

## *Laying the foundations for the future of insurance reporting*

*As your business reflects on both the changing shape of the Solvency II timetable and the eventual move to a new IFRS standard for insurance contracts, how can you build a durable platform for regulatory and financial reporting in the future?*

November 2012



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# Foreword



*Welcome to 'Laying the foundations for the future of insurance reporting'. This publication looks at how your business can prepare for the planned new IFRS for insurance contracts (IFRS Phase II) in the most efficient way, including making the most out of your investment in Solvency II for IFRS purposes.*

This is a follow up to our 2010 publication, 'Getting to grips with the shake-up', which looked at how to take advantage of the parallels between Solvency II and IFRS Phase II to reduce the cost and burden of implementation, while identifying the important differences and assessing their implications.

Since then, the timetables for both have been put back. Solvency II looks virtually certain to be delayed from the planned January 2014 launch date. Further time is needed to run an impact assessment on the proposals for the treatment of long-term guarantees and to reach a political consensus on the way forward. In turn, consultations on a second exposure draft setting out final proposals for IFRS Phase II won't begin until first half of 2013, which would mean that the changes are unlikely to be mandatory until 2017 or 2018.

Some insurers will see the continued delays in Solvency II and IFRS Phase II as a chance to put preparations on the backburner. But as we examine in this

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publication, smarter organisations will use the extra time to smooth the way to implementation and future-proof the business for further changes ahead. This includes building Solvency II into business as usual now and making sure systems can be easily adapted for the demands of IFRS Phase II.

With the potential for early adoption of IFRS Phase II and the likely delay to Solvency II, the opportunity for reporting projects to once again be considered together re-emerges. It will start to become clearer over the next few months whether a real option exists to early adopt IFRS Phase II when Solvency II is launched, providing an opportunity to develop a single communication strategy and to clear out legacy issues in one go.

We hope you find the publication useful. If you would like to discuss any of the points raised or any other aspect of Solvency II and IFRS, you are very welcome to contact us (details below) or one of the contacts listed on page 43.

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# Overview



## Failure to agree leads to delay

### Solvency II

The text for the Solvency II Directive is largely known, with much of the detail likely to remain unchanged from drafts already in circulation. However, the Council of the European Union (representing national governments around the European Union), the European Commission and the European Parliament (the ‘trialogue parties’) have failed to agree on measures to address products with long term guarantees (a consensus is necessary for the Directive to go through). Subsequently, the European Parliament has amended the indicative date for the vote on the Directive, which will allow the trialogue parties more time to reach an agreement and will also make it virtually impossible for the Directive to go live on 1 January 2014 (due to the procedures required in the legislative process). At the time of publication, the exact delay is unclear however we understand that one to two years from 2014 is being considered.

The most contentious issue is how to deal with volatility in credit spreads in the valuation of products with long-term guarantees. An impact assessment by the European Insurance and Occupational Pensions Authority (EIOPA) on the current proposals is expected this year. Due to uncertainties about what the results will show and how policymakers will react, it may be mid-2013 before the results are finalised and the implications can be assessed.

### IFRS

The International Accounting Standards Board (IASB) is planning to publish a second exposure draft (‘re-exposure’) setting out its final proposals for IFRS Phase II in the first half of 2013. Since the first exposure draft in 2010, the IASB has made significant revisions to address the perceived ‘artificial’ earnings volatility in the original model. It has also attempted to achieve convergence with the US accounting standard setter, but this is now unlikely due to the divergence in views.

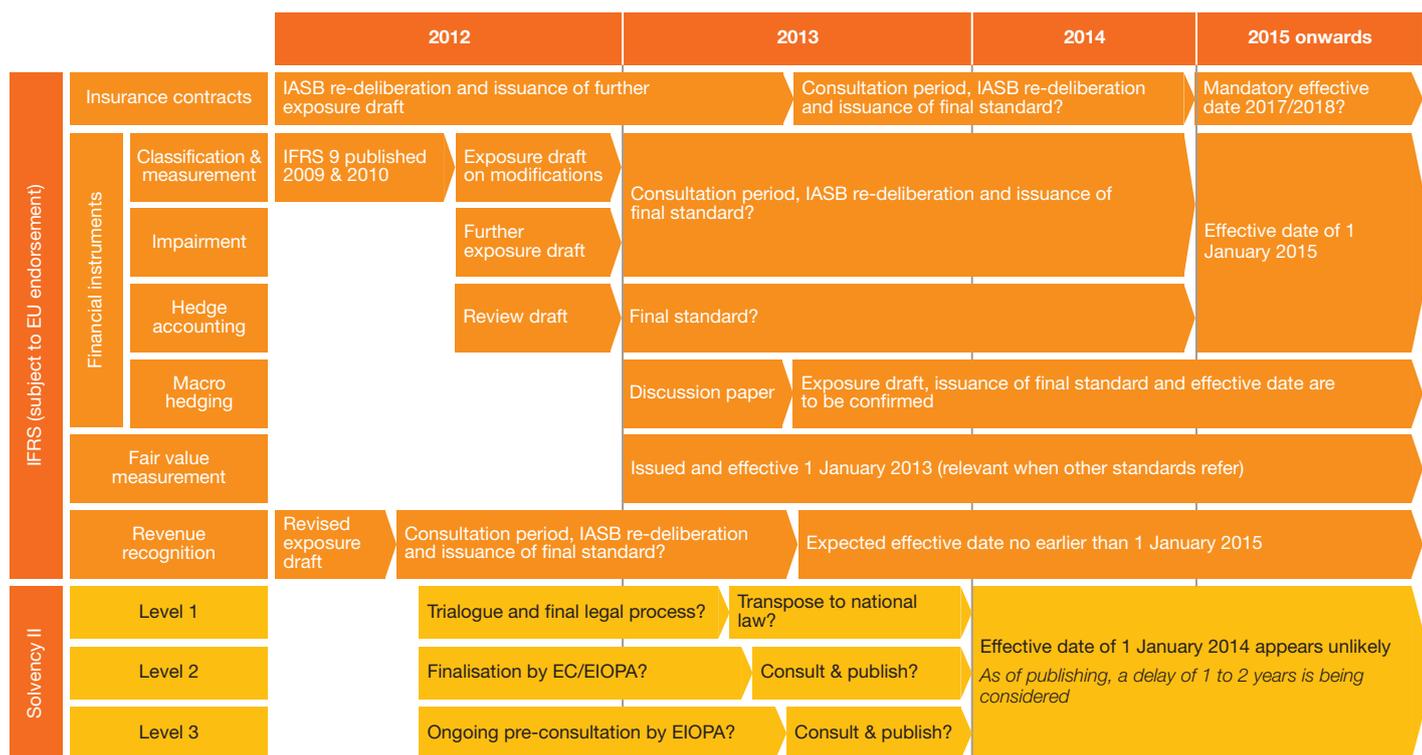
The re-exposure represents what may be the final opportunity for the industry to influence the new accounting standard and it is expected to be limited to five key areas:

- Treatment of unearned profit in contracts (‘unlocking’ the residual margin)
- Treatment of participating contracts
- Presentation of premiums in the income statement
- Presentation of the effect of changes in the discount rate in other comprehensive income
- Transition by retrospective application

Insurers also face changes to the classification and measurement requirements for financial instruments (the IASB is developing IFRS 9 which will replace the current IAS 39). IFRS 9 is expected to be effective from 1 January 2015, subject to a further exposure draft and subsequent endorsement for use in the European Union. This means there will now be a staggered adoption of this standard and the new insurance contracts standard.

Figure 1 sets out the current known timeline for both Solvency II and IFRS.

**Figure 1: Current known timeline for Solvency II and IFRS**



The timeline is based on information to October 2012 and may be subject to change.

Source: PwC analysis based on our understanding of the evolving frameworks

## Making the most of the breathing space

### Solvency II

Whilst the expected delay in Solvency II creates further uncertainty over the final timeframe, the bulk of the framework is established creating an opportunity to focus on embedding Solvency II programmes into ‘business as usual’.

Sustaining the momentum of Solvency II preparations will allow your business to prepare in good time and embed the framework, avoiding undue inefficiency and disruption. You would also benefit earlier from the payback on any planned restructuring, strategic realignment and investment in new information systems ahead of slower moving competitors.

Some contingency planning for the remaining issues will be necessary, including gauging the impact of different outcomes from the long-term guarantees assessment. But the system requirements, organisational considerations and other ‘heavy lifting’ won’t change. Giving greater focus to the practical challenges arising from the public and private disclosure requirements may also be beneficial as currently this is a common area of under investment in Solvency II preparations.

### IFRS Phase II

Given the delay, it will be important to use this time to fully understand recent developments and respond to the re-exposure draft. You can then look to begin more significant implementation

planning activities in the second half of 2013 when the final requirements will be clearer. This should include a detailed impact assessment to understand the financial and operational impacts of the revised requirements on your business.

An important consideration in your impact assessment will be how to deal with the different timelines in IFRS and Solvency II, as we explore later in this publication (in the ‘Mind the gap’ section). There is a real opportunity to ‘future-proof’ Solvency II actuarial and reporting models for IFRS. With the potential for early adoption of IFRS Phase II and the likely delay to Solvency II, the possibility of a coordinated one time transition to Solvency II and the new IFRS standards re-emerges.

## ***Bringing it all together***

The breathing space provides a valuable opportunity to put the foundations in place for a finance function which is capable of meeting these new demands and providing the insights that will give your business an edge in the new commercial landscape.

Key priorities include closer collaboration between the risk, actuarial and finance functions and making sure that the underlying risk and capital models being developed for Solvency II are flexible enough to be adapted for IFRS Phase II, given the similarities.

However, there will be some significant differences in the detailed requirements between the Solvency II and IFRS Phase II frameworks. Your business will thus need to reconcile, or at least explain, these variations. Otherwise you may face awkward questions from analysts and investors.

You may also feel that Solvency II and the new IFRS basis will not fully explain the true performance and potential of your business, and the strategic rationale that underlies this. You should consider how to approach any supplementary reporting, such as embedded value (or equivalent) and cash generation disclosures, that may be needed in the new reporting world.

The box opposite sets out key questions for your organisation to consider in the coming months when planning for future IFRS Phase II implementation.

## ***Outline of this publication***

This publication sets out the challenges in implementing the changes to IFRS, focusing on the proposed insurance contracts standard, in view of the significant Solvency II projects insurers are currently undertaking and considers the impact of the different expected implementation dates. It then examines the various technical challenges and key similarities and differences between IFRS and Solvency II in the areas of contract liabilities, disclosure and presentation, assets and other liabilities and group reporting. The appendices provide a more detailed point-by-point technical comparison.

The publication is based on our understanding of IFRS and Solvency II proposals as of October 2012, elements of which are in different phases of discussion and consultation. The final requirements of both IFRS and Solvency II may still evolve significantly up to their effective dates and, therefore, may differ from those set out in this publication. Given the recent challenges in finalising the requirements of the two regimes, it is also possible that the expected implementation timelines will change again in the future.



### *What you should be considering on IFRS*

- Are concerns over ‘artificial’ earnings volatility being adequately addressed in the revised IFRS Phase II proposals?
- How much impact is the implementation of IFRS Phase II going to have on your organisation from a strategic and operational perspective?
- How can you make sure you secure the right resources for future implementation?
- Would there be any benefits from changing your current accounting approach before mandatory IFRS Phase II implementation?
- How can you take advantage of the parallels between Solvency II and IFRS Phase II and develop ‘future-proof’ actuarial and reporting models capable of dealing with both sets of demands?
- Should the impact of new IFRS on your financial results affect your current decision making?

# Mind the gap!

*The timelines for Solvency II and IFRS Phase II are not aligned and you will need to consider your options for reporting in this gap period. How can your business limit the cost and disruption of running separate systems? Which reporting options are feasible in the gap period and how will they be perceived and understood by investors?*



There is a likelihood that the various new IFRS standards may come on stream at different times, resulting in multiple transitions and re-statements. Even with the expected delays, it still appears likely that Solvency II will be effective before IFRS Phase II.

The timing issues present a range of practical challenges and considerations, not least because the current IFRS reporting requirement for insurance contracts are often based on the current regulatory framework (Solvency I). If Solvency II does go live before IFRS Phase II, your business will have a number of potential options for IFRS reporting for insurance contracts in the interim ('gap') period. Effective stakeholder communication and explanation during this period of transition and uncertainty will be crucial.

A standard industry position may emerge over the coming years. Most insurers won't want multiple transitions between different approaches, not least to avoid the requirement for re-statements and potential artificial volatility in earnings. Other important considerations in assessing the options include the reported financial impact, actual cash cost (such as running two separate models), impact on distributable profit, ease of preparation, future proofing, 'first mover' risk and the future role and approach to supplementary reporting. The impact on your current tax position and future tax planning will also be important as in many countries tax regulations are based on accounting profit. Understanding investor preference for the basis of your reporting may help you to decide on your approach and to identify gaps where further effort will be required in your communication strategy.

The options to consider include:

## **(1) Maintain current approach**

In this option, existing IFRS reporting would be maintained during the gap period. This would require the parallel running of current models and processes, in addition to those required by Solvency II, which is likely to be a drain on costs and resources. While the approach provides stability and consistency in reporting as Solvency II is introduced, many of the current communication challenges faced by insurers will remain. Some of these challenges could be addressed by enhancing external disclosure on matters such as the drivers of IFRS operating earnings and the change in free capital over the reporting period. The wider the gap between the effective date of Solvency II and IFRS Phase II, the more important the decision to continue to incur the costs of running two models will become.

*“With the potential for early adoption of IFRS Phase II and the likely delay to Solvency II, the opportunity for a coordinated ‘big-bang’ exercise has re-emerged.”*

## **(2) Adopt Solvency II (or a modified version)**

Existing IFRS 4 permits changes to the accounting policies in respect of the measurement of contract liabilities if they meet certain criteria for improving ‘relevance and reliability’. An option for IFRS reporting during the gap period may be to adopt Solvency II or a modified version as the basis of financial reporting for insurance contracts, subject to meeting the requirements of existing IFRS 4. Potential challenges in adopting this option would include:

- How does the approach compare to the expected IFRS Phase II model? IFRS Phase II will give context for judgements about whether the ‘relevance and reliability’ criteria of IFRS 4 are met.
- Does the approach introduce additional prudence? IFRS 4 prohibits changes in accounting policies which introduce additional prudence in the measurement of insurance contracts where there is already sufficient prudence.
- Does the approach introduce non-uniform accounting policies across insurance groups? IFRS 4 prohibits increasing the diversity in accounting policies across insurance groups.

Adopting a pure Solvency II approach to measure the contract liability would allow the recognition of a profit at inception of a contract and this is also permitted in some current GAAPs. However, in IFRS Phase II such a profit is spread over the period of coverage by the inclusion of a ‘residual margin’ within the liability. In this option, as a modification to Solvency II, an insurer may seek to include a residual margin depending on its circumstances. Practices for the calculation and amortisation of the residual margin would then be required.

Specific considerations will also be required for non-life insurers as the option to adopt the simplified model for short duration contracts in IFRS Phase II is not an option in Solvency II.

The option to adopt Solvency II (or a modified version) may remove the requirement to maintain two different models, though a further change would then be required to adopt IFRS Phase II. As a result, two sets of re-statements (with comparatives) would be required. This approach is likely to be confusing to analysts and investors if not handled carefully.

