

Getting to grips with the shake-up

While the synergies between the emerging Solvency II and IFRS frameworks will allow insurers to develop a common reporting platform, there are bound to be some significant differences. In this publication we examine the differences and similarities between the two frameworks and start to assess how this will affect reporting systems, management evaluation and market communication.

October 2010



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Foreword



The move to Solvency II and the new IFRS for insurance contracts will have critical implications for the way insurers measure capital and financial performance and how they are judged by the financial markets and regulators. Implementation and operation of the reporting frameworks also present considerable logistical challenges.

The parallels between Solvency II and the planned changes to IFRS open up valuable synergies in areas such as data management and model development. However, there are also crucial differences between the two regimes. Insurers need to understand how these differences will affect the 'numbers' and how they can be reconciled and properly explained. Otherwise, firms could find themselves facing some challenging questions from analysts.

This publication is designed to help insurers identify the key differences between the two proposed regimes, and start to assess the implications for reporting systems and investor relations. It forms part of a series of guidance and research studies examining the strategic and implementation issues surrounding Solvency II and IFRS.

If you would like to discuss any of the points raised in this paper or any other aspect of Solvency II and IFRS, you are very welcome to contact me (details below) or one of the contacts listed on page 34.

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Introduction: A critical juncture

The overhaul of accounting and solvency regulations in the European insurance industry has reached a critical juncture with the European Commission's publication of the technical specifications for Solvency II's Fifth Quantitative Impact Study (QIS5) and the International Accounting Standards Board's (IASB) long-awaited Insurance Contracts Exposure Draft.

QIS5 is one of the last chances for European insurers to road-test and influence the new Solvency II regime. The consultation over the IFRS Insurance Contracts Exposure Draft (ED) is the best opportunity for the industry to influence the increasingly imminent new accounting standard. Insurers also face extensive changes to the classification and measurement requirements for financial instruments (the IASB is developing International Financial Reporting Standards (IFRS) 9, which will replace the current International Accounting Standard (IAS) 39) and to the principles governing revenue recognition through the Revenue from Contracts with Customers ED. Finally, the development of a single accounting standard to define fair value is important for insurers that measure assets or liabilities at fair value.

As Figure 1 highlights, 2011 will be a decisive year with the expected finalisation of the Solvency II 'Level 2' implementing measures and the expected publication of the new IFRS standards for insurance contracts, financial instruments

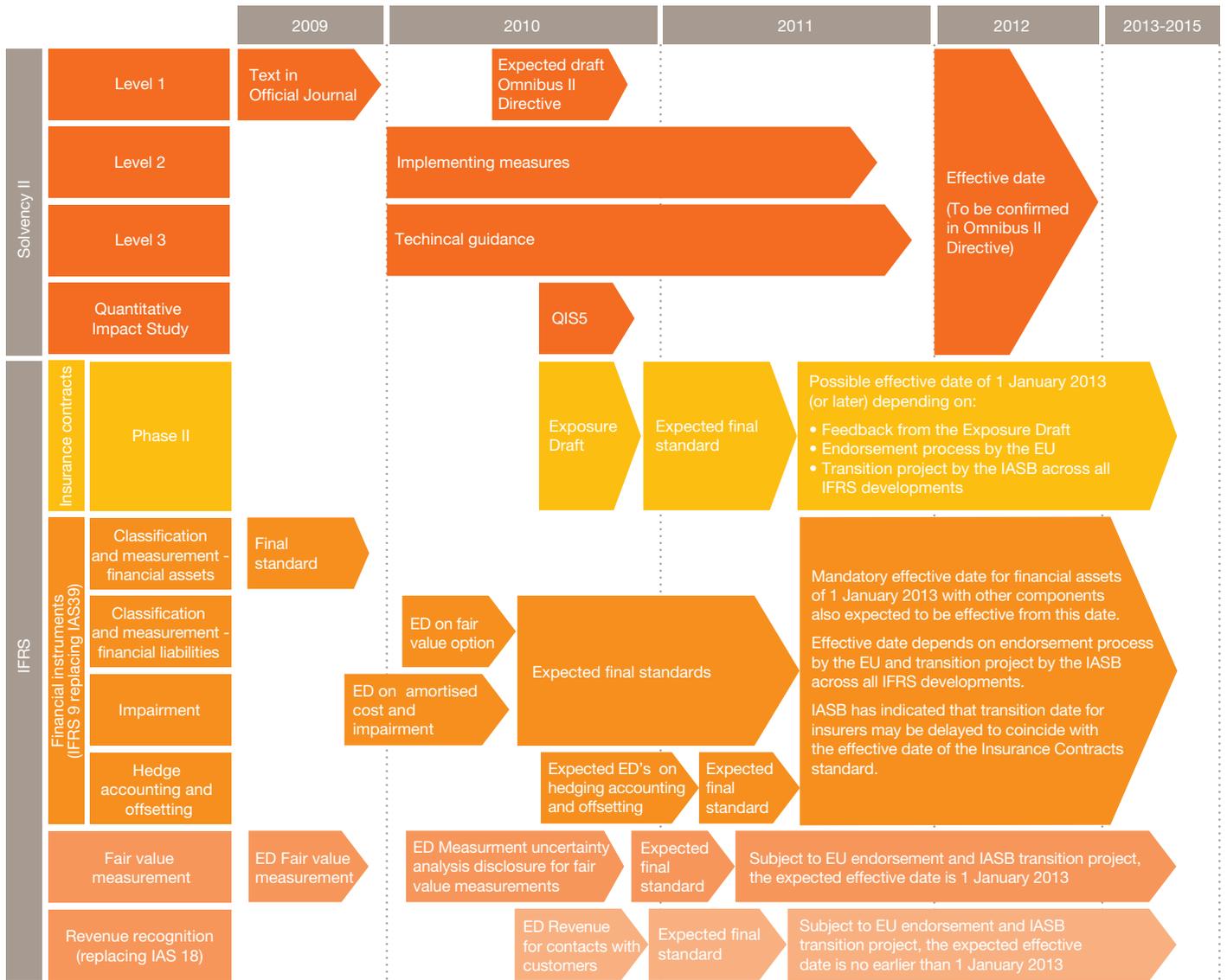
and revenue recognition all due at this time. There is still a degree of uncertainty about the effective date of all the implementing measures and standards. The latest statement from the European Commission indicates that Solvency II will be implemented from the end of 2012, and this proposal should be confirmed once the draft Omnibus II Directive is published later in 2010. The IASB plans to consult separately on the proposed effective date of the Standards it is publishing in 2011.

Insurers face significant challenges in delivering the scale of change, understanding the implications, embedding the results into all aspects of the business and, communicating this internally and externally. At the same time, there is an opportunity to achieve synergies and to create frameworks for disclosure that better reflect the value being created within the business and how the business is being run by management.

This publication begins with consideration of the first steps in implementing Solvency II and the changes to IFRS, primarily the proposed insurance contracts standard, in parallel. It then examines the key similarities and differences between IFRS and Solvency II in the areas of contract liabilities, assets and other liabilities, disclosures and group reporting. The appendices provide a more detailed point-by-point technical comparison.

The publication is based on IFRS and Solvency II proposals up to **30 September 2010**, many of which are in a consultation phase. 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.

Figure 1: Current timelines for the Solvency II and IFRS exposure drafts and final standards



The timeline is based on information published at 30 September 2010 and may be subject to change.
Source: PwC analysis

First five steps to integration



If you're already preparing for the implementation of Solvency II, there is an opportunity to integrate the changes that will be required by IFRS. Given the size and complexity of Solvency II implementation projects, particularly for multinational insurers, this will be a significant challenge. However, the alternative of a separate reporting project is likely to be both risky and costly, and will miss the opportunity to address the major criticisms of insurers in recent years: the failure to communicate the capital management and value creation story effectively.

