefore, these numbers should be reliable[8] and relevant. The report notes that quoted market prices where markets are not developed or are insufficiently developed, do not always provide reliable information. The report considers that marked-to-model measurements may need to be used in the absence of reliable quoted numbers, but that these should appropriately reflect the various inputs and related correlations. It notes that these mark-to-model measurements may include assumptions and parameters, and these may not be reliable in all circumstances.

4 **Criterion 3 - Recognition of the allocation and magnitude of risks:** The report states that the allocation of risks between entities is central to financial intermediation which impacts the resilience to shock and the efficiency of the financial system. Therefore, financial statements should properly reflect the allocation and magnitude of the exposure to risks as well as provide clear information on the potential impact on the entity's balance sheet. It also contemplates that the financial statements should also reflect the risks that the market struggle to assess such as instruments acquired with a long-term perspective. Similarly, given the increase in sophisticated risk transfer instruments, the accounting should reflect the economic effectiveness of such risk transfers.

5 **Criterion 4 - Provision of comparable financial statements:** The report considers comparability as particularly important for the European banking sector to facilitate consistent supervision. Furthermore, it may help to alleviate risks around misinformed banking acquisitions that could become systemic in nature.

6 **Criterion 5 - Provision of clear and understandable financial statements:** The report also mentions that enhanced transparency assists market discipline. It also emphasises that financial statements should be clear and understandable to specialist and generalist users alike. It comments that this can be particularly challenging for complex financial instruments, but argues that a balance is required between understandability, as well as relevance and reliability. If disclosures are too simple, they may not reflect the underlying risks and therefore may not be relevant. The report also discourages lengthy disclosures that reduces clarity but warns against the exclusion of key information about the bottom line or risk management.

---

[8] Defined as: "i.e. reflect the effective value at which an arm's-length transaction could be settled"

7 **Criterion 6 - Portrayal of the financial situation of banks (solvency, profitability, liquidity):** The report considers states that the financial statements should accurately represent the balance sheet of the entity. It also confirms that for financial stability, the solvency, profitability and liquidity are particularly relevant both for the short and long term. The report comments that implicit assurance of current and future trades of financial instruments at a certain price when this may not be the case would be misleading. This is specifically relevant in environments where the market focusses on accounting ratios such as return on equity which are sensitive to accounting numbers.

8 **Criterion 7 - Alignment of accounting rules and sound risk management practices:** The report states that financial statements should reflect sound risk management practices[9], to produce economically meaning financial information that recognises the risks incurred by the institution.

9 **Criterion 8 - Promotion of a forward-looking recognition of risks:** The report considers it important that any assessment of risks should incorporate information from the past but also include projections for the future. This means that accounting numbers should incorporate forward-looking elements such as market values. It also acknowledges that short-termism remains an important challenge.

10 **Criterion 9 - Avoidance of negative and promotion of positive externalities, in particular regarding the behaviour of banks:** The report acknowledges that accounting standards can incentivise entities to invest or not invest in specific types of instruments (or to change the financial features of those instruments), and this may have a long-term macroeconomic impact.

11 **Criterion 10 - Enhancement of market confidence and corporate governance:** The report notes that market confidence (which is key to financial stability) benefits from accounting standards that discourage and as far as possible, prevent manipulation or so-called “creative” accounting. It considers that, creative accounting can damage market trust and have disturbing effects on both financial stability and economic development. It again emphasised the crucial role played by adequate internal controls and internal corporate governance.

---

[9] Defined by the ECB as: “Fundamental elements of sound risk management include the following: (i) senior management and the governing board must set the institution’s risk profile by establishing appropriate policies, limits and standards, and by ensuring that they are followed and enforced; (ii) risks must be measured, monitored and controlled throughout the institution; (iii) clear procedures for assessing risk and evaluating performance must be established; (iv) adequate accountability, clear lines of authority and separation of duties between business functions, risk management and internal controls must be ensured.”