## **(3) Early adoption of the requirements of IFRS Phase II**

In this option, the requirements of IFRS Phase II would be adopted in advance of the mandatory date. Either through early implementation of the standard itself (as expected to be permitted in IFRS, but subject to its endorsement in Europe) or by taking on board some of its key requirements as a way of improving existing accounting policies under IFRS 4.

Early adoption may be attractive as part of a co-ordinated ‘big bang’ exercise that brings together Solvency II and the transition to IFRS Phase II, IFRS 9 and other new IFRS standards. A big bang would limit the number of re-statements. It would also provide an opportunity to develop a single communication strategy and to resolve any legacy issues in one go. However, the complexities of a combined transition could introduce greater delivery risk to both Solvency II and IFRS projects. As with any early adoption, there are advantages and risks to being the ‘first mover’ including the risk of subsequent revisions to the accounting requirements.

There are clear advantages and disadvantages to each of these options. Time spent assessing the options now, to identify the best approach for your organisation, will not be wasted as the likely future path will become clearer over time.

# Gearing up for an efficient transition

*The move to IFRS Phase II presents significant implementation and investor relations challenges. How can your business ensure an efficient transition?*

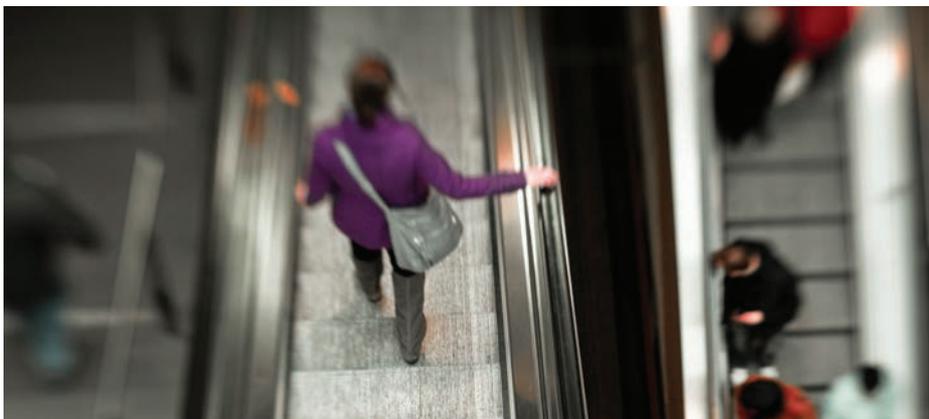
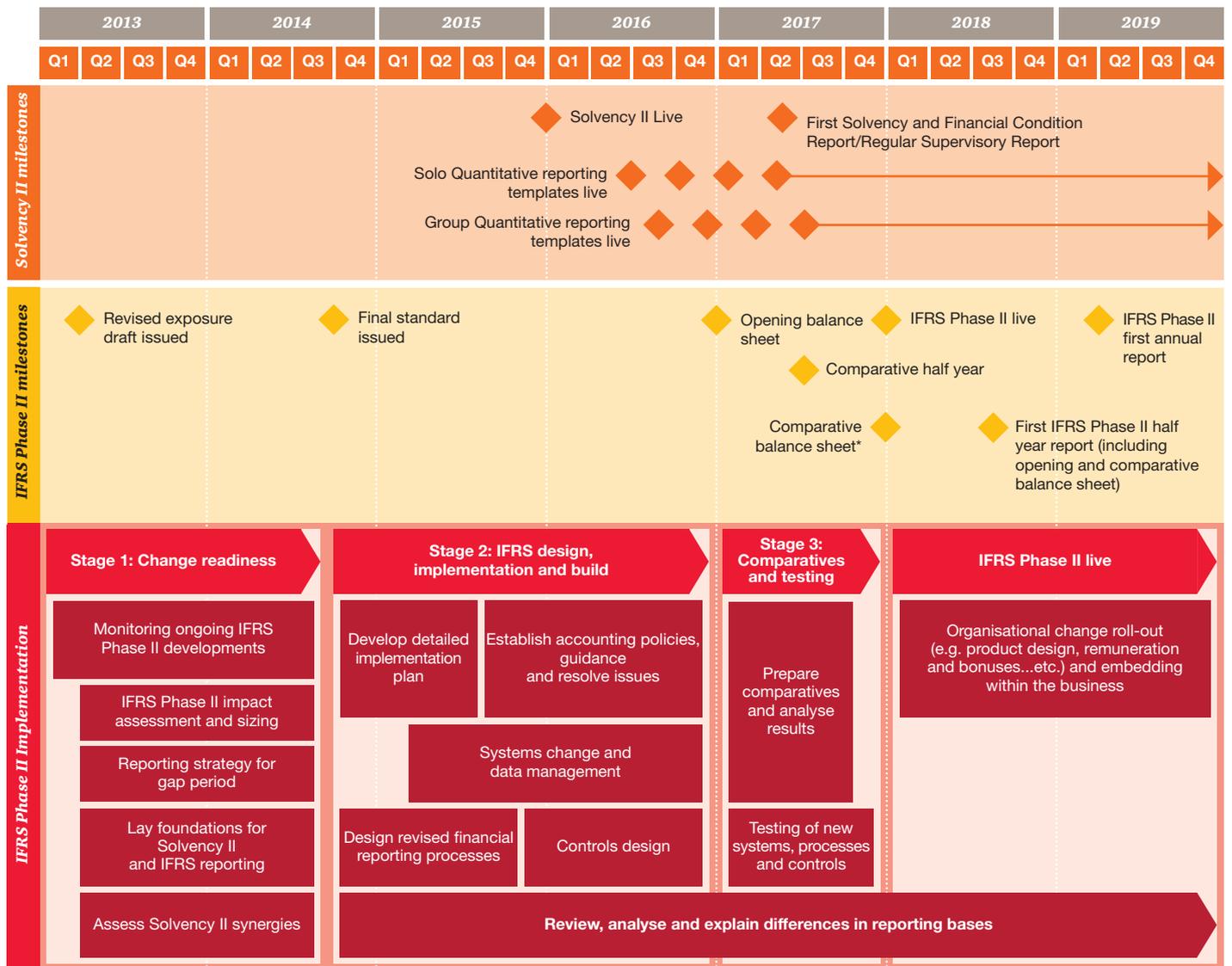


Figure 2 sets out an indicative plan for the implementation and phasing-in of IFRS Phase II. This is under the working assumptions that IFRS Phase II is mandatory from 1 January 2018, Solvency II is effective from 1 January 2016 and that during the 'gap' period the existing approach to IFRS reporting for insurance contracts is maintained. In planning to implement IFRS Phase II initial considerations include:

- **Leveraging Solvency II:** It is likely that the starting point for implementing IFRS Phase II will be the Solvency II models which insurers have recently developed. Understanding the differences between the two frameworks and whether your Solvency II models are flexible enough to be adapted for IFRS Phase II will be important.
- **Priority areas:** It will be important at an early stage to scope the most critical areas of the project. This includes the practical complexities such as full retrospective transition, so that your approach can be tailored to allow sufficient focus on these areas.
- **Scenario planning:** Investigate the different scenarios that could apply and understand the practical impact of each scenario as changes may be expected following the IASB re-exposure and as industry practice develops.
- **Disclosure and communication:** Don't underestimate the time needed to prepare and industrialise disclosure requirements and the importance of external communication. Experience from IFRS conversions in 2005 demonstrates the importance of early stakeholder management. The implementation of IFRS Phase II and Solvency II will lead to fundamental changes in how insurers evaluate and communicate performance, risk and capital both internally and externally. Investors will also value insurers and assess financial and capital flexibility differently. These changes represent a one-time opportunity for a 'root and branch' reform of reporting to address a number of the external communication challenges the industry has faced in recent years. The challenges for insurers will include bridging between the new and old metrics in a coherent manner. All the value gained from implementation could be lost during this phase.
- **Size of project:** Investigate the potential size of the project at an early stage (especially if your business currently reports under a mixture of GAAPs) so that budget requirements can be estimated in advance and sufficient time can be built in to secure resources.

**Figure 2: Indicative implementation plan for moving into IFRS Phase II**



Source: PwC analysis based on our understanding of the evolving frameworks and PwC assumption

\* For foreign private issuer (FPI) registrant companies, an additional year of IFRS comparative information may be required

# Overcoming the technical challenges

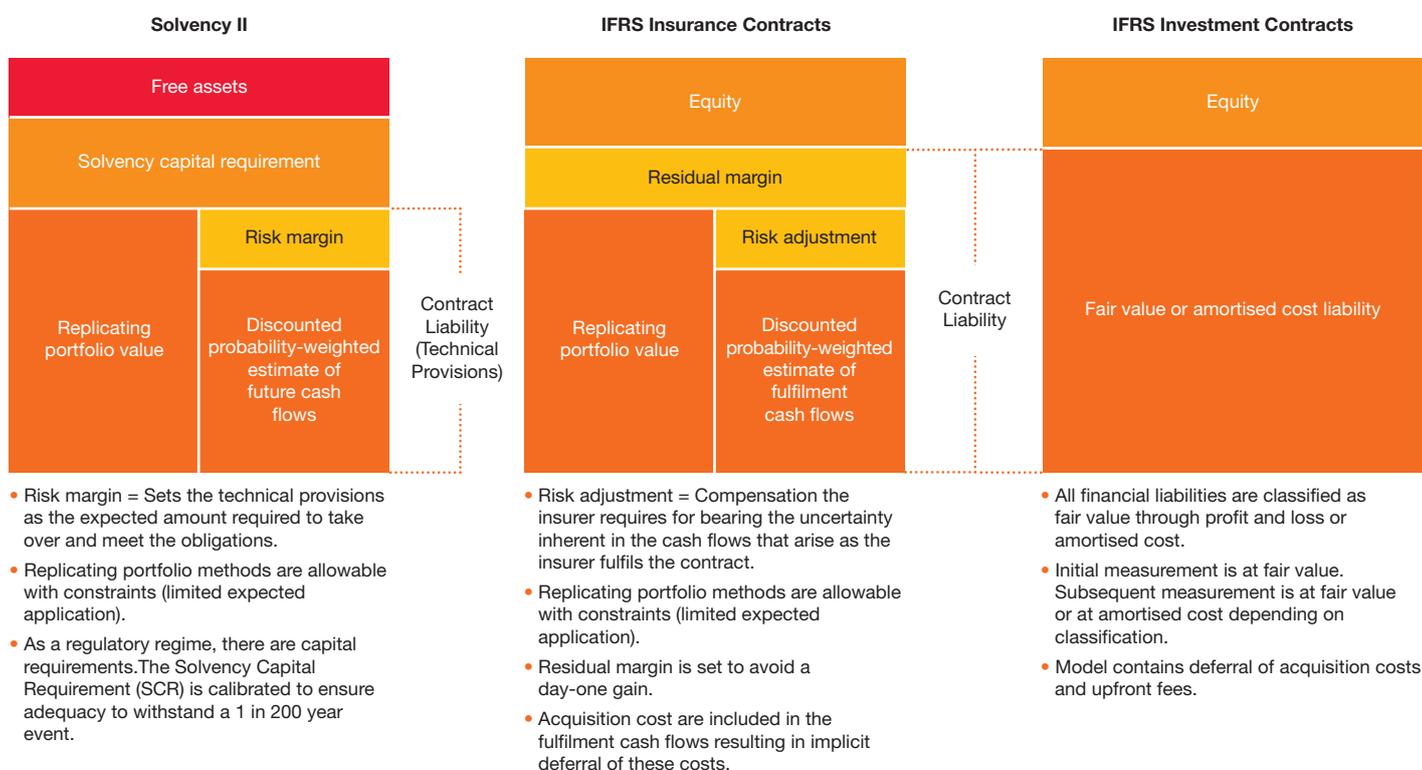
*Both Solvency II and IFRS Phase II include significant departures from current reporting. A number of issues are also yet to be resolved. Further challenges come from the differences in approach between the two frameworks. How can you assess the potential synergies and the practical challenges that IFRS Phase II will bring?*

## Overview

As a prudential regulatory regime, the focus of Solvency II reporting is on the financial strength (capital resources) of the insurer as opposed to its performance during the year. As such, the Solvency II balance sheet is intended to reflect an economic valuation of all assets and liabilities at the balance sheet date. As a financial reporting regime, IFRS is focused not only on reporting financial position at the balance sheet date but also on reporting performance in the period. This gives rise to some of the differences between reporting under Solvency II and IFRS; in particular:

- Under IFRS Phase II the recognition of the profit arising from an insurance contract is spread over the period of coverage – this is achieved by the inclusion of a ‘residual margin’ liability which is not present under Solvency II. The valuation of insurance contract liabilities under IFRS Phase II and Solvency II is discussed in the ‘Contract Liabilities’ section with Appendix A providing a comparison by component.
- Solvency II applies a consistent valuation approach to all contracts issued by insurers. Under IFRS ‘investment contracts’ issued by insurers which do not transfer significant insurance risk (and that do not contain a discretionary participation feature) are accounted for as financial instruments, not insurance contracts (see Appendix B).
- The focus on reporting of performance under IFRS leads to changes in the value of insurance liabilities (and certain financial assets) resulting from changes in interest rates not being reported within profit or loss (as discussed in the ‘Contract Liabilities’ section).
- IFRS contains specific requirements regarding the reporting of volume measures in the income statement and there will be differences between the disclosures required under Solvency II and IFRS (as discussed in the ‘External Reporting: Presentation and Disclosure’ section).
- Under Solvency II all assets and other liabilities will be reported at economic (fair) value. Where the IFRS valuation is also based on fair value the valuation bases will be aligned. However, in some areas Solvency II introduces different valuation bases where IFRS is not viewed as representing an economic valuation (as discussed in the ‘Assets and Other Liabilities’ section, with Appendix C providing a comparison by component).
- In both Solvency II and IFRS, reporting is required at the level of the group as well as at the level of the individual insurer. However, there are differences in the scope and approach to group reporting (as discussed in the ‘Group Reporting’ section, with Appendix D providing a comparison by component).

**Figure 3: Solvency II versus IFRS requirements for measuring contract liabilities**



The relative size of the diagram is purely for illustration purposes only and could differ significantly by product and company. A number of simplifying assumptions have been made. Asset valuations may differ between Solvency II and IFRS, resulting in differences in free assets and equity respectively. For insurance contracts, it assumes that there is no unbundling requirement and does not consider specific short duration contract treatment.

Source: PwC analysis based on our understanding of the evolving frameworks

A key aspect of the Solvency II regime is the requirement for an insurer to have sufficient financial strength to absorb future adverse developments. This is achieved through the requirement for insurers to hold a solvency capital requirement (SCR). There is no equivalent concept to the SCR within IFRS, and this paper does not consider Solvency II's requirements around calculating and reporting the SCR.

## Contract liabilities

### Measurement model

Both Solvency II and IFRS Phase II base the measurement of insurance contract liabilities on the concepts of a probability-weighted estimate of future cash flows, the time value of money and an additional allowance for risk.

In IFRS Phase II, an additional contract liability known as the residual margin is included to eliminate a gain on day one (while all day-one losses are recognised as incurred). There is no equivalent concept to the residual margin in Solvency II or in many current GAAPs. For short duration insurance contracts, which make up the majority of non-life contracts, a simplified unearned premium approach is permitted but not required under certain circumstances for pre-claims contract liabilities in IFRS. There is no equivalent concept in Solvency II.