PwC has created a five-step plan to prepare to integrate the new IFRS requirement with Solvency II preparations (see Figure 2) and describes each step in more detail here.

1 Understand the key requirements

As we outline in this publication, the market consistent measurement basis for insurance contracts under IFRS has strong similarities with Solvency II. However, it is important to understand the nature and implications of the differences described in subsequent sections as they will have a crucial bearing on the ability to integrate IFRS with Solvency II. At this stage, there are significantly more uncertainties surrounding IFRS than Solvency II, as the insurance contracts standard is only at the exposure draft stage.

It would therefore be useful to carry out a gap analysis to assess similarities and differences in the requirements (see

Figure 3) – and how these specifically impact your business – though the findings may be subject to change as both IFRS and Solvency II evolve up to finalisation. The degree of uncertainty surrounding certain IFRS proposals should be included in the gap analysis as it will be an important factor in assessing the immediate priorities and avoid wasting scarce time and resources. The output from the gap analysis forms the basis for an implementation plan for external reporting from 2012 and beyond.

There are timing as well as technical issues to consider at this stage. In particular, there is a risk that the various IFRS standards may come on stream at different times resulting in multiple transitions and restatements; and the risk that Solvency II may be effective **before** the new IFRS developments. The timing issues present a range of practical challenges and considerations, not least as the current IFRS reporting requirements for insurance contracts are often based on Solvency I or US Generally Accepted Accounting Principles (GAAP) methods. Insurers will have a number of potential options for IFRS reporting for insurance contracts in the interim period, if Solvency II is applicable prior to the new IFRS standard, including:

- **Maintain current approach.** 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.

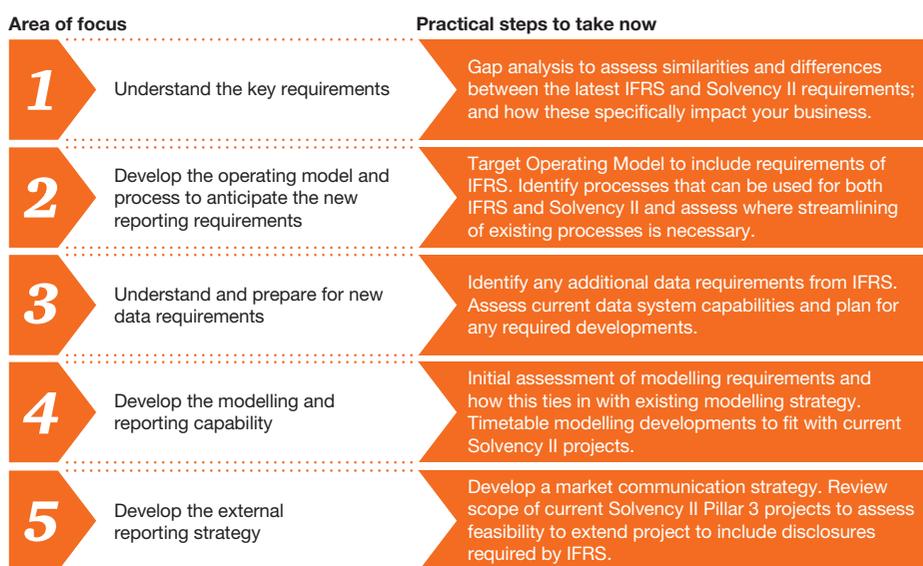
- **Adopt Solvency II (or a modified version).** This would require a careful assessment of the current IFRS 4 and IAS 8 requirements to check whether such an approach is permitted. A further change would then be required to adopt the insurance contracts standard, once it becomes mandatory.
- **Adopt the requirements of the insurance contract standard.** Insurers might adopt the requirements of the insurance contract standard, expected to be published in 2011, either through early implementation of the standard itself (subject to its endorsement in Europe) or by taking on board some of its requirements as a way of improving existing accounting policies under IFRS 4 (subject to confirming whether such an approach is permitted).

The uncertainty in approach over the interim period may resolve itself over the coming years as a standard industry position emerges. Most insurers will not want regular transitions between different approaches, not least to avoid the requirement for regular restatements and potential volatility in earnings. For most insurers, a key first step should be to assess the financial impacts of the potential options.

2 Develop the operating model and processes to anticipate the new reporting requirements, while allowing for potential further change

It is likely that insurers will look to use their existing Solvency II projects as a starting point for the implementation of the changes to IFRS and to assess how they can integrate these reporting requirements. For many insurers, Solvency II has seen the development of a 'target operating model' to articulate their governance, operational, structural and

Figure 2: A five-step plan to prepare to integrate the new IFRS requirements with Solvency II preparations



The practical steps are not necessarily sequential and will depend on the specific circumstances of each insurer.

Source: PwC analysis

capital priorities. Insurers will need to consider what changes IFRS will bring and how to incorporate these changes into their operating model and processes.

Effective operation will require closer integration of risk and finance functions' operational and technical capabilities. Figure 4 illustrates how this alignment of risk and finance may be structured in practice.

3 Understand and prepare for new data requirements

Solvency II is leading to a fundamental change in the management and governance of data, which will require exacting data quality thresholds and the development of a rigorous control environment. It is important for companies to make sure that any IFRS specific requirements that are now on the horizon are captured. For example, the calculation of the residual margin for insurance contracts under IFRS, as outlined later in this publication, is

required at a granular level – by portfolio of contracts, similar inception date and similar term – and as a result the best estimate liability and risk adjustment will be needed at this level. The split of data required is likely to be finer than many insurers are currently planning in their Solvency II model developments. Technical challenges include the allocation of diversification benefits in the risk adjustment within a portfolio.

There has been some debate on the transitional arrangements set out in the insurance contracts ED, which will not permit a residual margin on existing business. If the final insurance contracts standard allows or requires the inclusion of a residual margin on existing business – which is by no means clear – this would result in significant data and resource requirements. Insurers would need to return to day one of its contracts at a lower level of granularity than the portfolio, to calculate the residual margin and then amortise it to the reporting date.

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There are precedents in IFRS for full retrospective adoption of standards. For example, in the first phase of insurance accounting under IFRS, the definition of acquisition costs permitted to be deferred in respect of investment contracts was changed in many countries. However, the scale of calculating the residual margin on existing business would be much more significant. This is an example of a potential data requirement, which is not in the scope of Solvency II, where forward-thinking insurers may now be starting to factor this into current Solvency II data projects.

4 Develop the modelling and reporting capability

Building an actuarial cash-flow model that is fit for purpose for both Solvency II and IFRS is a challenge. The move to a market consistent approach presents a

number of implementation hurdles. For life insurers, this includes the need for sophisticated stochastic modelling capabilities, as those insurers that have embarked on Market Consistent Embedded Value (MCEV) in recent years understand. Many international groups also face the prospect of moving from multiple local GAAPs, which may not have required a market consistent valuation, to a single harmonised financial reporting standard. Developing the capability to a standard that stands up to independent scrutiny requires a significant investment, as already reflected in the Solvency II programmes of many insurers. Adding IFRS to this investment is important to avoid duplication and unnecessary additional cost. It is important to capture the subtle differences between Solvency II and IFRS, as illustrated later in this publication.