Appendix 2: Further extracts from 'Failures and near misses in insurance'

Introduction

1 The paper prepared by EIOPA contains useful and detailed information that could provide useful information when considering financial stability. For this reason, further information has been collated on this topic in the appendix. For further in-depth information, we would suggest referring to the source document.

2 EIOPA makes the following two key observations:

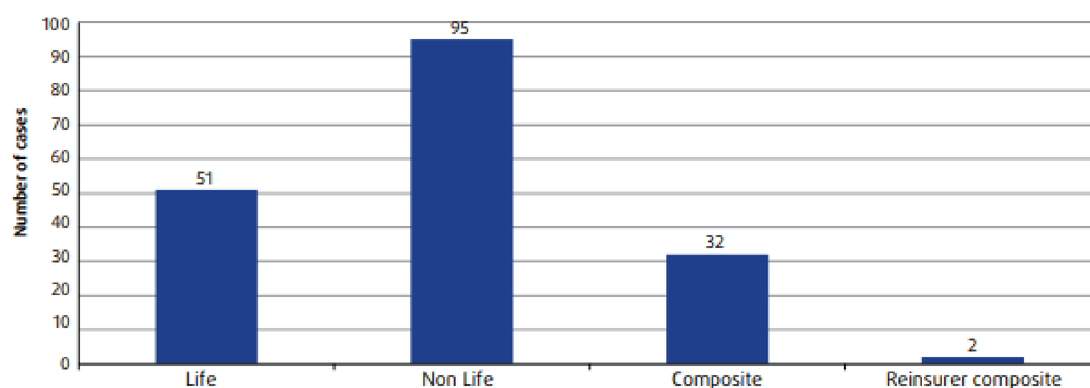
(a) In general, the distressed undertakings are small and represent a small share of the market, which EIOPA considers to be a possible mirror of the EU insurance market in that non-life insurers are predominant. Life insurers in distress appear to be more evenly distributed across the market based on total assets and on average are larger than the non-life companies.

(b) Whilst not necessarily widely known, the financial crisis had a significant impact on the life and composite insurers with approximately 35% of the observed distress situations in the period of 2008-2009. For non-life companies, only 15% of the occurrences were in the same period. EIOPA remarks that this may indicate that life insurers have a higher degree a of correlation with the business cycle compared to non-life insurers.

Further demographic information

3 The EIOPA paper provides useful insight into the demographic information of the affected insurers.

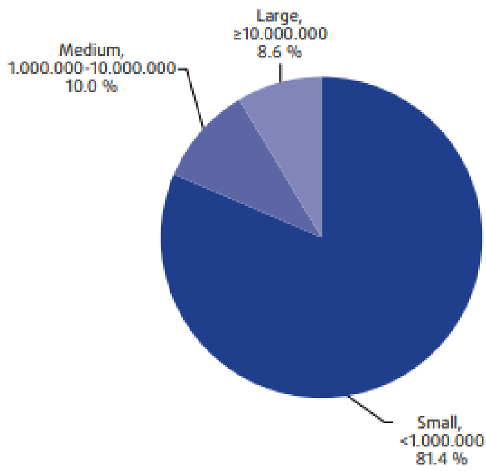
Figure 1: Total cases of failures and near misses, by type of insurer