In addition, there is a requirement to unbundle certain components of contracts and measure them under different IFRS standards, though these situations in practice are expected to be limited.

In IFRS, the measurement of contracts depends on their classification as either insurance or investment, while Solvency II makes no such distinction.

The IFRS classification depends on the level of insurance risk transferred to the insurer and this definition is expected to be largely unchanged from IFRS 4. In addition, investment contracts with a discretionary participating feature (participating investment contracts), where issued by an insurer, are expected to be in the scope of the new insurance contracts standard.

Non-participating investment contracts, for example, a pure unit-linked savings contract, are similar in nature to instruments found in other markets and sectors and, as a result, are subject to the IFRS financial instruments and revenue standards. The contract liability is typically measured at fair value or at amortised cost.

Figure 3 illustrates a comparison of the Solvency II and IFRS requirements for measuring contract liabilities.

Figure 4 presents a summary of the main differences between IFRS Phase II and Solvency II contract liabilities based on our understanding of the evolving frameworks.

**Figure 4: At a glance, a summary comparison of the main differences between IFRS Phase II and Solvency II contract liabilities**

<b>Topic</b>	<b>IFRS Phase II</b>	<b>Solvency II</b>	<b>Significance</b>	<b>Observations</b>
<b>Definition and scope</b>	Insurance and participating investment contracts	All contracts		<ul style="list-style-type: none"> <li>The measurement of investment contracts in IFRS may be significantly different from Solvency II.</li> </ul>
<b>Recognition</b>	Date coverage begins (plus onerous contract test for period before coverage begins)	Date party to contract		<ul style="list-style-type: none"> <li>The level of difference will depend on the onerous contract test in IFRS. For many contracts the recognition will be the same.</li> </ul>
<b>Unbundling</b>	Distinct investment components, embedded derivatives and certain goods and services	No		<ul style="list-style-type: none"> <li>It is expected that the scope of unbundling is limited so this difference may not be significant.</li> <li>Revenue items are not presented on the IFRS income statement for non-distinct investment components (known as 'disaggregation').</li> </ul>
<b>Contract boundary</b>	No longer required to provide coverage or contract does not confer any substantive rights to policyholder	Amend terms to 'fully reflect risk' No projection of premiums for savings contracts		<ul style="list-style-type: none"> <li>The contract boundary definition could be different between Solvency II and IFRS.</li> <li>In Solvency II (unlike IFRS) there is a requirement to separate contracts into components, where the contract boundary differs between components.</li> </ul>
<b>Cash flows (excluding acquisition costs)</b>	Incurred directly to fulfil portfolio of contracts	Prescribed		<ul style="list-style-type: none"> <li>There is a risk of differences in the cash flows included in the two frameworks. For example, the treatment of certain overhead expenses.</li> </ul>
<b>Acquisition costs</b>	Directly attributable at portfolio level	Expensed as incurred		<ul style="list-style-type: none"> <li>In IFRS, there is 'implicit' deferral of acquisition expenses. There is no equivalent concept in Solvency II.</li> </ul>
<b>Discount rate</b>	Top-down or bottom-up (current and locked-in for OCI purposes)	Prescribed based on swaps + (matching adjustment or counter-cyclical premium)		<ul style="list-style-type: none"> <li>The discount rate is the most significant area of uncertainty in Solvency II. It is unclear how the Solvency II discount rate will compare to the principle-based approach in IFRS.</li> <li>Two sets of discount rates (current and at inception) are required for IFRS income statement presentation.</li> </ul>
<b>Risk adjustment/margin</b>	No prescribed method	Prescribed 6% cost of capital		<ul style="list-style-type: none"> <li>The Solvency II risk margin is highly prescribed, while the IFRS risk adjustment is principle-based. It is likely that there will be differences in the two approaches.</li> </ul>
<b>Residual margin</b>	Eliminate day-one gain (update for certain subsequent changes)	No		<ul style="list-style-type: none"> <li>In IFRS, there will be retrospective application of the standard. The residual margin on transition will be the key area of complexity.</li> </ul>
<b>Participating contracts</b>	Cash flows from participating feature included (consistent with asset valuation and presentation)	Cash flows from participating feature included (except for 'approved surplus funds')		<ul style="list-style-type: none"> <li>The linkage of the cash flows in IFRS to the asset measurement and presentation is a significant difference from Solvency II if assets are not at fair value through profit or loss.</li> <li>The treatment of residual participating fund assets and the allocation between liability and equity will depend on the specific nature of the contracts and the approved national law. The comparison between IFRS and Solvency II is currently unclear.</li> </ul>
<b>Short duration contracts</b>	Unearned premium model for pre-claims liability while cash flow projection for claims liability	As for other contracts		<ul style="list-style-type: none"> <li>In IFRS, the unearned premium model is optional. A cash flow approach can be adopted as in Solvency II.</li> </ul>

Source: PwC analysis based on our understanding of the evolving frameworks

## Addressing volatility

Since the original IASB exposure draft in 2010, significant revisions have been made to the IFRS Phase II measurement model. A number of these changes go some way to address the concern of stakeholders on what is perceived to be the ‘artificial’ earnings volatility in the original model (see Figure 5). The changes include:

- Requiring the residual margin to absorb certain changes in estimates of future cash flows.
- Clarifying that a ‘top-down’ approach can be adopted to determine the discount rate.
- Requiring that the effect of changes in the discount rate be presented in Other Comprehensive Income (OCI) to address the interaction with the presentation and measurement of assets (when at fair value through OCI or amortised cost).

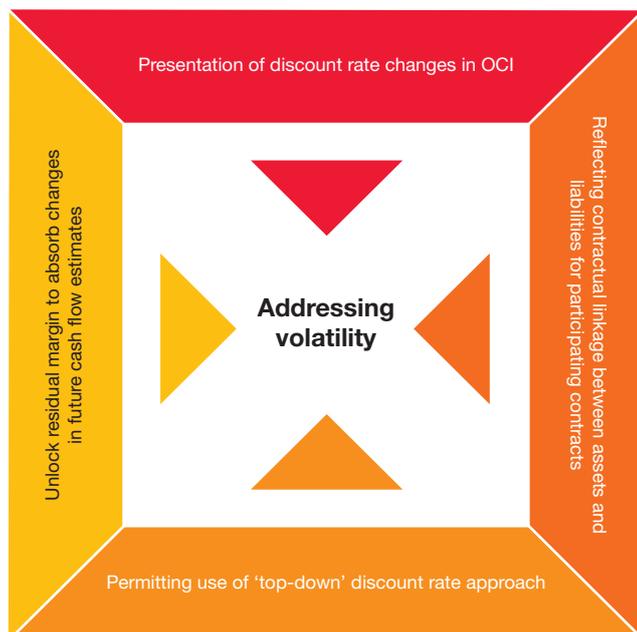
- Reflecting the contractual links between assets and liabilities in the measurement of participating contracts.

The benefits of these refinements are accompanied by increased operational complexities that are not mirrored in Solvency II due to its focus on balance sheet strength. It is also unclear whether the proposed changes will fully address all stakeholders’ concerns.

The following subsections of this publication explore in more detail the main difference between IFRS Phase II and Solvency II contract liabilities and the proposals to address the perceived ‘artificial’ earnings volatility in IFRS.



**Figure 5: Addressing volatility in IFRS 4 Phase II**



Source: PwC analysis based on our understanding of the evolving frameworks

*“The use of estimated future cash flows is the foundation of both frameworks. However, there are some potential differences which will present practical difficulties.”*

## Cash flows

The use of estimated future cash flows is the foundation for the measurement model for Solvency II and IFRS Phase II. However, there are some differences which may present practical difficulties, necessitating either separate models or greater flexibility within a single model. We highlight three specific areas:

### Scope of cash flows

In both Solvency II and IFRS Phase II, there is expected to be explicit guidance as to which cash flows are to be included in the measurement of the liabilities. Many of the cash flows will be the same in the two models, such as premiums and claims. However, not all the cash flows are expected to be fully aligned. For example, the inclusion of certain overheads costs may be different. This may trigger changes in your expense allocation process and lead to two sets of expense assumptions.

### Acquisition costs

In IFRS Phase II, the cash flow model includes directly attributable acquisition expenses and so there is ‘implicit’ deferral of these expenses through a reduction in the residual margin. Many current GAAPs permit an explicit deferral of acquisition costs as an asset on the balance sheet, so while the exact definition of acquisition costs permitted to be deferred may be different you may well have the systems already in place to capture this data. For non-participating investment contracts in IFRS, there is explicit deferral of acquisition costs as an asset on the balance sheet, but with a narrower definition of the costs permitted to be deferred compared to insurance contracts (broadly costs that are incremental at the contract rather than portfolio level). There is no equivalent concept of deferring revenue or costs over the life of the contract in Solvency II.

### Boundary of a contract

The boundary of a contract represents the point beyond which any cash flows relating to a contract are no longer recognised in the measurement of the liability. The boundary will be the same in the two frameworks for many contracts however there is a risk that some differences may exist. For example, there is a requirement in Solvency II to separate contracts into components, where the contract boundary differs between components. There is no equivalent requirement in IFRS.

In Solvency II, there is a separate contract boundary for those contracts which would typically be non-participating investment contracts in IFRS. The boundary is defined so that no future premiums are included in the cash flows, and as a consequence, embedded profits arising from these future premiums are not included on the balance sheet. In IFRS, as these contracts are often unit linked, there is no estimation of future cash flows and the liability is measured at fair value or amortised cost which is usually the unit balance.

Insurers will require data and cash flow model developments to deal with these implications.

### Discount rate

For insurers writing long-term savings products, the valuation of contract liabilities and resulting solvency ratios and accounting profit are highly sensitive to the selection of the discount rate.

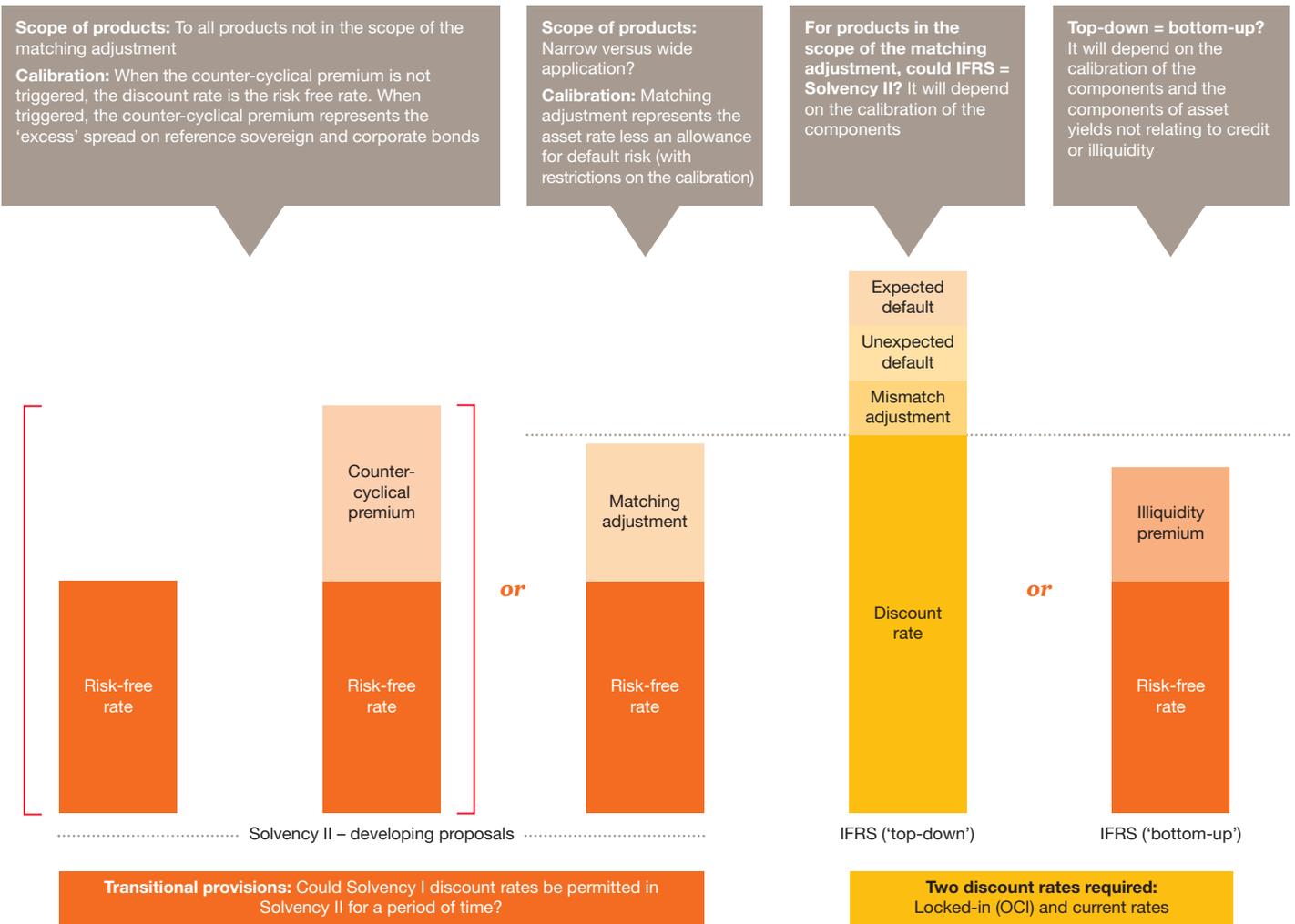
There remains considerable uncertainty over the discount rate in Solvency II pending the proposed long-term guarantees impact assessment. It is expected that the discount rate to be used will be determined by the regulator based on the swap curve plus either a matching adjustment (applicable to certain contracts) or a counter-cyclical premium (only applicable in certain extreme market conditions). These adjustments to

the swap curve are designed to address the impact of volatility in credit spreads on the solvency balance sheet. The matching adjustment is designed to reflect the possibility that there may be no (or limited) exposure to spread risk (excluding default risk) due to the characteristics of the liabilities and the asset-liability matching strategies adopted. The scope of liabilities to which the matching adjustment is applied (narrow versus wider) and the calibration of the adjustment remain uncertain. The counter-cyclical premium is designed, when triggered (by the regulator), to provide short-term relief during periods of ‘excess’ spread widening in sovereign and corporate bond markets. The calibration of the premium and the criteria as to when the premium is permitted remain uncertain.

In IFRS Phase II, the approach to the discount rate is principle-based and it must reflect the characteristics of the liabilities. You can use a ‘top-down’ approach, starting with the yield on the supporting or reference assets with deductions for default and mismatch risk (to adjust for differences in the timing of asset and liability cash flows), or a ‘bottom-up’ approach starting with the risk-free reference rate plus an illiquidity premium. A top-down approach is likely to be applied for ‘spread-based’ insurance contracts, notably annuities in payment.