5 Develop the external reporting strategy

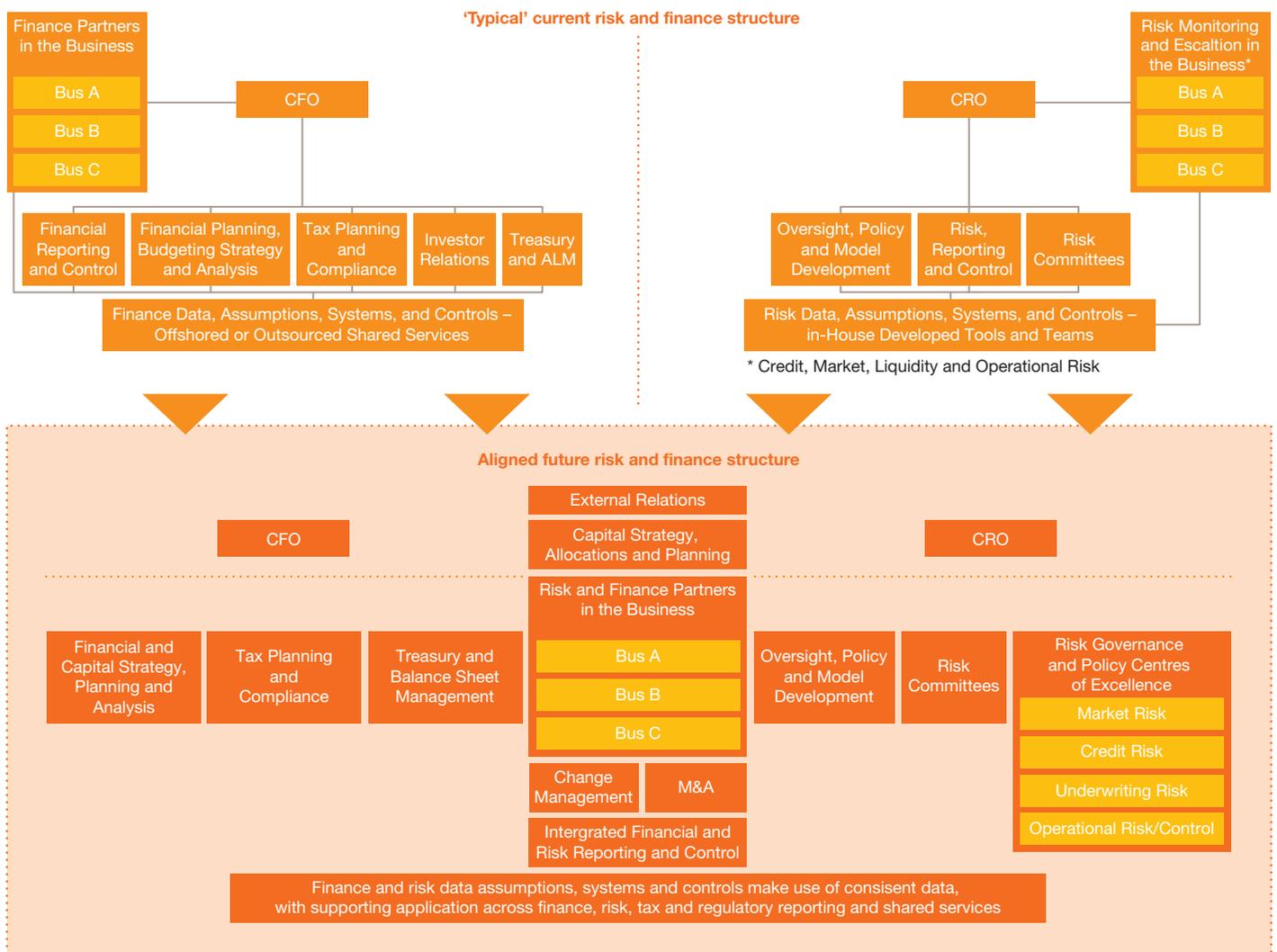
Moving to an economic framework for reporting is an opportunity to enhance the quality, depth and transparency of insurance reporting, addressing once and for all the criticism that insurers fail to communicate their value creation activities effectively and consistently. The ultimate aim is being able to convey a single view of the business that more closely reflects its risks and the way it is run. The differences in measurement between IFRS and Solvency II mean that insurers will need to explain the disparity in disclosure between the different approaches. Designing and presenting that message coherently – and bridging the story from IFRS 4 and Solvency I – will be challenging, but is more important than ever for insurers to get this right.

Figure 3: At a glance, a summary comparison of the main differences between the IFRS Insurance Contracts ED and Solvency II technical provisions

Area	Solvency II	IFRS	Significance	Observation
Definition and scope	All contracts	Insurance plus some participating investment contracts	Red circle	<ul style="list-style-type: none"> The measurement of investment contracts in IFRS is likely to be significantly different to Solvency II. In IFRS, participating contracts are not automatically in the insurance standard.
Recognition	Party to contract	Party to contract	Green circle	<ul style="list-style-type: none"> Similar requirements.
Unbundling	No	Not 'closely related' (3 examples)	Red circle	<ul style="list-style-type: none"> The scope of unbundling in IFRS is not clear. However, requirements to unbundle will have significant systems, data and process implications for some insurers.
Cash flows	Prescribed	Incremental at portfolio level	Orange circle	<ul style="list-style-type: none"> There is the potential for certain cash flows, for example overhead expenses and tax to be different between Solvency II and IFRS.
Discount rate	Risk-free plus illiquidity premium	Risk-free plus illiquidity premium	Orange circle	<ul style="list-style-type: none"> Potential grandfathering arrangements in Solvency II would significantly differ from IFRS. The discount rate is prescribed in Solvency II. It is likely that the Solvency II discount rate will be used as the starting point for determining the IFRS discount rate.
Risk adjustment	Prescribed 6% cost of capital	One of three methods	Orange circle	<ul style="list-style-type: none"> IFRS permits one of three methods, while Solvency II prescribes a 6% cost of capital approach. More diversification benefits will be permitted in Solvency II.
Residual margin	No	Eliminate day-one gain	Red circle	<ul style="list-style-type: none"> Significant difference. The level of granularity required for the residual margin will impact modelling and data requirements.
Acquisition costs	Expensed as incurred	Contractual cash flows	Orange circle	<ul style="list-style-type: none"> For IFRS, incremental acquisition costs are included in contractual cash flows. Additional data and modelling required compared to Solvency II.
Short duration contracts	No difference	Unearned Premium Reserve	Red circle	<ul style="list-style-type: none"> For IFRS, the Unearned Premium Reserve (UPR) model is mandatory for pre-claim liabilities with an onerous contract test at the portfolio level (by similar date of inception). There is no equivalent concept in Solvency II.

Source: PwC analysis

Figure 4: Example of future state with alignment of risk and finance



Source: PwC analysis

Many insurers have started to develop plans for Solvency II disclosure reporting (Pillar 3) and it is sensible to integrate the IFRS requirements to the extent there is sufficient certainty in the proposals. As part of this integration, the vision for external reporting from 2012 and beyond will need to be developed.

The key disclosures to start considering now are:

- Capital disclosures between existing and future reporting particularly at the transitional stage;
- Reconciliation from key Solvency II measures to their IFRS equivalent;
- Measures that explain how value is created while allowing for the associated risk, for example, a profit and loss attribution at a granular product level; and

- Cash-flow measures that show how capital turns into cash.

The IASB insurance contracts standard should also support the concept of an economic balance sheet as a key reporting measure outside the European Economic Area (EEA). This is important as it may not be long before their regulatory requirements move closer to Solvency II.

