#INSURANCE #ACCOUNTING #IFRS17 #SOLVENCYII

IMPLEMENTATION OF IFRS 17

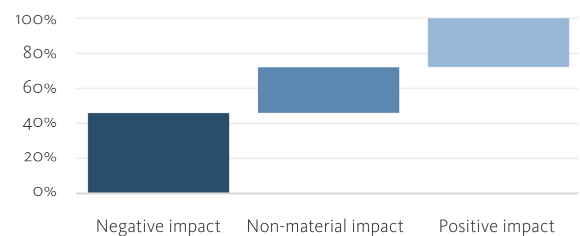
In January 2023, IFRS 17 became the new international accounting standard for insurance contracts, replacing the previous interim standard. The objective of this transition has been to enhance transparency within insurance accounting and reduce methodological differences through harmonization.

A year after IFRS 17's entry into force, this factsheet offers insights into its initial implementation and highlights how certain aspects of the new standard differ from Solvency II - based on a sample of 53 (re)insurance groups. For more information and deeper analyses, read our EIOPA's full report on IFRS 17 [relinked later].

FIRST INSIGHTS ON IFRS 17

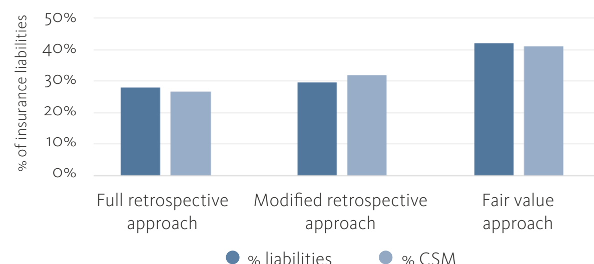
IMPACT ON SHAREHOLDER EQUITY

The move to IFRS 17 led to significant changes in the value of insurance liabilities, among others due to the use of different discount rates, the switch from hidden prudence to explicit risk adjustment and the newly introduced contractual service margin. This new component of insurance liabilities allows insurers to allocate expected profits over the lifetime of the insurance contract as the insurance service is provided. The move to the new IFRS had varied impacts, but it generally resulted in an increase of insurance liabilities and a consequent decrease in shareholders' equity.



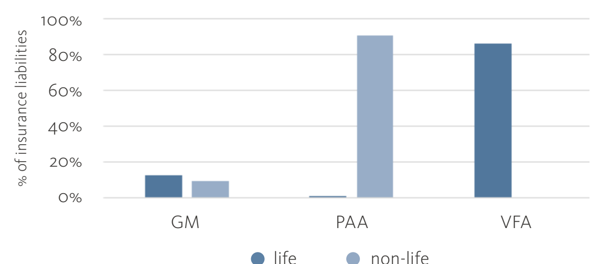
TRANSITION APPROACHES

IFRS 17 offers three transition approaches, namely, the full retrospective approach, the modified retrospective approach (which permits data adjustments for long-term legacy contracts) and the fair value approach. Although all three approaches have been used to a similar extent, the fair value approach has been the most frequently chosen option, accounting for 41.9% of insurance liabilities. On average, all three approaches resulted in similar levels of contractual services margins.



VALUATION METHODS

IFRS 17 also allows for three distinct valuation methods: the general model (GM), the premium allocation approach (PAA) and the variable free approach (VFA). The PAA is commonly applied to short-term contracts, whereas the VFA is a modification of the general model tailored for contracts with direct participation features, i.e., most savings products. For life insurance contracts, the VFA method was chosen to value 86.4% of insurance liabilities, while non-life insurance contracts are mainly valued using the PAA (90.4%).



DIFFERENCES BETWEEN IFRS 17 AND SOLVENCY II

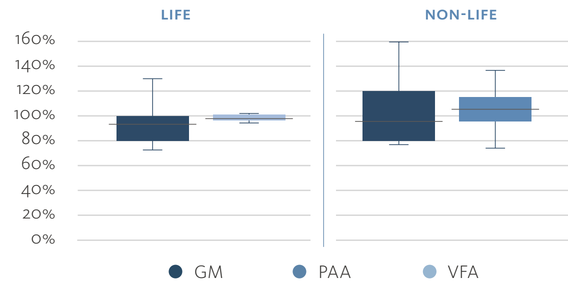
Although Solvency II and IFRS 17 serve different purposes – the former aims to protect policyholders while the latter focuses on providing reliable information on the financial position of undertakings – they share significant similarities. These include employing a market-consistent valuation approach, using probability-weighted estimates of future cashflows, and applying discount rates to determine the present value of these cashflows.

That said, they also diverge from one another in important ways. Major differences lie in the different valuation methods allowed by IFRS 17 and the inclusion of the Contractual Service Margin, which does not exist in Solvency II. Additionally, relevant differences exist regarding discount rates, risk adjustment/margin, contract boundaries, and the allocation of expenses.

QUANTITATIVE DIFFERENCES

Quantitative differences between Solvency II and IFRS 17 vary depending on the line of business. For life insurance contracts, insurance liabilities (excluding CSM) under IFRS 17 are, on average, 2.5% lower than Solvency II technical provisions. For non-life insurance contracts, however, IFRS 17 insurance liabilities (excluding CSM, except for contracts under the PAA) are, on average, 9.5% higher than in Solvency II. Since the PAA method and VFA method are rarely used for life insurance and non-life insurance, respectively, they are not depicted in the graphs.

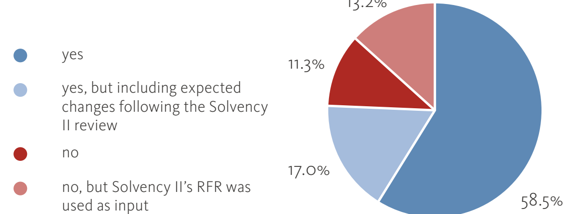
IFRS 17 LIABILITIES OVER SOLVENCY II TECHNICAL PROVISIONS



DISCOUNT RATES

Insurers use discount rates to determine the present value of future cash flows. While in Solvency II, this is a predefined rate calculated and published by EIOPA, under IFRS 17 insurers are responsible for deriving the risk-free rate themselves. In practice, 75% of participating insurers relied on EIOPA's risk-free rate (RFR) also in IFRS 17, although the final discount rate in IFRS 17 was frequently higher than in Solvency II (54% of cases), mostly due to illiquidity adjustments in IFRS 17.

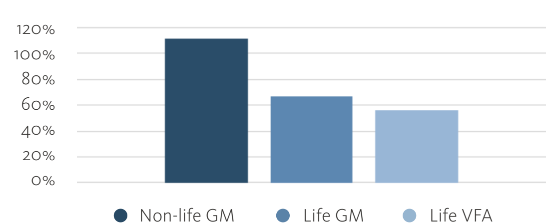
IS THE RFR RATE THE SAME?



RISK ADJUSTMENT

The calculation of the risk adjustment is another significant source of differences. While Solvency II specifies the calculation method and the confidence level for the risk margin, IFRS 17 allows users to choose the method to calculate the risk adjustment according to certain principles. For life business, the risk adjustment under IFRS 17 is significantly lower than the Solvency II risk margin. Conversely, for non-life business, the risk adjustment under IFRS 17 is slightly higher.

RISK ADJUSTMENT OVER RISK MARGIN



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