In IFRS Phase II, it is proposed that the impact of all changes in the discount rate over time are to be presented in OCI rather than through profit or loss. There is no equivalent concept in Solvency II. The approach will require the contract liability to be measured based on both the current and ‘locked-in’ (at inception) rates. This will introduce additional data and system requirements and will result in an accounting mismatch in the income statement for those contracts with supporting assets measured at fair value through profit or loss. However, where contracts are backed by debt securities measured at fair value through OCI the

**Figure 6: Illustrative discount rate comparison – Solvency II versus IFRS Phase II**



The relative size of the diagram is purely for illustration purposes only and could differ significantly by product line and company.  
 Source: PwC analysis based on our understanding of the evolving frameworks

*“There remains considerable uncertainty over the discount rate in Solvency II. Differences in approach between Solvency II and IFRS, including the requirement for current and locked-in rates in IFRS, introduce a number of operational challenges.”*

presentation of the discount rate will reduce accounting mismatch in the income statement.

Figure 6 illustrates the different approach in Solvency II compared to IFRS and raises a number of questions, including whether a wider application of the matching adjustment would be equivalent to a top-down approach in IFRS. The answers won't be known until Solvency II is finalised. Conceptually, there are similarities between the matching adjustment and the top-down approach. However, to include the counter-cyclical premium (triggered by a regulator's assessment of market events) in IFRS

would appear challenging given the requirement to reflect the characteristics of the liabilities, which are typically independent of market events.

In addition, there is the possibility that a transitional arrangement on the discount rate may exist in Solvency II. For example, use of Solvency I rules may be allowed or phased out gradually over a period of time for existing contracts on implementation of Solvency II. This could result in liabilities with the same characteristics having different discount rates in Solvency II, which would be challenging to justify in IFRS.

Where there are differences between the discount rate in Solvency II and IFRS, including the requirement for two rates in IFRS, this will introduce a number of operational challenges, including dual assumption and valuation processes, potentially different asset data requirements, multiple economic scenario calibrations and additional reconciliations.

For short duration insurance contracts, the issue of discounting is less significant for the pre-claims liability. However, it is important to be aware of the implications for the liability for incurred claims (post-claims) particularly long tailed claims liabilities, notably, periodic payment orders and latent claims (such as asbestosis).



## Allowance for risk

The concept of an explicit adjustment for risk is fundamental to both Solvency II and IFRS Phase II. In Solvency II, the allowance for risk is determined following a 'cost of capital' approach with a prescribed calibration, for example, a 6% assumed cost. In IFRS Phase II there is no prescribed method and the calibration must conform to a principle: 'the compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the contract'. If you are governed by Solvency II, it is likely that you will want to make use of the models you have developed for this purpose and are therefore likely to adopt a cost of capital approach under IFRS. However, there is the potential in IFRS to have a different cost of capital calibration from that used in Solvency II. For example differences could exist in respect of the assumed cost rate, the level of diversification benefit and the treatment of tax losses in the capital assessment. There are also practical considerations, including

whether the Solvency II models can be adapted, model run times and how any differences will be reconciled and communicated to stakeholders.

As the results from the Solvency II Fifth Quantitative Study (QIS 5) highlighted, the risk margin in Solvency II is expected to be a relatively small percentage of the technical provisions (see Figure 7), so any differences in the calibration for IFRS Phase II may not be that significant.

At inception of a contract, a difference in the calibration of the allowance for risk between IFRS and Solvency II does not impact IFRS profit or loss as it is offset by the calculation of the residual margin (to the extent that there is a gain at inception). However, the difference will impact the future recognition of profit due to the different patterns of releasing the risk adjustment and residual margin to profit or loss.

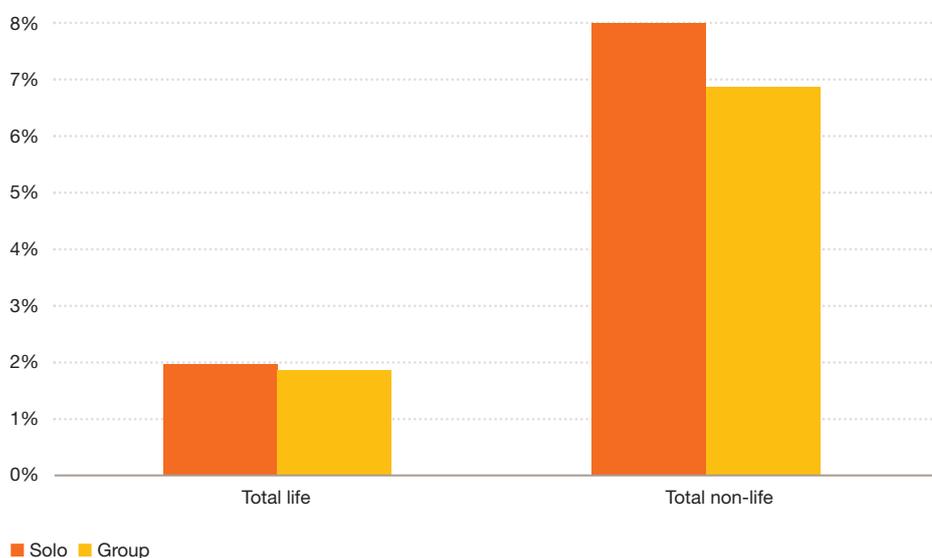
## Residual margin

As the residual margin is a concept with no direct comparison in Solvency II and many current GAAPs, you will need to develop a new model or separate system to determine this element of the liability and its release to profit or loss during the lifetime of the contracts.

The residual margin is determined at a 'portfolio level'. The release of the residual margin is to the period in which the service is provided and there is no prescribed level (unit of account). It is unclear how this will be interpreted in practice by insurers.

In addition, the margin is increased for interest at each reporting period at the locked-in rate (as considered in the discount rate section). Changes in estimates of future cash flows are not recorded in profit or loss, but are offset in the residual margin ('unlocking'), subject to the residual margin not becoming negative. You will still need to monitor a negative residual margin as changes in the estimates of future cash flows could result in the residual margin becoming

**Figure 7: Risk Margin as a percentage of Technical Provisions in QIS 5**



Source: EIOPA Report on the Fifth Quantitative Impact Study (QIS 5) for Solvency II (March 2011)

*“Full retrospective application will be challenging under IFRS as the residual margin on transition will require an assessment of contract profitability at outset and then reassessed to the current date, a period of over 20 years on some contracts.”*

### **Key questions to be considered in developing a residual margin model:**

1. What is the definition of your portfolios and do your existing cash flow models provide the required information at this level?
2. How will you release the residual margin to profit or loss, including both pattern and unit of account?
3. Can you identify in your models the impact from changes in estimates of future cash flows to unlock the residual margin?
4. What are the system options for modelling the residual margin?
5. A reconciliation of the residual margin between each reporting period has to be disclosed. How will you prepare this analysis?
6. Once established, the residual margin will be a significant component of profit in each period. How will you explain and analyse this internally?

The answers to these questions (among others) will help to determine the model requirements for managing the residual margin process following transition.

positive in future periods and presented as a liability on the balance sheet. Changes in the valuation of options and guarantees, discount rate and risk adjustment are not offset by the residual margin. The requirement to unlock the residual margin and charge interest introduces greater complexity and more granular data requirements.

The box above poses key questions to consider for developing a model to determine and manage the residual margin.

### **Participating contracts**

The basic definition of a participating feature is similar in Solvency II and IFRS Phase II. All participating contracts issued by an insurer are expected to be in the scope of IFRS Phase II. In both frameworks, certain cash flows arising from the participating feature are included in the same way as any other contractual cash flows, that is, on an expected present value basis with a risk adjustment.

In IFRS, the cash flows relating to the policyholder's participation are measured and presented mirroring the underlying assets in which the policyholder participates, so at cost or fair value

(through OCI or profit or loss); while options and guarantees are measured at their current value. There is no equivalent concept of mirroring in Solvency II as all assets are at economic (fair) value.

In IFRS, all expected payments to current or future policyholders are treated as a liability, even when at the insurer's discretion. In Solvency II, there is no directly equivalent concept, however, no liability is required for 'surplus funds' where this has been authorised under national law. The implications of these approaches will depend on the specific nature of the participating contracts and the approved national law.

The treatment of participating contracts in IFRS Phase II, including the practical application, remains an area of uncertainty as the IASB continues its deliberations. In comparison to many current GAAPs, it is expected that IFRS Phase II may introduce greater investment volatility in IFRS earnings.

### **Transition**

Both Solvency II and IFRS Phase II require retrospective application on transition. This represents a significant change for IFRS compared to the exposure draft in

2010, where it was assumed that no residual margin would be allowed on existing contracts, effectively writing off this future profit to equity on adoption of the new standard. In Solvency II transitional provisions (such as potentially for the discount rate discussed earlier) may remove in certain respects the requirement for a retrospective application.

As Solvency II is a full prospective measure there is limited additional complexity from retrospective application. However, it will be challenging under IFRS, as the residual margin on transition will require an assessment of contract profitability at outset which is then reassessed to the current date, a period of over 20 years on some contracts. The importance of this assessment cannot be understated given the significant impact the margin will have on IFRS earnings following implementation.

For IFRS Phase II, transition is effectively on a 'best endeavours' basis, as estimation methods will be permitted to determine the residual margin on transition when there is insufficient objective data for certain years. Examples of estimate methods could include adjusting embedded value new business margins

for differences to IFRS or adapting other legacy reporting metrics. There is added data complexity from the unlocking of the residual margin and the requirement for a discount rate at inception. Gathering data in the right format and at the right level of granularity is likely to be a substantial exercise, which should not be underestimated. An assessment on a product by product basis will help tailor the approach to those products where the most significant profit margins have existed. For some products, the margin may be clearly zero (or negative) due to age or adverse demographic assumption changes in the past. Whichever approach is adopted, it will need to be robust and capable of being audited.

Insurers are expected to adopt a similar approach to disclosing the impact of transition as was adopted for the implementation of IFRS 4 in 2005.

The residual margin on transition has the potential to create some surprising results, which will need to be explained, particularly for products written back in past decades when the market conditions and underwriting practices were different from those of today.



## **External reporting: presentation and disclosure**

### **Disclosures**

The IFRS Phase II package of disclosures is largely known, and includes a number of additional requirements beyond those currently required for IFRS 4. Insurers may find the requirements onerous, such as detailed opening to closing balance sheet reconciliations and the confidence level disclosures for the risk adjustment. Solvency II also creates a significant number of private and public reporting and disclosure requirements. In both frameworks, the required level of detail is expected to be more onerous than current accounting and regulatory requirements. In Solvency II, there is also increased frequency of reporting.

Given the status of the disclosure packages, it should be possible to carry out an initial comparison of the requirements and judge what could be brought together. For example, could the Solvency II analysis of change in technical provisions and claims development tables be used for equivalent IFRS disclosures? Automating the production will reduce reporting time frames and save on related costs. In addition, with separate accounting and regulatory reporting requirements, it will be important to explain and reconcile the two balance sheets.

### **Presentation of the income statement**

IFRS Phase II will prescribe the approach to income statement presentation. In a change from the original exposure draft, it will include premium, claim and expense information ('volume measures') on the face of the income statement. An 'earned premium' method is to be followed, where premiums are allocated to each period in proportion to the relative value of the insurance coverage and other services expected to be provided in that period. In addition, the

measurement of premiums, claims and benefits presented in the income statement excludes receipts and payments from certain investment components within contracts (typically expected to be many policyholder account balances). These changes represent substantial difference to many current GAAPs for insurers who write long-duration business, and so will impact significantly data and system requirements. How the volume measures are explained to stakeholders will need to be considered.

There are no equivalent concepts in Solvency II due to its focus on the balance sheet strength rather than performance reporting.

## **Assets and other liabilities**

The valuation of assets and other liabilities under Solvency II is, where possible, intended to be consistent with IFRS as endorsed by the European Union. It is therefore likely that there will be significant overlap between the two approaches, although there will be some measurement differences where IFRS is not considered to provide a suitable valuation for regulatory purposes.

### **Financial assets and financial liabilities**

Under IAS 39 and its replacement IFRS 9, financial assets are valued either at amortised cost or at fair value (either in OCI or through profit or loss). Where valued at amortised cost, insurers will need to convert them to fair value for Solvency II. Under IFRS, financial liabilities are valued at either fair value or amortised cost. Solvency II requires that financial liabilities should be valued in conformity with IFRS upon initial recognition however subsequent adjustments are made for changes in the risk-free rate. This deviates from a fair value valuation because changes arising from changes in the insurer's own credit standing are excluded from the Solvency II valuation.

### **Participations (subsidiaries, associates, joint ventures and special purpose vehicles)**

Under IFRS in solo financial statements, investments in participations are valued at either cost or fair value. This may differ for Solvency II, where listed participations are valued using quoted market prices, unlisted subsidiaries on an 'adjusted equity method' (being the share of net assets valued in accordance with Solvency II valuation principles or, when Solvency II valuation is not practicable, valued based on IFRS excluding intangibles and goodwill) and other undertakings (not subsidiaries) on an adjusted equity method (with an option to mark to model if an adjusted equity valuation is not possible).

### **Property plant and equipment (PPE)**

Solvency II proposes that PPE (excluding investment property) should be at fair value where these items are not otherwise measured at economic value. The revaluation model in IFRS is considered as a reasonable proxy for fair value. However IFRS also allows a more commonly used alternative method of valuing PPE at cost less depreciation. The shift to economic valuation in Solvency II is likely to be a change for most.

### **Goodwill and intangibles**

Under IFRS goodwill is recognised as a specific asset when an acquisition takes place and there is a positive difference between the purchase consideration paid and the fair value of the net assets acquired. Solvency II proposes that no value be ascribed to acquired goodwill.

Under IFRS intangible assets that qualify for recognition are measured under either a cost model or, where there is an active market for the asset, a revaluation model. Solvency II proposes that intangible assets are assigned a value only when they can be sold separately and a valuation can be derived from a quoted market price in an active market for the same or similar intangible. In practice most intangible assets of insurers are not traded in active markets and so no value will be assigned under Solvency II.

### **Leases**

Under Solvency II, finance lease assets are measured at fair value. This differs from the present value of the minimum lease payment under IAS 17, which is considered inconsistent with Solvency II valuation principles.

### **Contingent liabilities**

Under Solvency II material contingent liabilities are recognised as liabilities in the balance sheet and they are valued based on the discounted expected present value of the cash flows needed to settle the liability. Under IFRS, contingent liabilities are disclosed but not recognised on the balance sheet (except when arising upon an acquisition).

### **Employee and termination benefits**

Following the recent amendment to IAS 19, the treatment of employee and termination benefits under Solvency II and IFRS are closely aligned. Under QIS 5 it was possible for insurers to apply their own internal model to the valuation of employee benefits. Under most recent technical specifications from EIOPA published in October 2012, this approach is not mentioned. It is not clear whether this means the use of an internal model for the valuation of defined benefit pension obligations will no longer be permitted under the Solvency II regime.

## Group reporting

Both Solvency II and IFRS require reporting at group as well as at the entity level. For Solvency II, group reporting allows the insurer to make an assessment of its group capital position, and under IFRS consolidated accounts are prepared to present a single picture of the results of the group. Reflecting these different purposes, the scope, level and method of consolidation differs between IFRS and Solvency II, and the results prepared for each purpose may therefore be significantly different.

## Level at which group reporting applies

IFRS requires group reporting at the level of the top company (the ultimate parent company) of the group, regardless of the activities of the entities within the group. In addition consolidation may be required at a sub-group level either by IFRS (for example, where an intermediate parent has listed debt) or by requirements of national law.