Contract liabilities

Solvency II and the IFRS insurance contracts ED establish a market consistent valuation for measuring insurance contract liabilities, based on the concepts of a probability weighted estimate of future cash flows, the time value of money and an additional risk margin or adjustment. Unlike Solvency II, IFRS will not permit the recognition of a gain on the inception of an insurance contract.



Solvency II ushers in a single measurement model for all insurance and reinsurance contracts as the current cost to transfer obligations immediately to another undertaking. The liability is measured as the discounted probability weighted estimate of future cash flows plus a risk margin. In the limited cases where a complete replicating portfolio exists for contracts (for example, certain guaranteed equity bonds), the liability is defined as the value of the replicating portfolio.

In IFRS, the measurement of the contract liability depends on the classification of contracts as insurance or investment. The classification depends on whether significant insurance risk is transferred to the insurer. In addition, investment contracts with a discretionary participating feature (DPF) are treated as insurance contracts if they participate in the same performance pool as other insurance contracts.

Figure 5 illustrates the comparison of the Solvency II and IFRS measurement of contract liabilities.

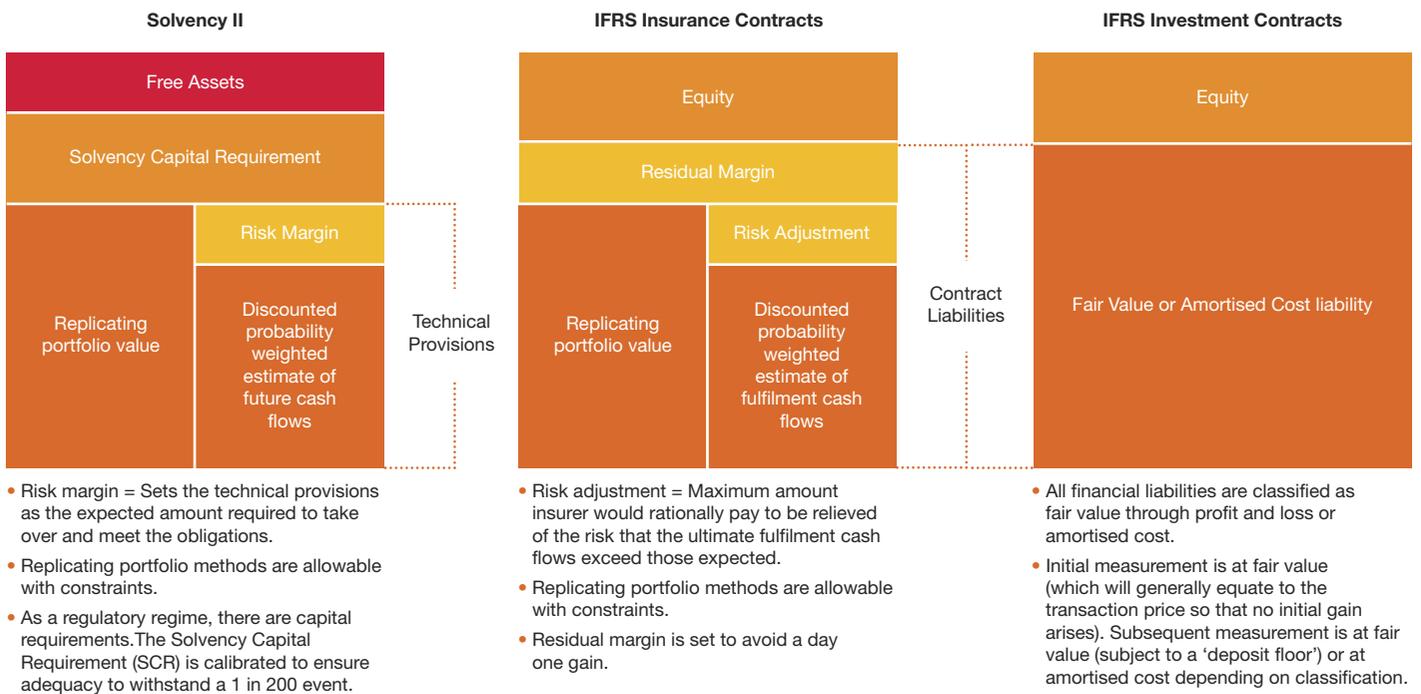
For insurance contracts in IFRS (for example, a term assurance), the liability is

measured as the amount required to fulfil the contractual obligations over the lifetime of the contract. This is calculated as the discounted probability weighted estimate of the fulfilment cash flows plus a risk adjustment. As for Solvency II, where a complete replicating portfolio exists, the contract liability is defined as the value of the replicating portfolio. In both cases in IFRS, there is an additional component to the liability – the residual margin – set to eliminate any day one gains, while any losses are immediately recognised. For short duration insurance contracts (where the period of cover is approximately one year or less (for example, the majority of non-life contracts), a simplified Unearned Premium Reserve (UPR) model is required for the pre-claims liability.

Investment contracts (for example, a pure unit-linked savings contract) do not contain significant insurance risk and so are similar in nature to instruments found in other markets and sectors. As a result, they are subject to the IFRS financial instruments and revenue standards. The contract liability is typically measured at fair value or amortised cost.

For insurance contracts, it will be necessary to unbundle components of the contracts that are not ‘closely related’ to the insurance coverage. The purpose of unbundling is to introduce comparability between insurers and other industries where similar components exist. The insurance contract ED does not define the term ‘closely related’ and so this is potentially open to interpretation. However, the ED does specifically note that certain policyholder account balances (for example, the unit balance of a unit-linked contract), embedded derivatives, and goods and services need to be unbundled and then measured under the relevant IFRS standard, principally financial instruments and revenue standards. The remaining components, excluding all unbundled cash flows, follow the insurance contract standard. The requirement to unbundle components will have a significant effect

Figure 5: Solvency II versus IFRS requirements



The relative size of the diagram is purely for illustration purposes only and could differ significantly by product line and company. A number of simplifying assumptions have been used. 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 are no unbundling requirements and does not consider specific short duration contract treatment.

Source: PwC analysis

on the emergence of profit due to the different measurement models applied to each component. Further, it introduces significant technical and practical challenges to insurers. For example, the identification of components not closely related to the insurance coverage, the separate reporting of unbundled components under relevant standards and the challenge of allocating acquisition and other costs between the components of the contract, and more generally through increased complexity in processes and controls. There is no equivalent concept of unbundling in Solvency II.

In the remainder of this section of the publication, we compare the technical differences between Solvency II and IFRS for the measurement of insurance and investment contracts. Appendices A and B provide a more detailed comparison.

Discount rate

Both Solvency II and IFRS for insurance contracts require that the discount rate is defined as a risk-free rate allowing for the inclusion of an 'illiquidity premium', where a higher discount rate may be used for more illiquid liabilities. This represents a significant departure from current practice for non-life business, where discounting is uncommon and for life business where an asset-backed discount rate is used in many countries.

The selection of the discount rate, specifically the method of determining the risk-free interest rate and the extent of inclusion of an illiquidity premium, continues to be an area of significant debate across the insurance industry. The inclusion of an illiquidity premium is of fundamental importance to 'spread' based life insurance contracts (for example, annuities in payment) where the pricing of such contracts takes into account the additional investment returns that may be obtained, from investing in assets with similar illiquid characteristics to those of the liability.