EU insurance undertakings, 1999 – 2016

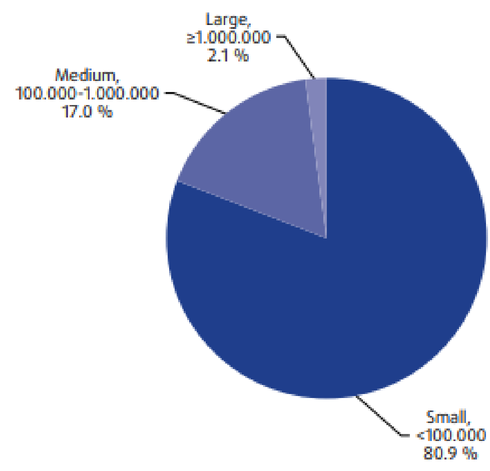
Page 17

Figure 4: Size of life and composite insurance undertakings reported



Technical provisions (in EUR Thousands), 1999 – 2016

Figure 5: Size of non-life insurance undertakings reported



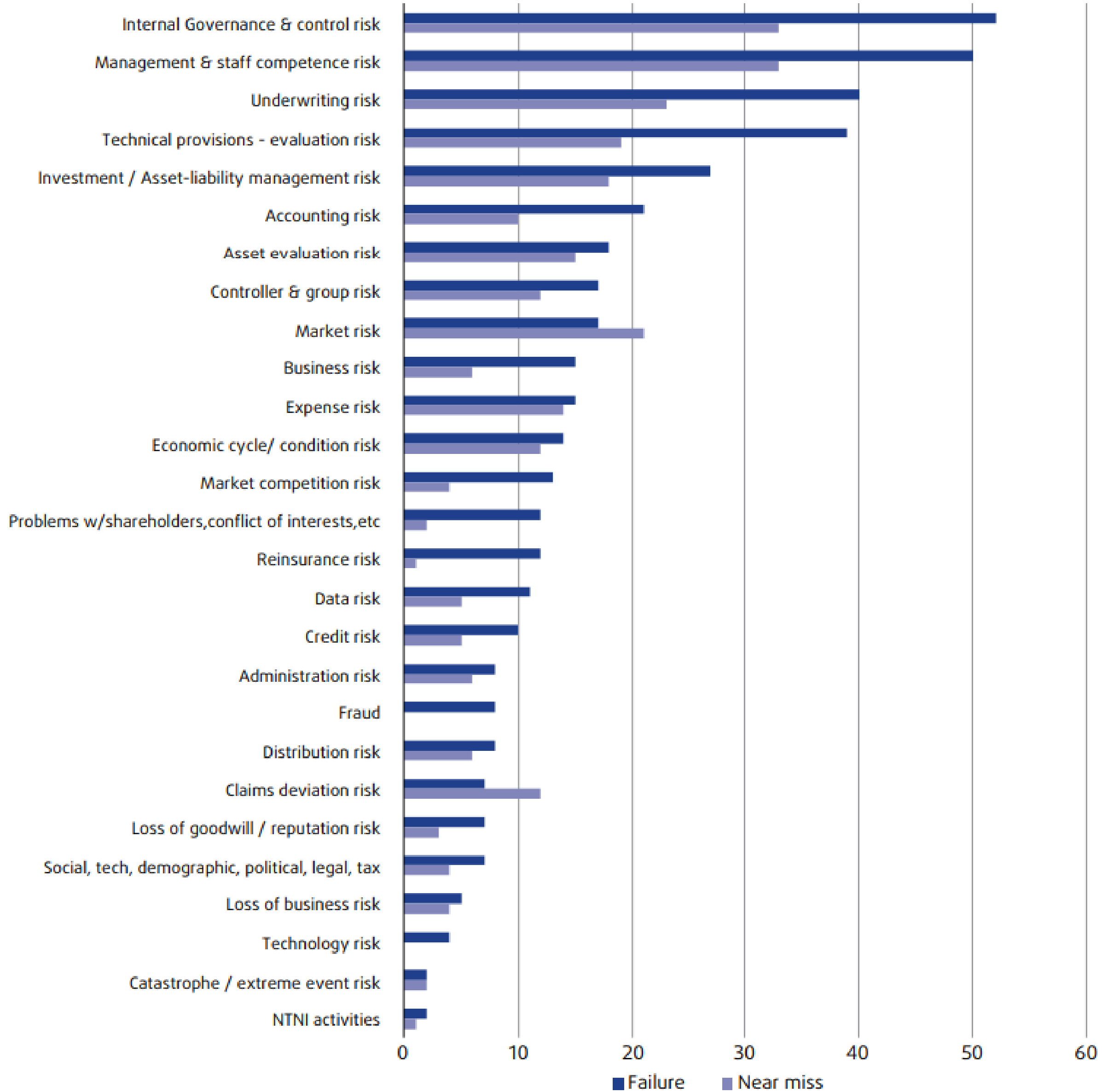
Gross written premiums (in EUR Thousands), 1999 - 2016