Under Solvency II group reporting is only applicable at the level of an insurance group which could be a subset of a larger group also conducting significant non-insurance activities. The level at which Solvency II group supervision applies depends on the location of the ultimate insurance parent and whether its regulatory regime is deemed equivalent to Solvency II:

- Where the ultimate insurance parent of the group is within the European Economic Area (EEA), Solvency II group reporting will be at this level.
- Where the ultimate insurance parent is outside the EEA, the group is subject to Solvency II group supervision at the ultimate EEA insurance parent level (that is at the sub-group level) and the requirement for any additional supervision will depend on whether the regulatory regime of the ultimate parent entity is deemed equivalent to Solvency II. If the regulatory regime of

the ultimate parent is deemed to be non-equivalent it is possible that the ultimate group parent will also be subject to Solvency II group supervision.

The level of Solvency II group reporting may therefore differ from IFRS either because Solvency II reporting is required at an EEA level where IFRS reporting may not be; or because the insurance group subject to Solvency II group reporting is a sub-group of a larger group subject to IFRS group reporting.

## Scope of consolidation

Another potential source of differences between Solvency II and IFRS group reporting lies in the definition of the group and as a result, which entities will be part of a group. Under IFRS a group is comprised of subsidiaries, joint ventures and associates. Under Solvency II the group is defined as the parent, its subsidiaries and participations. The definition of the entities comprising the Solvency II group is based on definitions contained in EU Accounting Directives; although these definitions are broadly consistent with IFRS, there are some differences that could potentially lead to a different scope of consolidation. In addition, supervisors are able to include other entities in the scope of Solvency II group supervision where they conclude that dominant or significant influence is exercised.

## Method of consolidation

IFRS requires a single approach to consolidation, which involves combining all the results of the parent and its subsidiaries in the group on an individual line item basis, then applying consolidation adjustments, for example to eliminate inconsistencies in accounting policies and intra-group transactions. Associated undertakings are accounted for using the equity method of accounting.

Solvency II has two methods by which the group results may be prepared. The default approach under Solvency II is the 'accounting consolidation-based method', using the consolidated accounts as a starting point. Although it is called the accounting consolidation method, in reality the mechanism of consolidation depends on the type of entities being consolidated. For example, insurance subsidiaries are consolidated on a full line by line basis; other financial institutions within the group are incorporated on the basis of the proportional share of their own funds; and non financial sector unlisted subsidiaries will be incorporated on an adjusted equity method. As a result, although there may be opportunities for synergies where a group prepares IFRS consolidated accounts at the same level as the Solvency II group calculation, it is clear that the Solvency II consolidation mechanism is quite different to IFRS. Alternatively under Solvency II, the 'deduction and aggregation' method may be used at the discretion of the group supervisor, which calculates group solvency based on the aggregation of the individual entities in the group on a Solvency II or equivalent basis.



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# ***Appendices***

## Detailed technical comparison of Solvency II and IFRS

***Appendix A: Insurance contracts***

***Appendix B: Investment contracts***

***Appendix C: Assets and other liabilities***

***Appendix D: Group reporting***

## Appendix A: Insurance contracts

### Solvency II

### IFRS

#### 1. Relevant standards / sources of information

- QIS 5 technical specification (where relevant)
  - Solvency II Level 1 Directive (where relevant)
  - Proposals on the Omnibus II Directive issued by the European Commission in January 2011, the Council of the European Union in September 2011 and the European Parliament in March 2012
  - EIOPA Technical Specifications for the Solvency II valuation and Solvency Capital Requirements calculations (Part I) published in October 2012
- Insurance Contracts exposure draft (where relevant – July 2010)
  - IASB Detailed Progress Report (October 2012)
  - IASB Staff Paper: Effect of the Board decisions (October 2012)
  - IASB Working draft papers (December 2011, July 2012)
  - Tentative decisions made by the IASB to October 2012

In addition, other public consultations and our current understanding of the evolving framework are included.

#### 2. Scope

- Solvency II applies to all insurance and reinsurance contracts written by insurers in the European Economic Area (EEA) and its group supervision requirements apply to insurance groups containing EEA insurers. In addition certain of Solvency II's requirements apply to contracts written by non-EEA insurers through branches in the EEA.
  - There is no distinction between insurance and investment contracts except for determining the cash flows that are within the boundary of a contract as discussed in a subsequent section.
  - There are scope exclusions for certain undertakings by virtue of their size, legal status, nature or specific services they offer.
- IFRS for insurance contracts applies to all contracts which:
    - Transfer significant insurance risk (except for those explicitly exempted, such as certain product warranties and fixed-fee service contracts that are primarily a provision of services; and financial guarantee contracts that the issuer has not previously asserted that it regards as insurance contracts (under IFRS 4)); or
    - Do not transfer significant insurance risk, **but are investment contracts with discretionary participation features that are issued by an insurer.**
  - **The definition of significant insurance risk is largely unchanged from IFRS 4**, with the exception that a contract does not transfer insurance risk if there is no scenario that has commercial substance in which the insurer can suffer a loss (on a present value basis). Special provisions allow certain reinsurance contracts that do not suffer an overall loss to continue to be within the scope of the insurance standard.
  - Distinct investment components (e.g. certain policyholder account balances), embedded derivatives and distinct goods and services contained in insurance contracts are unbundled and measured under the applicable IFRS standards.
  - There is no directly equivalent concept of unbundling and alternative measurement under Solvency II. The consequences of unbundling in IFRS, may in some circumstances, result in a significant difference from Solvency II, as the treatment of investment contracts and revenue differ between the two frameworks.
  - It is likely that many investment components will not be distinct due to interactions with the insurance component. **As a consequence, it is expected that there will be limited unbundling for measurement in IFRS.**

## Appendix A: Insurance contracts

### Solvency II

### IFRS

#### 3. Non-life insurance and other short duration contracts

- The fundamental building blocks of the probability-weighted average of future cash flows, discounting and the risk margin apply as discussed in the subsequent sections.
- For non-life insurance obligations, the best estimate for **claims outstanding and premium provisions** is carried out separately.
- The claims provisions relate to claim events already incurred at the valuation date (including incurred but not reported) and comprise all future benefits, expenses and premiums relating to those events.
- For premium provisions, the cash-flow projections relate to claims events, falling within the boundary of the contract, that occur after the valuation date. Cash flows include future claim payments in relation to claims that occur after the valuation date (that is, unexpired risks), future premiums and associated expenses. As cash inflows could exceed the cash outflows, the premium provision can be negative and hence expected future profit is recognised at day one.
- A risk margin is required for both the premium and claims provisions.

#### Liability for remaining coverage ('pre-claims' liability)

- A modified measurement model, the Premium Allocation Approach (PAA), is permitted (but not required) where either:
  - the period of cover is one year or less; or
  - the approach would produce measurements that are a reasonable approximation of those that would be produced by the building block model.

**This is expected to relate to the majority of non-life contracts and certain short-term life contracts. There is no equivalent option in Solvency II.**

- In the PAA model, the liability is measured using the premium receivable at inception less eligible acquisition costs. The liability is spread evenly over the contract period or based on the expected timing of incurred claims and benefits, if that pattern differs significantly (for example a portfolio with a high level of US hurricane exposure).
- In addition, in relation to the PAA model:
  - If the insurer elects, the acquisition costs can be expensed as incurred if the coverage period is one year or less.
  - The time value of money (discounting and interest accretion) should be reflected in the liability, using the locked-in discount rate at inception of the contract, if the contract has a significant financing component. As a practical expedient, discounting and interest accretion is not required if the period between premium receipt and the end of the coverage is one year or less.
- When the facts and circumstances indicate that a portfolio of contracts is or is likely to become onerous an additional liability is set up. The onerous contract test is an active assessment at each valuation date.

#### Liability for incurred claims ('post-claims' liability)

- The liability (incurred whether reported or not) is measured, similarly to Solvency II and the building block model, as the discounted probability-weighted future claim cash flows (with a risk adjustment) related to claim events having occurred before, or at the point of valuation (this is discussed further, in the subsequent sections).
- Claims and interest expense reported in profit or loss are determined using the locked-in discount rate at inception of the contract. The difference from the current rate used to measure the liability is reported in Other Comprehensive Income (OCI).
- However, unlike Solvency II, discounting is not required if the claims are expected to be paid within 12 months.

## Appendix A: Insurance contracts

### Solvency II

### IFRS

#### 4. Future cash flows

##### Probability-weighted future cash flows

- In Solvency II, the best estimate corresponds to the ‘probability-weighted average of future cash flows taking account of the time value of money’. This requires all future scenarios to be considered, which in some circumstances may necessitate the use of stochastic methods, for example when valuing the future discretionary benefits of participating contracts or other contracts with embedded options and guarantees. Conversely, for non-life liabilities and for other life insurance liabilities, the use of stochastic techniques may not be necessary, and deterministic or analytical techniques may be more appropriate. For example, in respect of the valuation of non-life liabilities, deterministic methods (for example chain-ladder methods) will usually be appropriate, providing these are calibrated (or else adjustments made) to target a best estimate. Alternatively, for life insurance liabilities the outcomes for certain risk variables are sufficiently symmetric that a deterministic valuation will suffice.
- The calculations are on a policy-by-policy basis though, for practical reasons, grouping and approximations are likely to occur where these can be demonstrated as being materially the same. For example, for non-life liabilities or more generally where stochastic methods are adopted.
- There is no deposit floor and negative liabilities are permitted. For example, the total liability for a unit linked contract can be below the account balance (unit fund).
- There is a minimum level of segmentation required when calculating the technical provisions, and contracts containing life and non-life features are required to be split.

##### Contract boundary

- The contract boundary sets the point at which obligations can be recognised on existing business. Within the boundary period, both contractual premiums and benefits arising from policyholder options to review or extend their policy are taken into account on a best estimate basis.
- The boundary is set as the point where **the insurer can unilaterally terminate the contract, refuse to accept a premium; or amend the benefit or premium without limit (to fully reflect the risks, so there is no scenario under which the benefits and expenses payable exceed the premium).**
- **The ability to amend (or re-price) to reflect risk is at the level of a portfolio of obligations except for certain life insurance obligations where it is at the contract level** (this is in the case where an individual risk assessment was carried out at the inception of the contract and the assessment cannot be repeated before amending the premiums or benefits).
- If there is **no material transfer of insurance risk or financial guarantees in the contract**, then any obligations that do not relate to premiums which have already been paid do not belong to the contract, unless the insurer can compel the policyholder to pay the future premium. So effectively, these contracts are treated as being ‘paid-up’ and embedded profit from future premium is not included on the Solvency II balance sheet. **It is not immediately clear that the ‘significant’ insurance risk test in IFRS is the same as this boundary definition in Solvency II.**
- There is a requirement to **unbundle** contracts into components where the contract boundary definition would differ between parts. This is a different concept to the unbundling requirements in IFRS.

##### Probability-weighted future cash flows

- In IFRS, the contract liability is measured on the basis of an explicit, unbiased and probability weighted estimate of the future cash outflows less the future cash inflows that will arise as the insurer fulfils the contracts. It is the expected value. **The considerations regarding the valuation techniques to be used are likely to be similar to Solvency II.** However, IFRS provides less explicit guidance on the technique to be applied than Solvency II.
- The considerations over grouping and approximations apply equally under IFRS.
- **A gain is not permitted at inception and would be eliminated by the residual margin.**
- A minimum level of segmentation is defined by the requirement to determine the residual margin at a portfolio level **(where a portfolio comprises contracts (a) subject to similar risks and priced similarly relative to the risk taken; and (b) managed together as a single pool).**

##### Contract boundary

- The boundary is at the point where the contract **no longer confers substantive rights on the policyholder.**
- **For insurance contracts**, this is considered to be either when:
  - the insurer is no longer required to provide coverage; or
  - the insurer is able to fully reassess and re-price the risk attaching to an individual policyholder.There are additional conditions that apply where the reassessment and re-pricing of risk is at the portfolio level.
- **For investment contract with a discretionary participation feature (DPF)**, this is considered to be either when:
  - the policyholder no longer has a contractual right to receive benefits arising from the DPF; or
  - premiums charged confer upon the policyholder substantially the same benefit as those that are available, on the same terms, to those who are not yet policyholders.
- **There is a risk that the contract boundary for Solvency II and IFRS for insurance contracts may diverge. Both definitions permit, under certain conditions, a boundary based on a re-pricing assessment at the contract and portfolio level.** Insurers will need to look closely at the two definitions across their full range of contracts to assess whether the revised definition will change the existing contract boundary.

## Appendix A: Insurance contracts

### Solvency II

### IFRS

#### 4. Future cash flows continued

##### Recognition and derecognition

- A contract is initially recognised at the earlier of the date when the insurer or reinsurer becomes party to the contract and the date when the cover begins.
- For binder business, the contract between the insurer and the binding authority is not an insurance contract, and consequently the underlying insurance contracts are recognised as per the previous paragraph.
- A contract is derecognised when the contractual obligations are extinguished, discharged, cancelled or expired.

##### Assumptions underlying the best estimate

For economic assumptions, there is expected to be guidance as to what constitutes active, deep, liquid and transparent financial market data to be used unadjusted in the valuation, and where data does not have these characteristics, how the data should be treated. This is important:

- Where insurance liabilities are longer dated than available market data and extrapolation is required, such as in respect of economic assumptions for the risk-free rate and equity implied volatilities; or
- Where current or historic average data could be applied, such as in respect of equity and swaption implied volatility assumptions; or
- Where there is no current market data, such as for asset correlation assumptions.

The derivation of the risk-free rate, including the use of market data, is expected to be provided by EIOPA on a frequent basis.

For non-economic assumptions, an entity-specific approach is required, but with reference to external data sources where this is relevant.

The interaction between economic and non-economic variable (for example, persistency dependent on economic conditions), management actions and policyholder behaviour must be included.

##### Scope of cash flows

- There is explicit guidance over which premiums, benefits, expenses and tax cash flows should be incorporated.
- The cash flows are on a going concern basis and there is no allowance for the risk of non-performance by the insurer (own credit risk).

##### Recognition and derecognition

- Insurance contracts are initially recognised when the coverage period begins. If facts and circumstances indicate that the contract is onerous, a liability is recognised earlier.
- Investment contracts with a DPF are recognised when the insurer becomes a party to the contractual provisions of the instrument (as applied in IFRS 9).
- **The IFRS requirements regarding the point of recognition are different from Solvency II.**
- Similar to Solvency II, a contract is derecognised when the contractual obligations are extinguished, discharged, cancelled or expired.
- An insurer is required to derecognise an existing contract and recognise a new contract as a result of certain modifications, including if the modification changes whether the contract is in scope of the insurance standard or whether the contract can apply the PAA.

##### Assumptions underlying the best estimate

- **The approach to market variables in IFRS is similar to Solvency II.** In particular, IFRS specifically states that such variables 'shall be consistent with observable market prices'. **There is less practical guidance in IFRS than in Solvency II, and therefore there is potential for a wider range of interpretations. However, insurers would have to consider how to justify different interpretations where the two frameworks are similar in principle.**
- Similar to Solvency II, an entity-specific approach is required for non-economic assumptions, and management actions and policyholder behaviour are required to be included in the expected cash flows.