Solvency II is more prescriptive than IFRS with, for example, QIS5 prescribing both the risk-free rate interest rate and the illiquidity premium to be applied to all liabilities. There is uncertainty in respect of Solvency II, as a number of technical aspects are being road-tested through QIS5 for the first time, including extrapolation of the risk-free rate and the calibration of the illiquidity premium. For many European insurers, it is likely that the Solvency II discount rate will be used as the starting point for determining the IFRS discount rate.

QIS5 is also road-testing a transitional arrangement to 'grandfather' the existing Solvency I asset-backed discount rate rules, though it is not clear at this stage what businesses and over what period

such provisions would apply.

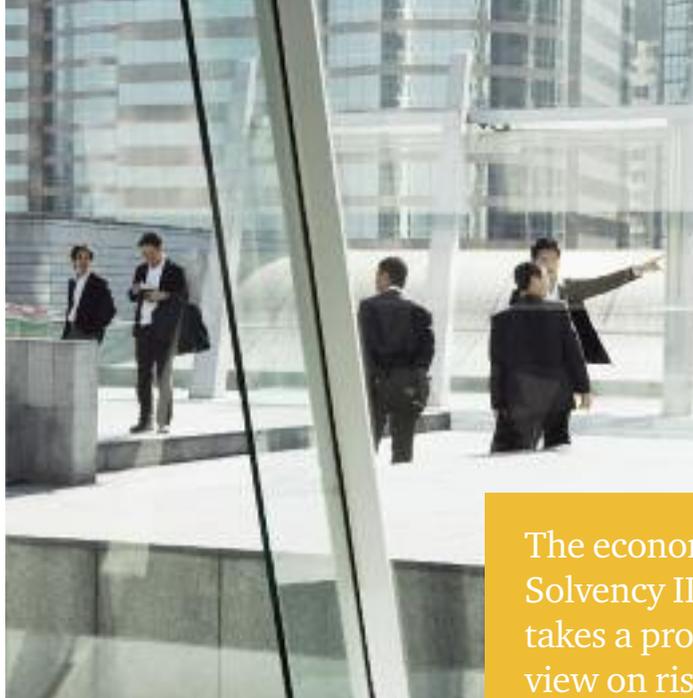
Grandfathering arrangements would represent a significant divergence from IFRS, where an asset-backed discount rate is prohibited.

Risk margin or adjustment

Although the concept of an adjustment for risk is fundamental to both Solvency II and IFRS for insurance contracts, the calculation methods and calibrations may differ as will the magnitude of the resulting adjustment:

- IFRS permits three measurement techniques, with disclosure requirements to provide comparability, while Solvency II permits only a cost of capital approach that is highly prescribed (for example, a cost of capital rate of 6% for the purposes of QIS5); and
- Diversification benefits are currently set at the entity level for Solvency II and at the portfolio level for IFRS and so are expected to be greater in Solvency II.

For QIS5, many insurers are likely to adopt simplified risk margin calculations, with plans for more sophisticated approaches for full Solvency II implementation. In developing these plans, insurers will want to consider the requirements of IFRS.



For short duration contracts accounted for using the UPR model, the risk adjustment is only relevant for the calculation of the outstanding claims liability. Further, there is no explicit concept of risk adjustment for investment contracts under IFRS, although it may be relevant when determining a fair value using a model rather than by direct observation from the market.

Cash flows

The cash flows included in the measurement model for Solvency II and IFRS for insurance contracts are fundamental to actuarial modelling, the magnitude of the contract liability and the resulting profit emergence. There is explicit guidance in Solvency II as to which cash flows are to be included, while in IFRS for insurance contracts, cash flows which are incremental at the level of a portfolio of insurance contracts are included (the 'fulfilment' cash flows). Many of the cash flows will be the same in the two models, for example, regular premiums and benefits. However, there are a number of potential differences that insurers should consider. Overhead expenses that can be allocated on an economic basis are included in Solvency II, while in IFRS, general overheads are excluded. The treatment of 'policyholder' tax cash flows in IFRS follows the requirements of the relevant accounting standard (IAS 12 – Income Taxes), which may be different to an economic interpretation in Solvency II. The tax regimes across the EEA vary significantly, so insurers will need to consider each territory separately. Further, there are some cash-flow items in IFRS which are open to potentially significant judgement – for example, cash flows arising from 'abnormal' amounts of wasted labour or 'abnormal' amounts of other resources used to fulfil the contract are excluded.

Acquisition expenses

For insurance contracts in IFRS, directly incremental acquisition expenses identified at the individual contract level are implicitly deferred as a reduction to the liability (as opposed to being explicitly deferred as an asset). This is achieved by including such expenses as a contractual cash flow and so reducing the initial measurement of the residual margin. The resulting smaller residual margin is subsequently amortised in the income statement over the period of insurance coverage. The definition of acquisition expenses, though similar to that currently adopted for investment contracts in IFRS, is narrower than in many existing insurance accounting frameworks. Insurers that perform direct marketing or have a salaried in-house sales force are likely to have lower acquisition costs, which are considered incremental to a specific insurance contract, compared to those that use external agents. As a result, they will have a larger residual margin for a contract that is recognised over the coverage period and will expense most of their acquisition costs immediately giving rise to an initial loss.

For investment contracts in IFRS, the 'Revenue from Contracts with Customers ED' requires that all acquisition costs are expensed to the income statement when incurred. This represents a major change from current accounting and will result in significantly increased day-one losses from writing such new business. Moreover, it is proposed that all deferred acquisition cost (DAC) assets on the balance sheet relating to such existing business are eliminated to shareholder equity on transition to the new standard.

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Participating business

The basic definition of a participating feature is the same in Solvency II and IFRS. Under IFRS, participating contracts within the scope of the insurance standard contain either significant insurance risk or are investment contracts that participate in the same performance pool as other insurance contracts.

In Solvency II and IFRS for insurance contracts, the treatment of participating contracts is similar with the exception of the residual margin. All 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.

The requirements regarding the 'contract boundary' discussed below would preclude any cash flows expected to become payable to future policyholders from the measurement of the contractual liability. Some might argue, however, that if investment returns earned on assets backing existing contracts are expected to be paid to future policyholders then those cash flows could be considered to arise from the existing contracts. In particular, the insurance contracts ED makes explicit reference to including cash flows relating to future policyholders within the

A difference observed is whether the ability to reprice contracts at the portfolio level is the boundary in Solvency II compared to the contract level in IFRS. Insurers will need to look closely at the two definitions across their full range of insurance contracts.

measurement of the contract. However, it is unclear how the 'estate' within a proprietary or mutual entity will be allocated between equity and the contract liability. While there is no equivalent reference to future policyholders in the draft Solvency II guidance, this is an area where further clarification of the proposed treatment is needed under both Solvency II and IFRS.

For participating investment contracts not within the scope of the IFRS insurance contracts standard, the financial instruments standards will apply. This will require careful application as up until now participating features have not been considered in the context of these standards. In particular, companies will need to:

- Identify the liability and equity part of the instrument (under IAS 32) and consider the accounting treatment of any equity elements, which may cause accounting mismatches in the income statement;
- Decide whether a fair value or amortised cost approach is adopted to measure the liability; and
- Consider the treatment of any embedded derivatives and the measurement of assets backing the liability to avoid accounting mismatches.

The treatment of participating investment contracts under IFRS therefore has the potential to be at odds with Solvency II.

Contract boundary

The contract boundary distinguishes between future cash flows on existing contracts and those that relate to future contracts. Within the boundary period, both contractual premiums and benefits arising from policyholder options to amend, renew or extend their policy are taken into account on a probability weighted basis. QIS5 sets the boundary as the point where the insurer can unilaterally terminate the contract, refuse to accept a premium or amend the benefits or premiums without limit. Any

premiums received after that date do not belong to the existing contract and should therefore be excluded. For insurance contracts, excluding participating investment contracts that participate in the same performance pool as other insurance contracts, IFRS sets the boundary as the point where the insurer is no longer required to provide coverage or has the right or practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.