Page 18

Further information about causes

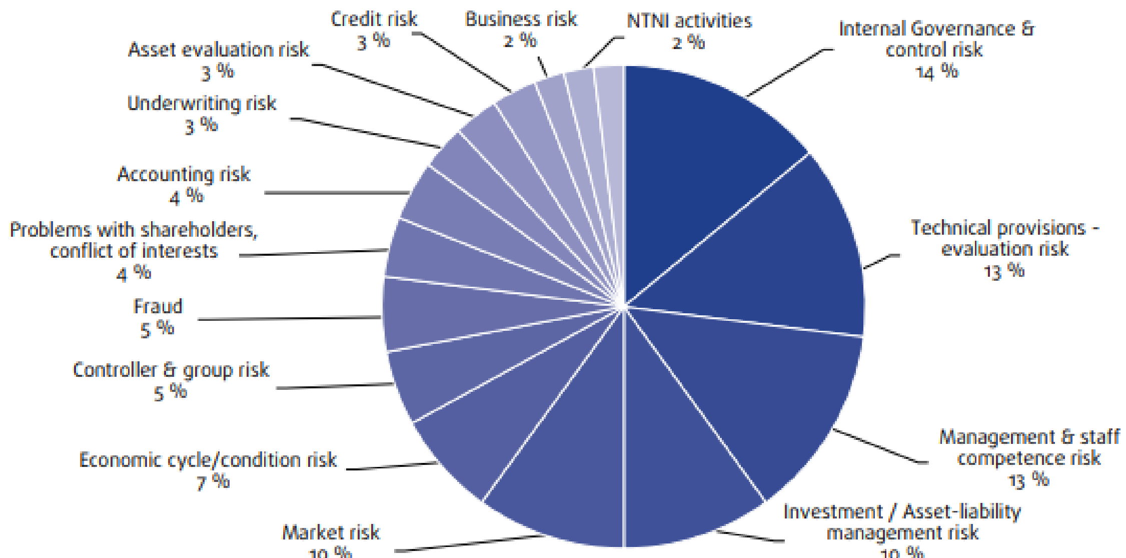
4 The EIOPA paper provides further information about the general causes for distress situations as identified by the National Competent Authorities.