##### Scope of cash flows

- All cash flows that the insurer will incur directly as it fulfils the contracts in a portfolio are included. Consistent with Solvency II, the cash flows are on a going concern basis and there is no allowance for own credit risk.
- For participating contracts, both guaranteed and discretionary cash flows are included, regardless of whether they are paid to current or future policyholders.
- **Many of the cash flows are the same as in Solvency II, for example, regular premiums and benefits. However, there are potential differences relating to expense cash flows, as illustrated in the following section. The treatment of taxes paid on behalf of policyholders remains an outstanding topic to be discussed by the IASB and could be a potential difference with Solvency II.**

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#### 4. Future cash flows continued

##### Expense cash flows

- All expenses that will be incurred in servicing all obligations over the lifetime of the contracts are included. Including both overhead expenses and expenses that are directly assignable to individual claims, policies or transactions (for example administration, investment management, claims management, claims handling and acquisition expenses, including commission expected to be incurred in the future).
- Overhead expenses include salaries to general managers, auditing costs and regular day-to-day costs (e.g. office rent). They also include expenses related to the development of new insurance and reinsurance business, advertising and improvements to internal processes (e.g. buying new IT systems). Both future expected cost increases and reductions may be included, but any expected cost reductions should be realistic, objective and based on verifiable data and information.
- Expense assumptions should consider the availability and relevance of any available market data representative of the portfolio.

##### Investment return cash flows

- Investment return cash flows are not taken into account unless the liability to the policyholder depends on the cash flows, for example participating and certain unit-linked contracts.
- When investment return cash flows are required, the selection of the investment return in a stochastic calculation is commonly the 'risk-free' rate ('risk neutral' projection) or an expected asset growth rate ('real world'/'deflator' projection). The selection of the investment return is consistent with the discount rate to provide a 'market consistent' style method.

##### Tax cash flows

- Only tax payments that are charged to policyholders or that would be required to be made by the undertaking to settle the obligations are included. All other tax payments are included elsewhere on the balance sheet.
- Transaction-based taxes and levies that arise directly from existing contracts or can be attributed to the contracts on a reasonable and consistent basis are included.
- Where changes to tax requirements are substantially enacted, the change is reflected in the best estimate.

##### Expense cash flows

- All expenses that relate directly to the fulfilment of the portfolio of insurance contracts are included. Examples of such expenses are claims handling costs, policy administration and maintenance (including recurring commission) costs, costs of directly engaged personnel and costs incurred in providing contractual benefits in kind. Some costs such as salaries will cover more than one portfolio, but directly relate to insurance contracts or contract activities. Such costs are allocated to portfolios on a rational and consistent basis.
- A systematic allocation of directly attributable fixed and variable overheads is also included. Costs that do not relate directly to the contract or contract activities (such as indirect overheads like staff training costs or advertising costs) are excluded.
- Costs arising from abnormal amounts of wasted labour or abnormal amounts of other resources are excluded from the cash flows.
- Directly attributable acquisition expenses in acquiring a portfolio of contracts are included in the cash flows and serve to reduce new business strain (implicit deferral through the residual margin). Acquisition costs incurred before a contract is recognised are recorded as part of the contract liability for the portfolio.
- **The scope of expense cash flows is different from Solvency II, specifically acquisition costs and certain non-direct overhead expenses.**

##### Investment return cash flows

- Consistent with Solvency II, investment return cash flows are not included when the policyholder benefits do not depend on them.
- When policyholder benefits do depend on investment return cash flows, this dependency is reflected in the measurement of the contracts. Techniques include replicating portfolios or a stochastic method (to capture potential asymmetries) using actual investment cash flows consistent with the discount rate and the measurement of the underlying assets.
- The use of replicating portfolios is considered in a subsequent section. **It is likely that the most common approach will be a stochastic method similar to Solvency II; however, the linkage to the IFRS asset valuation will cause a difference where the underlying assets are not at economic (fair) value (required for Solvency II), as is commonly the case for Continental European participating contracts.**

##### Tax cash flows

- Income tax payments and receipts are recognised and measured under IAS 12 (Income Taxes). In some territories policyholder benefits are dependent on future net of tax investment returns (and expenses) and the proposals may not permit these future tax flows to be reflected in the measurement of the liability if they meet the definition of an income tax under IAS 12. **The treatment of taxes paid on behalf of policyholders remains an outstanding topic to be discussed by the IASB. The outcome of this discussion may differ from Solvency II.**
- As for Solvency II, transaction-based taxes and levies are included.
- Under IFRS, specifically IAS 12, there is a comparable concept of 'substantively' enacted.

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#### 5. Discount rate

The discount rate is defined as the current risk-free interest rate term structure for each currency. The risk-free rate is defined as:

- Swap curve (as the starting point in developed financial markets) less a deduction for credit default and basis risk.
- Plus an additional counter-cyclical premium ('adaption to the rate') or matching adjustment to the term structure depending on the characteristics of the liabilities and current financial markets.

**There remains considerable uncertainty at the date of this publication over the determination of the risk-free interest rate term structure, including potential transitional arrangements** (as discussed in a subsequent section). However, given the importance of the risk-free rate to Solvency II, the method of calculation is expected to be heavily prescribed and the rates that insurers must use will be published regularly by EIOPA. In this section we set out our current understanding of the developments and potential options under investigation:

#### Swap curve

- The key areas of debate on the swap curve are: (i) approach to extrapolation (entry point, period of transition and ultimate long term target); and (ii) how an allowance for credit and basis risk should be made.
- In certain less developed financial markets, the starting point may be the local government bond curve rather than the swap curve.

#### Counter-cyclical premium (CCP)

- The CCP is designed to adjust the swap curve for 'excess spread' in government and corporate bond markets.
- There are a number of uncertainties over the CCP, including: (i) when it would apply (the 'trigger'); and (ii) its calibration ('quantum'), for example, the selection of asset portfolio to determine the CCP and which risks in corporate and government bond yields are excluded.
- The CCP cannot be applied to products using a matching adjustment, but the interaction between the two is not fully clear.

#### Matching adjustment (MA)

- The MA is designed to reflect the stable characteristics of certain liabilities which permits insurers to be long-term investors and reduce or eliminate exposure to short term spread movements in assets (while default risk does remain).
- There are two approaches currently under discussion:
  1. A narrow application to certain products meeting strict criteria (risks exposed to, assets held and matching of cash flows), typically, this would be certain immediate annuity-style contracts.
  2. A wider application reflecting that a portion of liability cash flows for a wide variety of contracts is stable due to product features (e.g. surrender penalties) and associated policyholder behaviour (e.g. lapses). There are practical challenges to a wider application, including the interaction with the SCR Standard Formula.
- The MA is calibrated as the yield on the matching assets (actually held) less an allowance for credit default. It is expected that minimum assumptions will be prescribed to be used in the components forming the credit default risk allowance.

- The discount rate is defined to be consistent with the current observable market prices for instruments with cash flows which reflect the characteristics of the liability (timing, currency and liquidity).
- **Unlike the requirements in Solvency II, there is no prescribed method in IFRS for the determination of the discount rate.** It can be determined using:
  - A 'bottom-up' approach, adjusting a risk-free yield curve (typically for an illiquidity premium reflecting the different liquidity characteristics between assets and insurance liabilities); or
  - A 'top-down' approach, adjusting a yield curve that reflects current market returns on either the actual portfolio of assets held or a reference asset portfolio. Adjustments would be made for credit default risk and an allowance for cash flow mismatches between the assets (actual or reference) and the liabilities. Calibration of expected and unexpected credit default risk will be an area of focus in the approach.
- **It is unlikely that a top down and bottom up approach will provide the same yield curve in all circumstances.**
- **It is also not clear whether the prescribed Solvency II yield curves would be appropriate in IFRS. For example, whether a wider application of the matching adjustment could be equivalent to a top-down approach.**
- In IFRS, for contracts where the liability depends on the performance of specific assets (e.g. participating and unit-linked products) the valuation should reflect the dependence. **As noted previously, this is likely to be a stochastic method similar to Solvency II; however, the linkage to the IFRS asset valuation will cause a difference where the underlying assets are not at economic (fair) value (required for Solvency II).**
- For IFRS and Solvency II, the contract liabilities are measured using a current discount rate. In IFRS, **changes in the current discount rate (from that at inception) are presented in Other Comprehensive Income (OCI)** rather than in profit or loss. Consequently, several discount rate assumption sets will be required to measure contract liabilities. **There is no equivalent concept in Solvency II.**

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#### 6. Allowance for risk (risk margin/adjustment)

- Risk margin is calibrated to ensure that the technical provisions are equivalent to the **expected amount required by another insurer to take over and meet the obligations**. No risk margin is required where the technical provision has been determined as a whole using a replicating portfolio. The use of replicating portfolios is considered further in a subsequent section.
  - The methodology and calibration of the risk margin is prescribed under Solvency II. A cost-of-capital approach is required with a cost-of-capital rate of 6% specified.
  - The capital requirement is designed to cover a confidence level of 99.5% over a one-year time horizon and captures underwriting risk, residual market risk (other than interest rate), operational risk and certain counterparty default risk. The capital requirements are based on an approved internal model calibration otherwise the Standard Formula is adopted.
  - An unadjusted risk-free discount rate is used, excluding any allowance for matching adjustment or counter-cyclical premium.
  - The risk margin reflects the level of diversification of the insurer ('entity level' diversification) and so reflects diversification between lines of business.
  - No allowance is made for the loss-absorbing capacity of deferred tax.
  - The risk margin is a current measure, which is revised each period and run off in line with the risk exposure. A single net of reinsurance risk margin is determined.
- The risk adjustment is calibrated as the compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contracts.
  - There is no prescribed technique or limit on the range of techniques, however application guidance will describe three example techniques: confidence level, conditional tail expectation and cost of capital. **In view of Solvency II, we expect most European-based insurers will adopt a cost of capital approach in IFRS, albeit with a potentially different calibration.**
  - Two key components of the cost-of-capital method are the assumed cost rate and the capital amount (that is the confidence level and the capital projection method). **Unlike Solvency II, there is the potential to set different confidence levels and costs for different types of contracts.**
  - The risk adjustment reflects all risks associated with the insurance contract. **The range of risks in scope is potentially narrower than under Solvency II.** There is no risk adjustment associated with reinsurer default (non-performance of the reinsurer is considered elsewhere in the model), investment risk (except where it affects the amount to policyholders, such as on participating business) and general operational risk relating to future transactions.
  - No unit of account is prescribed for the calculation of the risk adjustment, resulting in the potential for **similar or more diversification benefits compared to Solvency II.**
  - Unlike Solvency II, there is no explicit prohibition on taking into account the loss-absorbing capacity of deferred tax.
  - The risk adjustment is a current measure, as for Solvency II, which is revised each period and runs off in line with the risk exposure. Changes in the risk adjustment are recognised in profit and loss in the period of change. **Unlike Solvency II, there are two risk adjustments relating to the gross of reinsurance and reinsurance positions.**
  - There is a separate requirement to disclose the confidence level to which the risk margin corresponds, even if an alternative technique is adopted. **This will introduce additional complexity and valuation runs compared to Solvency II.**

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#### 7. Residual margin

No concept of a residual margin, so day one gains can exist.

- The residual margin is calibrated at inception to an amount that **avoids recognising a gain when an insurer enters into the insurance contract**. A loss at inception is immediately recognised.
- The residual margin is determined at a 'portfolio level'. The release of the residual margin is to the period in which the service is provided and there is no prescribed level (unit of account). It is unclear how this will be interpreted in practice by insurers.
- **The residual margin cannot be negative (i.e. it cannot be an asset)** and interest is accreted using the discount rate determined at inception (the 'locked-in' rate).
- Favourable and unfavourable changes in estimates of future cash flows are offset prospectively in the residual margin ('unlocking'). However, changes in experience or in the risk adjustment cannot be offset. **In practical terms, the impact of changes in demographic (e.g. mortality and morbidity) and expense assumptions is absorbed by the residual margin rather than being directly reflected in the income statement. Adverse mortality experience in a certain year and all changes in the risk adjustment are reflected directly in the income statement.**
- There will be significant data requirements for the determination, release and unlocking of the residual margin. A negative residual margin will need to be monitored as changes in estimates of a future cash flows could result in the residual margin becoming positive and presented as a liability on the balance sheet in future periods.

#### 8. Discretionary participating business

Future discretionary benefits ('participating feature') are benefits, excluding index-linked and unit-linked benefits, with one of the following characteristics:

- The amount or timing is at the discretion of the insurer; or
- The benefits are legally or contractually based on one or more of the following results: (i) the performance of a specified group of contracts or a specified type of contract or a single contract; (ii) realised or unrealised investment returns on a specified pool of assets held by the insurer; or (iii) the profit or loss of the insurer or fund that issued the contract.

The best estimate includes all future discretionary benefit cash flows, **except those relating to surplus funds where this has been authorised under national law** (which possess the characteristics of Tier 1 basic own funds).

A stochastic valuation is likely in most cases to value options and guarantees due to the dependency of the policyholder benefits on future investment return through the participating feature. Management actions and policyholder behaviour are included in the assessment.

- The definition of a discretionary participating feature is expected to be unchanged from IFRS 4 (Insurance Contracts). Participating investment contracts issued by insurers are also included in the scope of the insurance standard.
- The measurement of the participating cash flows should mirror the measurement of the underlying items in the financial statements ('mirroring'). **The direct linkage to the asset valuation may cause a difference from Solvency II when the IFRS asset valuation is not economic (fair) value (required in Solvency II), as is commonly the case for Continental European participating contracts.** In addition, changes in the liability are presented in either the income statement or OCI consistent with the presentation of the linked asset. The mirroring takes precedence over the OCI treatment for changes in the discount rate.
- All options and guarantees are measured at a current value through profit or loss. As for Solvency II, it is likely that a stochastic valuation will be required.
- As for all contracts, where there is no replicating portfolio, a risk adjustment and residual margin is required.
- The measurement of the liability should **include all payments that result from the contract, including expected future participations whether they are paid to current or future policyholders.** There is no equivalent reference in Solvency II.
- **The treatment of participating contracts in IFRS remains a developing area.**

## Appendix A: Insurance contracts

### Solvency II

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#### 9. Replicating portfolios

- Where a replicating portfolio of financial instruments exists and meets certain criteria it is used to value the technical provisions as a whole. There is no additional risk margin.
  - Criteria for permitting the use of replicating portfolios are restrictive. The cash flows of the financial instruments are required to replicate reliably the uncertainty in amount and timing of the liability cash flows in all possible scenarios. Cash flows depending on underwriting risk cannot be reliably replicated. Furthermore, the financial instruments should be traded in active markets that are deep, liquid and transparent. Where the criteria are met and unbundling is feasible, then the replicating portfolio is used for those cash flows and a best estimate and risk margin method is used for the remaining cash flows.
  - The primary example provided is the unit balance on a pure unit-linked contract. There are likely to be limited other cases where a replicating portfolio approach is permitted.
- Replicating portfolios are a permitted technique for contracts where the policyholder liability depends on the performance of a specified pool of assets. A replicating portfolio is one whose cash flows exactly match those contractual cash flows in amount, timing and uncertainty. There is no prescription for the use of replicating portfolios. **It is expected that the use of replicating portfolios will be limited in IFRS as for Solvency II.**
  - As for Solvency II, cash flows can be split between those that can be replicated and the remaining ones. For the replicated cash flows, no additional risk adjustment is required. For the remaining cash flows, the probability-weighted cash flows and risk adjustment model is followed.
  - There is no requirement to use a replicating portfolio. However, where they are available and an alternative method is followed, then the methods should produce materially the same answer.