There has been recent market comment, primarily due to the practical examples in the Annex to the QIS5 technical specifications that these two definitions could diverge in practice. A difference observed is whether the ability to reprice contracts at the portfolio level is the boundary in Solvency II compared to the contract level in IFRS. Insurers will need to look closely at the two definitions across their full range of insurance contracts.

Transitional arrangements

Under IFRS (for both insurance and investment contracts) and under Solvency II, there is retrospective application of the new requirements. Crucially, the measurement approach for existing insurance contracts in IFRS excludes a residual margin at the point of transition. The changes in measurement for insurance contracts arising on transition to the new IFRS will be recognised in shareholder equity and not in the income statement. As a result, there may be a negative impact on future earnings compared to existing accounting frameworks for insurance contracts under IFRS.

Profit recognition

In Solvency II, the measurement based on future cash flows with an allowance for risk is in some respects similar to the profit emergence observed in current MCEV reporting; in particular, under both Solvency II and MCEV, gains can be recognised on the inception of insurance contracts. This contrasts with the position under IFRS for both insurance and

investment contracts, where all day-one gains are eliminated, while losses are immediately recognised.

For insurance contracts in IFRS, the elimination of a day-one gain is through the residual margin, which is subsequently released over the coverage period, either on the basis of passage of time or on the basis of expected claims or assets under management (depending on the product). All changes in subsequent estimates (financial and non-financial) are recognised as incurred.

For non-participating investment contracts in IFRS, a day-one loss is likely, as acquisition costs would no longer be deferred under the Revenue Recognition ED. Subsequently, deferred upfront fees are earned, either over the expected term of the contract or as the services are provided. Regular fees, for example, administration and fund-related fees, are recognised as the services are provided.

There is little precedent in accounting under IFRS for participating investment contracts not within the scope of the insurance contracts standard (as such contracts currently fall within the scope of IFRS 4). In addition, the terms of such contracts tend to vary from country to country. The accounting treatment that will be applicable to such contracts, including the pattern of profit recognition, is therefore likely to depend on the specific contractual terms and the outcome of the IASB's current 'financial instruments with characteristics of equity' project.

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 economic valuation.

Solvency II requires assets and liabilities to be valued on a basis that reflects their fair value (described as an 'economic valuation'), with the exception that liabilities should not be adjusted to take account of an insurer's own credit standing. Many IFRS standards are also based on the fair value measurement principle, which means that a significant degree of convergence will exist. However, some adjustment will be required for those standards not based on the fair value concept or where different options are permitted.

The Solvency II valuation requirements, based on the most recent iteration in QIS5, give clear guidance on where IFRS is not considered to provide a suitable economic valuation for use under Solvency II, so the differences between Solvency II and IFRS are likely to be relatively clear. These differences are explained in detail in Appendix C, and the most significant of which are highlighted below.

The development of further new and revised IFRS standards will introduce changes to the valuation adjustments from those that insurers will apply for QIS5.

Financial assets

Under IAS 39 and its proposed replacement IFRS 9, financial assets are valued either at amortised cost or at fair value. Valuation at fair value under IFRS is considered to provide a reasonable proxy for economic value under Solvency II. However, where financial assets are valued at amortised cost for accounting purposes, insurers will need to convert them to fair value for Solvency II.

The insurance contract ED contains an option on implementation to redesignate a financial asset to fair value from amortised cost, but not vice versa. The restriction over the redesignation to amortised cost could result in accounting mismatches, given unbundling requirements and changes in the scope of contracts included in the financial instruments standard. However, IFRS 9 allows assets to be redesignated into, and from, fair value through profit or loss on transition, so insurers may resolve such difficulties if the standards are adopted simultaneously.

Financial liabilities

Under both current IFRS and the proposals to be incorporated into IFRS 9, financial liabilities are valued initially at fair value and, subsequently, at either fair value or amortised cost. 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.

Solvency II requires that financial liabilities should be valued in conformity with IFRS upon initial recognition. No subsequent adjustments are made to take account of the change in own credit standing; however, adjustments for changes in the risk-free rate have to be accounted for.

Many IFRS standards are based on the fair value measurement principle, which means that a significant degree of convergence with Solvency II will exist. However, adjustments will be required where the fair value concept is not required or where different options are permitted in IFRS.

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

Under IFRS, from the perspective of the investor's entity accounts, investments in participations are valued, either at cost or at fair value. In QIS5, participations are classified into three classes for valuation:

- Listed companies should be valued using quoted market prices in active markets;
- Unlisted subsidiaries should be valued on an 'adjusted equity method' (being the parent's share of the excess of the assets over the liabilities of the subsidiary valued in accordance with Solvency II valuation principles); and
- All other undertakings (not subsidiaries) should wherever possible use an adjusted equity method with an option to mark to model if the adjusted equity method is not possible.

However, notwithstanding the above, if an insurer invests in a 'financial institution', defined as either a bank or an investment firm, the participation must effectively be valued at nil for solvency purposes.

Property plant and equipment

Solvency II proposes that property (excluding investment property), plant and equipment should be at fair value where these items are not otherwise measured at economic value. For this purpose the revaluation model in IFRS is considered as a reasonable proxy for fair value. This model requires that valuations shall be made 'with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value'. Solvency II specifies that external valuations of property shall be undertaken at least every three years (and more frequently where significant changes occur in the real estate market).



IFRS also allows an alternative method of valuing property, plant and equipment at cost less depreciation. This method is more commonly used by insurers in practice and the shift to economic valuation in Solvency II is likely to be a change for most.

Goodwill and intangibles

IFRS allows goodwill to be 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, given that goodwill is not considered to be an identifiable and separable asset in the marketplace.

Solvency II proposes that intangible assets are assigned a value, only where they may be fair valued under IFRS. Only those intangible assets that are traded in an active market are permitted to be accounted for at fair value under IFRS. It is unlikely, in practice, that many intangible assets of insurers will be traded in active markets and so assigned a value under Solvency II.

Disclosures

Both Solvency II and IFRS have complex and extensive requirements for external reporting and disclosure. While there are clear synergies in some areas, including risk and capital reporting, insurers will have to generate a significant volume of information to meet both sets of requirements.

Solvency II will introduce extensive disclosure requirements in the form of an annual public Solvency Financial Condition Report (SFCR), a private Report to Supervisors (RTS) (required in full periodically with changes reported in subsequent years) together with quarterly quantitative reporting. The SFCR and RTS include qualitative information covering the areas of: business and performance, system of governance, risk profile, regulatory balance sheet, capital management and information on the internal model if applicable. The SFCR and RTS must also include an Annex containing detailed and granular quantitative information disclosed on prescribed templates, which also form the basis of the quarterly quantitative reporting.

In addition to quantitative financial reporting, IFRS currently requires extensive risk management and capital disclosures within the annual financial statements – these will develop further under the proposed new IFRS standards. In some countries, insurers are also required by law to include qualitative information in their annual report beyond that required by IFRS, for example narrative commentary on the performance of the business.

There are clear opportunities for synergies between the various disclosures made in the IFRS financial statements and those made under Solvency II. For example, there is significant alignment between IFRS risk and capital disclosures, the risk profile and capital management sections of the SFCR and RTS, and it is likely that the information disclosed in the business-focused sections of the annual report could be leveraged for the business and performance section of the SFCR and RTS.