Figure 12: Overview of the general causes of failure and near miss reported



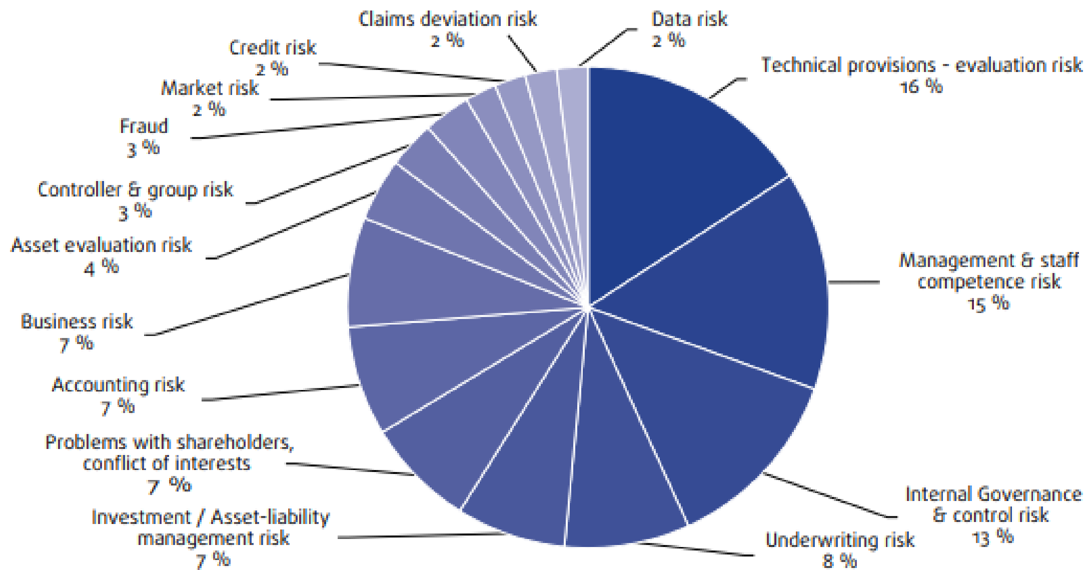
EU insurance undertakings, 2000 - 2016

Figure 14: Primary causes of failure and near miss - Large insurers



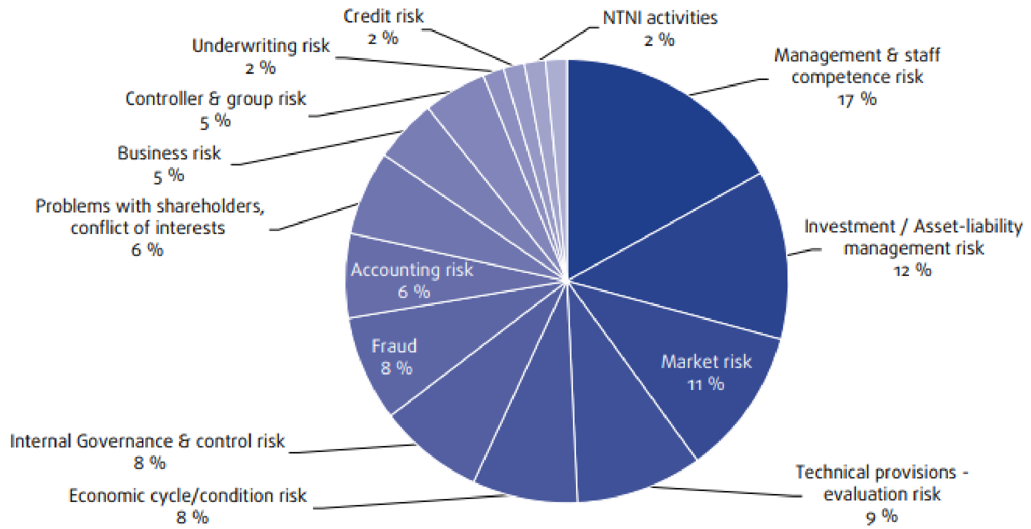
EU insurance undertakings (Large companies), 2000 - 2016

Figure 15: Primary causes of failure and near miss - Small insurers



EU insurance undertakings (small companies), 1999 - 2016

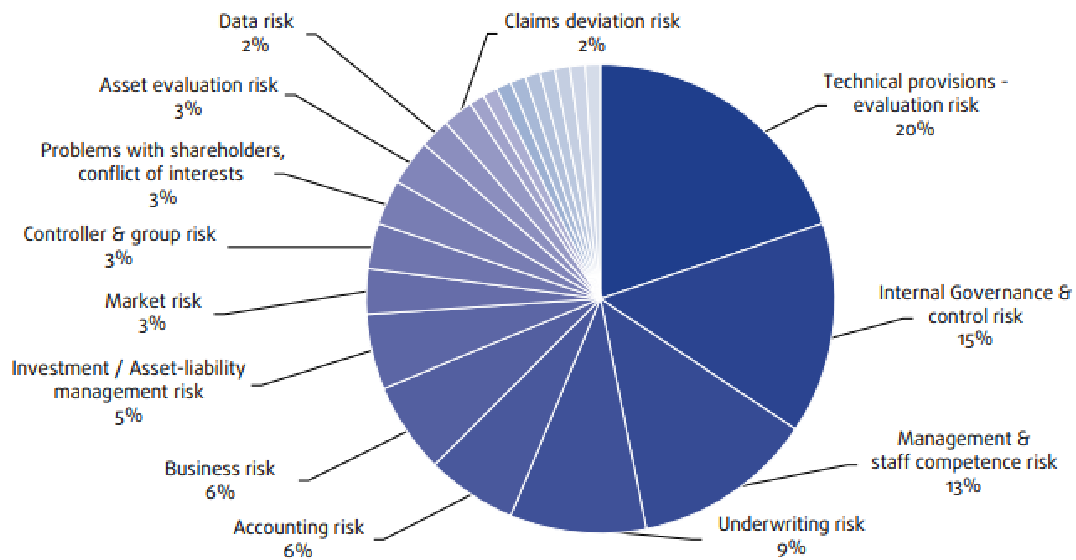
Figure 16: Primary causes of failure and near miss - Life