#### 10. Reinsurance

- Reinsurance recoveries are in general recognised and measured as for the gross cash flows and then presented as a separate asset on the balance sheet. Depending on the nature of the risks transferred in a reinsurance arrangement, there is a possibility that the measurement could be different from the gross cash flows such as the contract boundary (if there is no insurance risk transferred as an illustration) or the Matching Adjustment in the discount rate (if a wider application method is adopted).
  - The reinsurance-related cash flows include the risk of expected reinsurer counterparty default. Cash flows are based on an assessment of the probability of default of the counterparty and the resulting average loss ('loss-given-default' approach).
  - There is only a single net of reinsurance risk margin on the balance sheet, which includes reinsurer credit risk.
  - There is no concept of a residual margin.
- As for Solvency II, reinsurance recoveries are recognised, measured and presented separately.
  - The reinsurance-related cash flows are calculated on an expected present value basis of the future cash inflows, plus a risk adjustment (which represents the risk being removed through reinsurance).
  - Non-performance by the reinsurer is captured by applying the financial instruments impairment model when determining recoverability.
  - Instead of recognising a day one gain on entering into a reinsurance contract, it is deferred and amortised through a reinsurance residual margin. In the case of a loss it is either recognised immediately (if the contract is for past events) or spread over the coverage period (if it relates to future events).

#### 11. Business combinations and portfolio transfers

- There is no concept in Solvency II of business combinations or portfolio transfers. All contracts are treated as if written within the current entity and follow the same recognition, measurement and presentation approach.
- Business combination matters are yet to be re-deliberated by the IASB. It is unclear as to whether proposals within the Insurance Contracts Exposure Draft (2010) will change in this area.
  - The Exposure Draft proposed that for insurance contracts assumed in a portfolio transfer or acquisition, the residual margin of the insurance contract is calibrated to be the excess of the consideration received (portfolio transfer) or fair value (business combination) over the best estimate plus risk adjustment. If best estimate plus risk adjustment is greater than the consideration received or fair value, then a loss is recognised or goodwill is increased respectively.

## Appendix A: Insurance contracts

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#### 12. Transitional arrangements

- There is the possibility that a transitional arrangement may exist over the discount rate. For example, a period of time over which Solvency II requirements are phased in for Solvency I requirements for those liabilities under the Consolidated Life Directive. It is not clear how a 'phased-in' approach would interact with the counter-cyclical premium and matching adjustment.
- In addition, there is the possibility that:
  - The discount rate or one of its components (such as the matching adjustment) may have a defined review arrangement after the implementation date of Solvency II.
  - Other transitional arrangement for technical provisions may exist in the final Solvency II framework.
- **Unlike the proposed set up for Solvency II, there is no grandfathering of existing rules for the discount rate. The use of Solvency I discount rates for a period of time under Solvency II may represent a significant difference from IFRS (depending on the liabilities under consideration).**
- **There is full retrospective application of the insurance standard which includes the calculation of the residual margin.** Insurers are required to determine the residual margin on transition using a full retrospective adoption **as far back as practicable.**
- A practical expedient applies for estimating the residual margin for those periods when **full retrospective** determination of the residual margin cannot be performed (because the estimate of the residual margin would not be based solely on objective information).
- In addition, if it is not practicable to apply the standard retrospectively for any other reason (for example, the data cannot be recreated in a suitable form) the residual margin is determined by reference to the carrying amount of the liability before transition (so the existing GAAP basis).
- It is assumed that all changes in cash flow estimates between contract inception and the date of transition are known at initial recognition and hence unlocked within the residual margin on transition.
- To present changes in the discount rate through OCI, discount rates at inception for the historic business will be required. A practical expedient is proposed whereby an insurer can use a suitable observable rate for historical periods beyond three years prior to the date of transition.
- On transition to the insurance standard, insurers will continue to apply IFRS 9 asset classifications. However, some additional provisions will specifically apply on transition for designating assets under the fair value option (or revoking previous designations) and elections to use fair value through OCI measurement for equity instruments.
- There will be minimum disclosure requirements for transition.

## Appendix B: Investment contracts

### Solvency II

### IFRS

#### 1. Relevant standards / sources of information

- As for Appendix A – Insurance contracts
- IAS 32 – Financial Instruments: Presentation
- IFRS 13 – Fair Value Measurement
- IFRS 9 – Financial Instruments (2010)
- IAS 39 – Financial Instruments: Recognition and Measurement
- IAS 18 – Revenue
- IASB IFRS 9 Classification and Measurement Project
- Revenue from Contracts with Customers Exposure Draft ('Revenue Recognition ED')
- Matters as for insurance contracts (in defining the scope of insurance contracts and therefore implicitly the scope of investment contracts)
- There remains uncertainty as to the treatment of investment contracts in IFRS due to the range of new developing standards

#### 2. Scope

- Solvency II applies to all insurance and reinsurance contracts written by EEA insurers and its group supervision requirements apply to insurance groups containing EEA insurers. In addition, certain of Solvency II's requirements apply to contracts written by non-EEA insurers through branches in the EEA. There is no distinction between insurance and investment contracts except for determining the cash flows that are within the boundary of a contract as discussed in Appendix A.
- There are scope exclusions for certain undertakings by virtue of their size, legal status, nature or specific services they offer.
- Contracts not transferring significant insurance risk are commonly known as investment contracts.
- Investment contracts are usually separated into an investment management service component (measured in accordance with IAS 18) and a financial instrument component (measured in accordance with IAS 39 or IFRS 9). Distinct investment components and embedded derivatives unbundled from insurance contracts are also measured in accordance with IAS 39 or IFRS 9 (and IAS 18 where relevant).
- Investment contracts issued by insurers containing a discretionary participation feature are within the scope of the Insurance Contracts Standard.

#### 3. Measurement approach

- The same recognition and measurement principles apply for insurance and investment contracts in Solvency II.
- Unless full replication is possible, the technical provisions are the probability-weighted average of future cash flows taking account of the time value of money plus a risk margin as for insurance contracts.
- It is likely that most investment contracts will be treated as being premium paid up as a result of the contract boundary definition.
- There is no deposit floor. For example, the total liability for a unit linked contract can be below the account balance (unit fund).
- All financial liabilities are measured initially at fair value. Subsequent measurement is either at fair value (typically for unit-linked contracts) or amortised cost using the effective interest method (typically for guaranteed non-linked and non-participating investment contracts).
- For those contracts measured at fair value there is a deposit floor (a surrender value). A deposit floor means that the fair value of a financial liability with a demand feature is not less than the net present value of the amount payable on demand.
- For contracts measured at fair value, currently the bid value of units is used for typical unit-linked contracts. **IFRS 13 on fair value measurement does not preclude the use of mid-market pricing or other pricing conventions used by market participants as a practical expedient for fair value measurements within a bid-ask spread.**
- For contracts measured at amortised cost, any embedded derivatives are separated and valued at fair value if the separate instrument meets the definition of a derivative and the characteristics are not closely related to the host contract.

## Appendix B: Investment contracts

### Solvency II

### IFRS

#### 4. Profit recognition

There is no concept of deferring revenue to match the provision of services. Any day-one gain or loss is recognised at inception.

Under IAS 39 (or IFRS 9) any gain or loss on initial recognition of the financial instrument component can only be recognised where the fair value is determined based upon observable market data.

For the investment management service component, profit is recognised as services are provided:

##### Deferral of acquisition costs

- The Revenue Recognition ED requires an entity to recognise an asset for the incremental costs of obtaining a contract with a customer if it expects to recover those costs. The asset is amortised on a systematic basis consistent with the pattern of transfer of the goods and services. The treatment of acquisition costs is expected to be the same as IAS 18 (Revenue), the current standard. **However, the definition of deferrable acquisition costs for investment contracts is narrower than for insurance contracts and consequently results in higher expected new business strain for these contracts, all else being equal.** The extent to which there is unbundling of investment management service components for insurance contracts is important given the different levels of deferral.
- In addition, compared to the proposed method for insurance contracts, the deferral for investment contracts is as an explicit asset rather than 'implicit' deferral through the residual margin.

##### Deferral of origination fees

- The Revenue Recognition ED proposes additional paragraphs to be included within IAS 39 application guidance. These clarify that an entity should continue to distinguish fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services. The proposals therefore suggest that origination fees relating to investment management services should continue to be accounted for within the revenue recognition standard. As such, fees are deferred and earned as services are provided, for example, over the expected term of the policy.

#### 5. Other matters

There is no allowance for the risk of non-performance by the insurer (own credit risk).

The following other matters are noted:

- Where investment contract liabilities are held at fair value under IAS 39, the change in fair value (including changes relating to own credit risk) is recognised in profit or loss. In IFRS 9, if a financial liability is designated at fair value (via the fair value option), the portion of the change in fair value due to changes in own credit is recorded in Other Comprehensive Income. This is expected to be relevant only in a limited number of cases (certain non-linked investment contracts and embedded derivatives).
- For unit-linked insurance contracts, an insurer may recognise treasury shares and owner-occupied property at fair value through profit or loss to eliminate an accounting mismatch. It remains unclear whether this change will also apply to unit-linked investment contracts.

## Appendix C: Assets and other liabilities

Item	Solvency II	IFRS
Relevant standards/ sources of information	<ul style="list-style-type: none"> <li>As for Appendix A – Insurance contracts</li> </ul>	<ul style="list-style-type: none"> <li>IFRS standards in existence as of publication date</li> <li>IASB IFRS 9 Classification and Measurement Project</li> <li>IASB Leases Project</li> </ul>

### 1. Assets

General	<ul style="list-style-type: none"> <li>Assets and liabilities other than technical provisions are expected to be valued at economic value under Solvency II. Unless otherwise specified, there is a presumption that economic value equates to IFRS under most circumstances. However, the regulator retains a measure of discretion to determine situations where this is no longer the case; for example, in cases of extreme market disruption.</li> </ul>	
Goodwill on acquisition	<ul style="list-style-type: none"> <li>Goodwill is not considered an identifiable and separable asset in the marketplace. <b>The economic value of goodwill for solvency purposes is nil.</b></li> </ul>	<ul style="list-style-type: none"> <li>Initial measurement at cost (the excess of the fair value of consideration transferred over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities). Subsequent measurement is at cost less any impairment loss.</li> </ul>
Intangible assets	<ul style="list-style-type: none"> <li>Intangible assets are ascribed value only when they can be sold separately and a valuation can be derived from a quoted market price in an active market for the same or similar intangible.</li> <li><b>In practice, there will be very few cases where intangible assets meet the criteria to be ascribed value under Solvency II.</b></li> </ul>	<ul style="list-style-type: none"> <li>An acquired intangible asset is recognised when it is probable that the expected future economic benefits will flow to the entity and the cost of the assets can be measured reliably.</li> <li>Initial measurement is at cost. Subsequent measurement is at either (i) cost model: cost less any accumulated depreciation and impairment loss; or (ii) revaluation model: fair value at date of revaluation less any subsequent accumulated depreciation or impairment where fair value is determined by reference to an active market.</li> </ul>
Property plant and Equipment ('PPE')	<ul style="list-style-type: none"> <li>PPE should be measured at economic value for solvency purposes.</li> <li>PPE valued at cost in financial statements must be re-measured at fair value (equivalent to economic value) for solvency purposes.</li> <li><b>The revaluation model under the IFRS on PPE is considered to be a reasonable proxy for economic value.</b></li> </ul>	<ul style="list-style-type: none"> <li>PPE includes owner-occupied property. Initial measurement is at cost. Subsequent measurement is using either the cost or the revaluation model described in the entry for intangible assets above.</li> </ul>

## Appendix C: Assets and other liabilities

Item	Solvency II	IFRS
<b>1. Assets continued</b>		
<b>Leases</b>	<ul style="list-style-type: none"> <li>• Finance lease assets and liabilities are measured at fair value. Lessor accounting for finance leases is consistent with IAS 17. However, lessee accounting needs adjustments as lessees have to fair value all lease assets – the present value of the minimum lease payment under IAS 17 is not considered consistent with Solvency II valuation principles.</li> <li>• Operating leases are measured consistently with IAS17.</li> </ul>	<ul style="list-style-type: none"> <li>• Finance leases are measured initially at the lower of fair value and the present value of the minimum lease payment under IAS 17. Operating leases are not capitalised on the balance sheet, with lease payments generally recognised as an expense straight-line over the lease term.</li> <li>• <b>In 2010, an exposure draft was released proposing amendments to IAS 17, which, coupled with further decisions since 2010, would significantly alter lease accounting as set out below.</b></li> <li>• <b>Lessee accounting</b> – Leases of more than 12 months are recognised on-balance-sheet with a liability for the present value of the lease payments and a 'right-of-use' asset at inception.</li> <li>• <b>Lessor accounting</b> – There are two potential approaches for lessors. The receivable and residual approach requires lessors to derecognise the leased asset and instead recognise both a lease receivable and a gross residual asset. Otherwise, the underlying asset remains on the lessors balance sheet and income is recognised straight-line, similar to today's operating lease accounting.</li> </ul>
<b>2. Investments</b>		
<b>Investment property</b>	<ul style="list-style-type: none"> <li>• Investment property is measured at economic value. Investment properties that are measured at cost in the financial statements must be remeasured at fair value for solvency purposes. <b>The fair value model under the IFRS on Investment Property is considered a good proxy for economic value for Solvency II.</b></li> </ul>	<ul style="list-style-type: none"> <li>• Measurement is initially at cost. Subsequent measurement is using either the cost (as per PPE above) or the fair value model.</li> </ul>
<b>Participations / related undertakings in subsidiaries, associates and joint ventures</b>	<ul style="list-style-type: none"> <li>• Related undertakings are classified into three classes for valuation: <ul style="list-style-type: none"> <li>– Listed companies, valued using quoted market prices in active markets;</li> <li>– Unlisted subsidiaries, valued on an 'adjusted equity method' (parent's share of subsidiary's net assets); and</li> <li>– All other related undertakings (not subsidiaries) should, wherever possible, use the 'adjusted equity method' with an option to mark to model if the adjusted equity method is not possible.</li> </ul> </li> <li>• The 'adjusted equity method' default approach is that valuation must be in accordance with Solvency II valuation rules. For related undertakings that are not insurers, where valuation under Solvency II is not practicable, it can be based on IFRS with deduction of goodwill and intangibles that would be valued at zero under the Solvency II rules.</li> </ul>	<ul style="list-style-type: none"> <li>• Participations in subsidiaries are valued under IAS 27 in the parent company's separate financial statements, either at cost or at fair value under IAS 39 (see the entry in respect of financial assets).</li> <li>• If a participation is purchased purely with a view to sell, it is valued under IFRS 5 at the lower of carrying amount and fair value less costs to sell, unless the participation has previously been valued at fair value under IAS 39, in which case it continues to be measured at fair value.</li> </ul>