However, Solvency II will also require insurers to disclose a significant amount of information that goes beyond the annual financial statements. The quantitative disclosures proposed under Solvency II are significantly more detailed and are at a much more granular level than the current regulatory reporting in most countries and those reported under IFRS. Solvency II quantitative disclosures are also based on the ‘Solvency II balance sheet’ used to calculate own funds – this is not in keeping with IFRS valuations in all respects, as we outline in this publication, and so will introduce valuation differences that insurers will need to explain in their Solvency II reporting.

Some of the qualitative information proposed in the SFCR and RTS is also significantly in excess of that included in the annual financial statements under the requirements of IFRS and other legislation. For example the information required in respect of the insurer’s business and external environment, which includes the main trends and factors that have contributed to the development, performance and position of the insurer over the year; and in respect of the insurer’s system of governance, which includes a description of the adequacy of the system of governance, a statement of its adequacy and an overview of any material changes that have taken place in the governance structure during the year.

The disclosure requirements under Solvency II are subject to the Level 2 implementing measures to be adopted by the European Commission and the Level 3 guidance and binding technical standards due to be published by European Insurance & Occupational Pensions Authority (EIOPA) in 2011. The IFRS disclosure requirements proposed in the insurance contracts ED may be subject to change in the final standard. The most significant challenges for insurers developing their reporting will be to ensure that both sets of disclosures convey consistent messages to the market, regulators and rating agencies, and that they communicate their value generating activities effectively and consistently, while making the most of opportunities for synergies and efficiency in producing the various disclosures.

For more information on how to tackle the reporting logistics in Solvency II please see the PwC publication: ‘Up to speed with reporting’.

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.



The differences are explained in detail in Appendix D and the most significant are explained below.

Solvency II is concerned with the supervision of insurance groups only. For the group reporting requirements of Solvency II to apply, therefore, the group must contain at least one insurance company that must either hold a participation in another insurance company or must be owned by an insurance holding company. Once a group has been established, the scope is also limited to the participations held by the highest insurer or insurance holding company in the group, which may not be the highest entity in the group. In contrast, IFRS requires consolidated group reporting to be prepared covering the entire group, regardless of activities.

The basis of determination of entities within the group is similar under Solvency II and under IFRS. Both frameworks have consistent definitions of subsidiaries, which must be included in the group reporting, and the definition of an associate under IFRS is similar to the definition of a 'participation' under Solvency II. However, Solvency II also

gives a group's supervisor the power to require the inclusion of any other entity which would not otherwise be included within the scope of group supervision. To the extent to which it is used in practice this power may introduce differences between the entities included in the group for IFRS and Solvency II purposes.

Both Solvency II and IFRS require group reporting at the level of the top company in the group (albeit these may be different as described above). However, where the ultimate insurance parent of the group is outside the EEA, Solvency II also requires group reporting at the level of the top EEA insurance holding company. In addition, national supervisors may, where they deem it necessary, also require group reporting at EEA subgroup level.

IFRS requires a single approach to consolidation, which involves combining all the results of the companies 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. The default approach under Solvency II is the 'accounting consolidation-based method', which takes the consolidated accounts as a starting point, which will provide synergies where a group is required to prepare IFRS consolidated accounts at the same level as the Solvency II group calculation is performed. Solvency II also describes an alternative 'deduction and aggregation' method to be used at the discretion of the group supervisor, which calculates group results as the aggregation of the individual results of the entities in the group prepared on a Solvency II or equivalent basis. Both of the methods are based on a single set of principles, including Solvency II valuation principles and the elimination of intra-group creations of capital.

Under both Solvency II and IFRS, group reporting will include the prescribed qualitative and quantitative disclosures as explained in the Disclosures section of this publication.

Appendices

Appendix A

Appendix A: Insurance contracts

Solvency II

Relevant standards

- QIS5 technical specification
- Solvency II Level 1 Directive.

Scope

- Solvency II applies to all insurance and reinsurance contracts written by the issuer in the EEA or branches of EEA-based insurers outside the EEA. There is no distinction between insurance and investment contracts.
- There are scope exclusions for certain undertakings by virtue of their size, legal status nature or specific services they offer.

IFRS

- Insurance Contracts ED.

- 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 have as their primary purpose the provision of services; or
 - Do not transfer significant insurance risk, but have a participating feature and participate in the same performance pool as other insurance contracts.
- There is no requirement for such contracts to be written by an insurance or reinsurance undertaking.
- Certain policyholder account balances, embedded derivatives and certain goods and services contained in insurance contracts are unbundled and measured under the alternative IFRS standards, principally financial liabilities (IAS 39/IFRS 9) or revenue (IAS 18/Revenue from Contracts with Customers ED). The requirement to unbundle other components outside of these three examples is not fully clear. **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 to Solvency II, as the treatment of investment contracts and revenue differ between the two frameworks. Conversely, in other circumstances, the differences may be less, for example, a unit balance. **The requirement to unbundle, will introduce significant technical and practical challenges to insurers. For example, the identification of components not closely related to the insurance coverage, the separate reporting of unbundled components under relevant standards and the challenge of allocating acquisition and other costs between the contract's components, and more generally through increased complexity in processes and controls.**

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 having occurred before, or at, the valuation date (including incurred but not reported) and associated expenses.
- For premium provisions, the cash-flow projections relate to claims events occurring after the valuation date and during the remaining in-force period of the contract. 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.
- In IFRS, a modified measurement model applies to short duration contracts where the period of cover is approximately one year or less and where there are no embedded derivatives significantly affecting the variability of cash flows. **This is expected to relate to the majority of non-life contracts and short-term life contracts.**
- Post-claims liabilities are measured, similarly to Solvency II and other insurance contracts in IFRS, as the discounted probability weighted future 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.

Appendix A: Insurance contracts *continued*

Solvency II

IFRS

Non-life insurance and other short duration contracts *continued*

- A risk margin is required for both the premium and claims provisions.
- **For pre-claims liabilities, a simplified approach is mandated rather than the full model for other insurance contracts.** The simplified approach is the UPR, including implicit spreading of incremental acquisition costs as these reduce the initial premium. The premium is assumed to be earned evenly over the contract period or based on the expected incurred claims and benefits, if that pattern differs significantly (for example a portfolio with a high level of US hurricane exposure). Interest is credited on the carrying amount of pre-claims liability. **There is no day one profit which differs from the Solvency II treatment of premium provision.**
- If the insurance contract, at a portfolio level with a similar inception date, is onerous an additional liability is set, similar to the current Additional Unexpired Risk Reserve concept.

Future cash flows

Probability weighted future cash flows

- Under 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) are common, reflecting the nature of such liabilities and the availability of data.
- 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.
- There is no deposit floor and negative liabilities are permitted.
- 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.

Probability weighted future cash flows

- Under IFRS, this represents 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. **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 negative liability (i.e. 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 is defined as a contract subject to broadly similar risks and managed together as a single pool), and within a portfolio by similar date of inception and similar coverage period.

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.

Contract boundary

- The boundary is at the point where the insurer is no longer required to provide coverage, or has right or practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.
- **There has been recent market comment, primarily due to the practical examples in the Annex to the QIS5 technical specifications that these two definitions could diverge in practice. The difference observed is whether the ability to reprice contracts at the portfolio level is the boundary in Solvency II compared to the contract level in IFRS.** Insurer will need to look closely at the two definitions across their full range of insurance contracts.