EU life undertakings, 2000 - 2016

Page 34

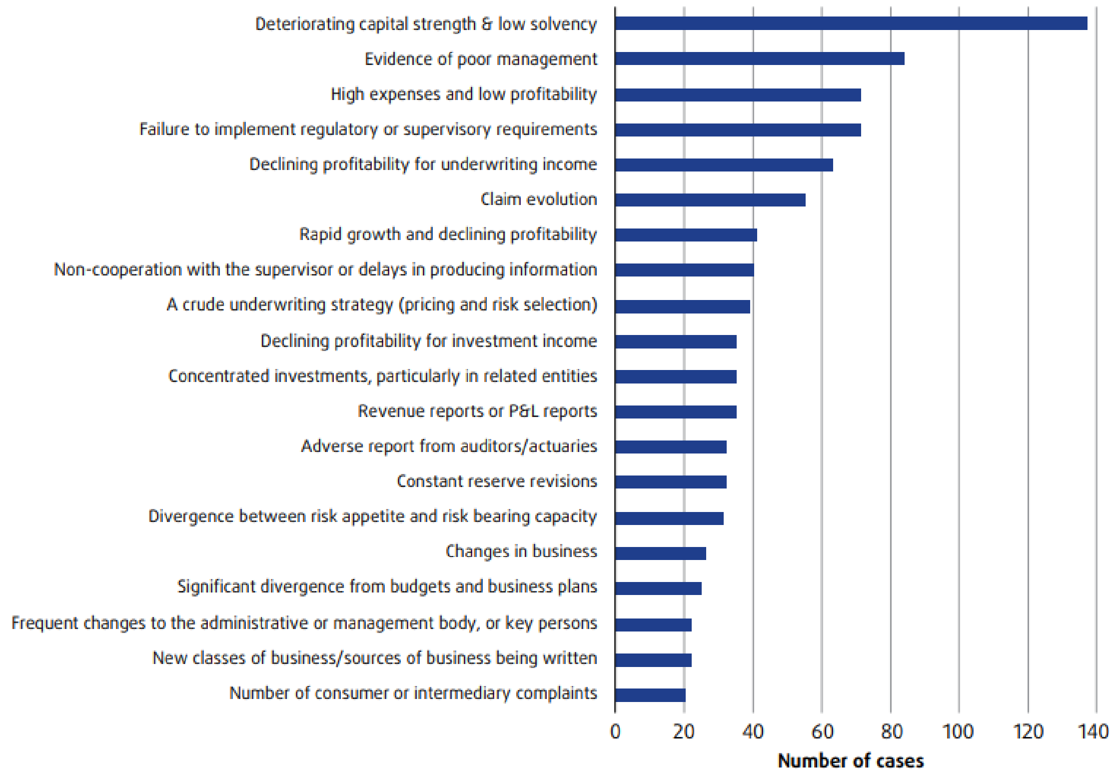
Figure 17: Primary causes of failure and near miss - Non-life



EU non-life undertakings, 1999 - 2016

Page 35

Figure 18: Top 20 early identification signals reported on failures and near misses



EU insurance undertakings, 1999 - 2016

Page 40