## Appendix C: Assets and other liabilities

Item	Solvency II	IFRS
<b>2. Investments continued</b>		
<b>Financial assets</b>	<ul style="list-style-type: none"> <li>• <b>Financial assets should be measured at fair value for solvency purposes, even when they are measured at amortised cost in an IFRS balance sheet.</b> The fair value measurement approach in IAS 39 is considered a good proxy for economic value under Solvency II.</li> </ul>	<ul style="list-style-type: none"> <li>• Under existing IFRS 9 the following asset measurement categories are set out: - <ul style="list-style-type: none"> <li>– Amortised cost: Debt instruments giving rise on specified dates to cash flows that are solely payments of principal and interest; where the business model is to hold assets in order to collect contractual cash flows; and where the fair value option is not used to eliminate an accounting mismatch.</li> <li>– Fair value through profit or loss (FVPL): All other financial assets (except when an entity has elected for equity instruments to be held at fair value through OCI).</li> </ul> </li> <li>• As part of the limited modifications to IFRS 9 the IASB has introduced a third fair value through other comprehensive income (FVOCI) category where (i) the business model is to both collect contractual cash flows and sell financial assets; and (ii) debt instrument cash flows are solely payment of principal and interest.</li> <li>• FVPL options exist under both existing and modified IFRS 9 for accounting mismatches and the FVOCI option for equity instruments remains unchanged.</li> </ul>
<b>3. Other assets</b>		
<b>Non-current assets held for sale or discontinued operations</b>	<ul style="list-style-type: none"> <li>• These types of asset must be re-allocated to other asset categories depending on their nature and re-valued accordingly.</li> </ul>	<ul style="list-style-type: none"> <li>• Non-current assets are held at the lower of carrying amount and fair value less costs to sell.</li> </ul>
<b>Deferred tax assets</b>	<ul style="list-style-type: none"> <li>• Deferred tax is calculated <b>in accordance with the method used under IFRS based on the valuations in the Solvency II balance sheet.</b></li> </ul>	<ul style="list-style-type: none"> <li>• Deferred tax assets should be valued as the temporary difference between the IFRS value of an asset or liability and its tax base multiplied by the tax rate that will be applicable when the difference reverses. Deferred tax assets should be offset with deferred tax liabilities if and only if the entity has a legal right of set-off, which requires inter alia both the asset and the liability to relate to the same taxation authority, and if the entity intends either to settle net or to realise the asset and settle the liability simultaneously. Deferred tax assets are not discounted.</li> <li>• Deferred tax assets should be recognised only where it is probable that the entity will earn sufficient taxable profits in the future against which it can make the tax deductions.</li> </ul>
<b>Current tax assets</b>	<ul style="list-style-type: none"> <li>• Current tax assets are valued at the amount expected to be recovered.</li> </ul>	<ul style="list-style-type: none"> <li>• Current tax assets are valued at the amount expected to be recovered.</li> </ul>
<b>Cash and cash equivalents</b>	<ul style="list-style-type: none"> <li>• Cash is valued at <b>an amount not less than the amount payable on demand.</b></li> </ul>	<ul style="list-style-type: none"> <li>• Cash is a financial asset and is therefore valued under IFRS 9 / IAS 39 as described above.</li> </ul>
<b>Other assets</b>	<ul style="list-style-type: none"> <li>• <b>All assets where there are no specific valuation rules are valued in accordance with IFRS, provided that this is consistent with an economic valuation.</b> When applying an economic valuation of assets insurers should refer to a three level valuation hierarchy. The use of quoted prices is the default method of valuation. Where this is not possible, insurers should use quoted prices of similar assets. Where no quoted prices can be used, the insurer can develop an alternative valuation method that makes maximum use of market inputs.</li> </ul>	<ul style="list-style-type: none"> <li>• An entity may have other assets, for example prepayments or accrued income, which are subject to specific accounting rules under IFRS.</li> </ul>

## Appendix C: Assets and other liabilities

Item	Solvency II	IFRS
<b>3. Other assets continued</b>		
<b>Off-balance-sheet financing</b>	<ul style="list-style-type: none"> <li>Subject to supervisory approval, <b>certain items of off-balance-sheet financing (for example, letters of credit) may be recognised as ancillary own funds under Solvency II.</b> Consistent with Solvency II valuation principles, valuation should be at economic value at either an amount or using a method approved by the supervisor.</li> </ul>	<ul style="list-style-type: none"> <li>By definition, items of off-balance-sheet financing are not recognised on the IFRS balance sheet.</li> </ul>
<b>4. Liabilities</b>		
<b>Financial liabilities</b>	<ul style="list-style-type: none"> <li>Financial liabilities should be valued at <b>fair value in conformity with IFRS upon initial recognition.</b> Subsequent measurement should take account of differences in the risk-free rate but <b>not the insurer's own credit standing.</b></li> <li><b>Financial liabilities that are valued at amortised cost basis according to IAS 39 or IFRS 9 must be valued at fair value for solvency purposes.</b></li> <li>Subordinated liabilities which satisfy the relevant requirements for recognition may be treated as own funds on the Solvency II balance sheet rather than as liabilities under IFRS.</li> </ul>	<ul style="list-style-type: none"> <li>Financial liabilities should be valued under IFRS 9 either at fair value or at amortised cost.</li> <li>Where financial liabilities are included at fair value, this valuation will reflect the credit risk of the liability and therefore take account of the insurer's own credit standing.</li> <li>For the valuation of financial liabilities designated at fair value (via the fair value option) including subordinated liabilities, changes in the liability's own credit risk should be reported in OCI rather than profit and loss.</li> </ul>
<b>Provisions other than technical provisions</b>	<ul style="list-style-type: none"> <li>Both the recognition criteria and the measurement approach in IAS 37 for provisions (other than technical provisions) are considered to be consistent with Solvency II regulations.</li> <li>As a result, provisions other than technical provisions are <b>valued in accordance with IFRS.</b></li> </ul>	<ul style="list-style-type: none"> <li>Provisions other than those relating to insurance contracts should be recognised under IAS 37 where it is probable that an outflow of economic resources will be necessary to settle a present obligation of an entity that can be reliably measured. Provisions should be valued at a best estimate of the amount required to settle the obligation at the balance-sheet date, being the amount that the entity would rationally pay to settle the obligation.</li> </ul>
<b>Contingent liabilities</b>	<ul style="list-style-type: none"> <li>Material contingent liabilities, as defined under IFRS, should be recognised as liabilities for Solvency II. Valuation should be based on the expected present value of future cash flows required to settle the contingent liability, discounted at the basic risk-free interest rate term structure.</li> </ul>	<ul style="list-style-type: none"> <li>Contingent liabilities should not be recognised under IAS 37, but should be disclosed and continuously assessed. <b>Under IFRS, contingent liabilities are off balance sheet (unless on acquisition); however, these will be recognised on balance sheet under the approach proposed for Solvency II.</b></li> </ul>
<b>Deferred tax liabilities</b>	<ul style="list-style-type: none"> <li>Deferred tax liabilities should be valued in accordance with IFRS (undiscounted) based on the Solvency II balance sheet. Whilst the methodology for calculating deferred tax balances is consistent with IFRS, as it is determined by reference to the Solvency II balance sheet, other measurement differences within the Solvency II balance sheet may cause the Solvency II deferred tax balance to differ from IFRS.</li> </ul>	<ul style="list-style-type: none"> <li>Deferred tax liabilities should be valued as described above for deferred tax assets.</li> <li>With limited exceptions, all deferred tax liabilities should be recognised, even where the entity expects to have future tax losses that could relieve the liability.</li> </ul>
<b>Current tax liabilities</b>	<ul style="list-style-type: none"> <li>Current tax liabilities should be valued at the <b>amount expected to be paid.</b></li> </ul>	<ul style="list-style-type: none"> <li>Current tax liabilities are measured at the amount expected to be paid.</li> </ul>
<b>Employee benefits and termination benefits</b>	<ul style="list-style-type: none"> <li>Liabilities for employee and termination benefits should be valued in accordance with IFRS. Following the recent amendment to IAS 19 where the use of the corridor approach was removed, IAS 19 is now considered consistent with Solvency II. Under QIS 5 there was an option for insurers to use their own internal model method in valuing their pension assets / liabilities. In the October 2012 technical specifications from EIOPA this options was removed. However, it remains to be seen whether this was done solely to achieve consistency in the next impact study or whether this represents a change in policy.</li> </ul>	<ul style="list-style-type: none"> <li>Recent amendments to IAS 19 have removed the corridor approach and altered the presentation of gains and losses, meaning that all changes in defined benefit obligations and in the fair value of plan assets are recognised immediately in OCI with other costs recognised immediately in the profit and loss account. <b>This change makes the treatment of employee and termination benefits closer to the treatment under Solvency II, which does not allow the corridor approach to be used.</b> In addition, instead of calculating a separate interest expense and expected return on assets as part of the annual pension cost calculation, one amount is calculated based on the discount rate multiplied by the net pension surplus or deficit amount.</li> </ul>

## Appendix D: Group reporting

### Solvency II

### IFRS

#### 1. Relevant standards/sources of information

- As for Appendix A – Insurance contracts.
- IAS 27 – Consolidated and Separate Financial Statements
- IFRS 10 – Consolidated Financial Statements

#### 2. Scope of group reporting

A group consists of a participating undertaking, its subsidiaries and the entities in which it and its subsidiaries hold a participation, in addition to any other undertaking which is managed on a unified basis. A group may also be based on the existence of strong and sustainable financial relationships between undertakings.

**The scope of group supervision under Solvency II is restricted to insurance groups**, limited to subsidiaries or participations of an insurance company or an 'insurance holding company' (any company whose main business is to acquire and hold participations in insurers or reinsurers).

For the purposes of assessing the scope of the group, **the definitions of 'parent' and 'subsidiary' are based on EU Directives. In most cases the definition of parent and subsidiary will be consistent with those used under IFRS, but might differ in very particular scenarios.** A 'participation' exists whenever one entity controls more than 20% of the capital/voting rights of another undertaking (this could be extended to cases where the supervisor is of the opinion that significant influence is exerted over an entity where voting rights are below the 20% mark), and is **similar in concept to an associate under IFRS**. However, both of these definitions may be **extended or restricted by the group's supervisor to include or exclude any entity from within the scope of the group which may result in a difference under Solvency II and IFRS**.

The scope of consolidation under IAS 27 is based on the principle that the accounts should include the results of the **parent company and all of its subsidiaries**. A subsidiary is any entity that is controlled by the parent company, either through ownership of more than half of the voting rights of that entity, or through any other circumstance which enables the parent company to control the subsidiary in practice. The scope of consolidation under IAS 27 takes into account all subsidiaries of a parent, **regardless of whether their business activities differ from the activities of other entities in the group**.

IFRS 10 revises the definition of control. Consolidation is required only if the investor possesses power over the investee, has exposure to variable returns from its involvement with the investee and has the ability to use its power over the investee to affect its returns. IFRS 10 does not provide 'bright lines' and requires consideration of many factors. **The new standard will change how insurance groups that also own asset management entities assess the investment funds they manage for consolidation purposes and may change the number of funds that are consolidated.**

#### 3. Level of group reporting

Under Solvency II, **the level at which a group is required to prepare consolidated results depends on the structure of the group** and where the ultimate insurance parent company of the group is situated:

- If within the EEA, group reporting is at the level of the ultimate insurance parent. However, **Member State supervisors are able to require additional group reporting at a limited number of lower levels** where it is considered necessary.
- If outside the EEA and deemed **equivalent with Solvency II, then there is no requirement for group reporting under Solvency II at the level of the ultimate insurance parent**. However, to gain equivalence, one of the criteria is that a solvency assessment based on the group (in accordance with local regulation) is required.
- If in a non-equivalent non-EEA territory, consolidation **may be required at whatever level the EEA group supervisor considers appropriate**.

**Where a group with an ultimate parent based in a non-EEA territory has subgroups within the EEA, then, in addition to any requirements to report at the level of the ultimate insurance parent, the requirement for group reporting under Solvency II applies at the level of the group headed by the ultimate EEA insurance parent.**

**The ultimate parent company of a group is required to prepare consolidated accounts under IFRS.**

Under IAS 27 and IFRS 10, an intermediate parent (i.e. one that is itself a subsidiary) is exempt from preparing consolidated financial statements where the following conditions apply:

- The company's owners have been informed and do not object to not preparing consolidated accounts;
- The company has not issued publicly traded debt or equity;
- The company does not file its accounts with a securities commission or other regulatory body for the purpose of issuing any class of instruments in a public market; and
- The company's ultimate parent (or any intermediate parent above the company in the group) prepares consolidated financial statements in accordance with IFRS which are available to the public.

## Appendix D: Group reporting

### Solvency II

### IFRS

#### 4. Method of group reporting

Groups are required to prepare group reporting to **assess the capital adequacy of the group**, taking into account the Solvency Capital Requirement ('SCR') and own funds calculated at group level.

The group results must be based on Solvency II principles, including: balance-sheet valuation principles; proportional recognition of participations of less than 100%; elimination of intra-group creation or double use of own funds; and adjustments to reflect group own funds restricted in their ability to absorb group losses.

Solvency II has two **methods by which the group results may be prepared**:

- The default accounting consolidation-based method uses the **group's consolidated accounts as a starting point** in the calculation of group SCR and group own funds. As these must be prepared based on Solvency II principles it may differ from the IFRS accounts. Calculation of group own funds is based on the full consolidated balance sheet (unless there are differences in the scope of the group under consolidation for Solvency II purposes); however, only insurance-related subsidiaries are considered on a consolidated basis when calculating SCR. Contribution of other group members to SCR are aggregated on an entity-by-entity basis (and do not reflect diversification benefits);
- The deduction and aggregation method, which groups may apply subject to supervisor permission, calculates the group results as the **aggregation of the results and SCRs of each entity within the scope of the group**. Where the participation is less than 100%, only the group's proportion of that entity's results and SCR are included, unless the entity is in deficit, in which case the full amount is included. The individual results must be based on Solvency II principles (unless based in a non-EEA territory deemed equivalent with Solvency II) and adjustments made to eliminate any capital charge on intra-group transactions.

Participations are included in the group's results as investments of the entities holding them, subject to certain exceptions, as detailed in the section of this document on assets and liabilities not related to technical provisions.

A consolidation performed under IFRS **presents all the results of the entities in the group combined to form a single set of results**. The method of consolidation is to add together all the individual results of the entities in the group, then make adjustments to:

- Eliminate the investment in each subsidiary and the parent's portion of equity of each subsidiary;
- Adjust accounting policies to be consistent with the group;
- Eliminate pre-acquisition reserves and the results of intra-group transactions;
- Recognise material adjusting post-balance-sheet events;
- Adjust subsidiary results where not coterminous with the parent company; and
- Recognise the 'minority interest'/'non-controlling interest' of the other shareholders, for subsidiaries not owned 100% by the group (which forms part of the equity of the parent).

Under the equity method, the interest in associates are initially measured at cost and subsequently adjusted for the investor's share of post-acquisition profits or losses.

# Addressing the practicalities

*PwC is helping a range of insurers to assess the implications and address the practical challenges of preparing for Solvency II and IFRS Phase II. If you would like to discuss any of the issues raised in this paper or other aspects of the frameworks, please speak to your regular PwC contact or one of the following:*

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