Appendix A: Insurance contracts *continued*

Solvency II

Future cash flows *continued*

Recognition and derecognition

- A contract is initially recognised at the point when the insurer or reinsurer is party to the contract and at the latest when the cover begins. A contract is derecognised when the obligations are discharged, cancelled or expired.

Assumptions underlying the best estimate

- For economic assumptions, a market consistent approach is required. There is guidance as to what constitutes 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.
- 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 are required to 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).

Expense cash flows

- All expenses that will be incurred in servicing all obligations over the lifetime of the contracts 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) are included.
- Overhead expenses include general management and service department costs that are not directly involved in policy maintenance or new business and are insensitive to volumes (new business and in-force).
- Future expected cost increases are included. Expected cost reductions can be included provided they are realistic, objective and based on verifiable data and information.

IFRS

Recognition and derecognition

- **The requirements regarding recognising and derecognising contracts are similar to Solvency II.** In both cases, there is a requirement to recognise contracts that have not commenced, but the insurer is bound to issue or accept them at a constrained prices. Whether an insurer is bound by an insurance contract will depend on the legal requirements in the territory in which it operates.

Assumptions underlying the best estimate

- The approach to economic variables in IFRS is similar to Solvency II. In particular, IFRS specifically states that such variables 'shall be consistent with observable market prices at the end of the reporting period'. **There is less practical guidance in IFRS than Solvency II, and therefore the 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.
- Similar to Solvency II, management actions and policyholder behaviour are required to be included in the expected cash flows.

Scope of cash flows

- All cash flows that are incremental at the level of a portfolio of insurance contracts are included and no other. There are explicit details of which cash flows are and are not in scope.
- Consistent with Solvency II, the cash flows are on a going concern basis and there is no allowance for own credit risk.
- **Many of the cash flows are the same, for example, regular premiums, benefits, etc. However, there are potential differences relating to expense and taxation cash flows as illustrated below.**

Expense cash flows

- All expenses incremental at the level of a portfolio of insurance contracts are included. Examples of such expenses are claims handling costs, policy administration and maintenance (including recurring commission) costs, 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.
- Costs that do not relate directly to the contract or contract activities, such as general overheads are excluded.
- Cash flows arising from abnormal amounts of wasted labour or abnormal amounts of other resources used to fulfil the contract are excluded.

Appendix A: Insurance contracts *continued*

Solvency II

IFRS

Future cash flows *continued*

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, then a market consistent approach is followed. Commonly, the selection of the investment return in a stochastic calculation is the risk-free rate ('risk neutral' projection) or an expected asset growth rate ('real world'/'deflator' projection). The selection of the investment return is linked to the discount rate to ensure a market consistent approach.

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 are included.
- Where changes to tax requirements are substantially enacted, the change is reflected in the best estimate.

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 the swap curve less a deduction for credit default risk (c10bps) plus an illiquidity premium depending on the characteristics of the liability. Most discount rate curves are specified (over 30 in QIS5) including the extrapolation from the last liquid observable data point. It is expected that the discount rate curve for each major currency will be specified when Solvency II becomes effective.
- All contracts can allow for some illiquidity premium. The illiquidity premium is set at 100%, 75% or 50% of the current market illiquidity premium. Contracts where the only underwriting risk is longevity and expense and there are no incoming cash flows, apply 100%. Participating contracts not fulfilling the previous criteria can apply 75%. All other contracts apply 50%. The assessment is performed at the contract level.

- Incremental acquisition expenses identified at the individual contract level (not portfolio level) are included, i.e. only those costs that would not have been incurred if the sale had not taken place.
- **The scope of expense cash flows is different to Solvency II, specifically acquisition expenses and general 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 investment return cash flows are required, IFRS refers to reflecting this dependency in the measurement of the contracts, and that replicating portfolio techniques may be an appropriate method to capture this linkage. **There is no explicit reference to commonly used market consistent stochastic techniques as in Solvency II. Further, Solvency II explicitly recognises limitations of replicating portfolios for insurance risk. However, as IFRS does refer to the use of observable market prices at the reporting date in setting economic assumptions it maybe that Solvency II techniques are applied.**
- The use of replicating portfolios is considered further in a subsequent section.

Tax cash flows

- Income tax payments and receipts are recognised and measured under IAS 12. In some territories policyholder benefits are dependent on future net of tax investment returns and the proposals will 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. **This is expected to be different to 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.

- The discount rate is defined to be consistent with the current market prices for instruments, which reflect the characteristics of the liability (timing, currency and liquidity).
- For contracts where the liability does not depend on the performance of specific assets (for example general insurance, conventional non-profit life and savings products), the discount rate would be represented as a risk-free yield curve with an adjustment for an illiquidity premium. **There is no further guidance on the calibration of the discount rate, though the overall framework is consistent with Solvency II. The challenge for insurers will be to determine when it is appropriate to apply an adjustment for illiquidity and by how much. As a result, this is an area where Solvency II and IFRS may differ.**

Appendix A: Insurance contracts *continued*

Solvency II

IFRS

Discount rate *continued*

- Illiquidity premium is added to the credit adjusted spot swap curve up to the point where the curve enters extrapolation.
 - QIS5 is road-testing a transitional provision whereby discount rates based on the yield on the backing assets (minus a prudent margin) may continue to be used for those liabilities where such an approach has been followed under the Consolidated Life Directive.
- For contracts where the liability does depend on the performance of specific assets (e.g. participating and unit-linked products) then the valuation should reflect the dependence. **The approach to be followed is not fully clear, however, it may be that market consistent stochastic asset modelling techniques, as for Solvency II, are applied.**
 - There are no transitional provisions in respect of the discount rate under IFRS. **The use of an asset-backed rate for a period of time under Solvency II would represent a significant difference between frameworks.**

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 replicating portfolios. 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 for the purposes of QIS5.
 - The capital requirement is designed to cover a confidence level of 99.5% over a 1-year time horizon and captures underwriting risk, unavoidable market risk (assumed to be zero for all but long-time life obligations), operational risk and credit risk with respect to reinsurance contracts and special purpose vehicles. The capital requirement is measured by applying a series of prescribed stresses (the standard formula) or an insurers' designed internal model. A pure liquid discount rate is used.
 - Level of diversification is at the entity level between lines of business.
 - There is a specific prohibition of taking into account the loss-absorbing capacity of deferred tax in the calculation.
 - 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 maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected. Consistent with Solvency II, no risk adjustment is required for the components valued using a replicating portfolio approach. The use of replicating portfolios is considered further in a subsequent section.
 - There is no single prescribed technique for calculating the risk adjustment. There are three permitted techniques: confidence level, conditional tail expectation and cost of capital. There is a requirement to disclose the confidence level to which the risk margin corresponds, even if an alternative method is adopted. **There is no detailed calibration of the confidence level for the capital amount or the cost of capital rate when applying the cost of capital approach.** Additionally, unlike Solvency II, there is no explicit prohibition on taking into account the loss-absorbing capacity of deferred tax.
 - For the cost of capital approach, the capital amount is set at a sufficiently high level that it captures almost the entire tail of the distribution. It is intended to provide a high degree of certainty that an insurer can fulfil its obligations. The cost rate is set to reflect the risks that are relevant to the liability. **There is the option 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 narrower than under Solvency II.** There is no risk adjustment associated with reinsurer default (non-performance of the reinsurer), investment risk (except where it affects the amount to policyholders such as on participating business) and general operational risk relating to future transactions.
 - The risk adjustment is calculated at the level of a portfolio of contracts resulting in **less diversification benefit than in Solvency II.**
 - 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. **Unlike Solvency II, a separate risk adjustment is required for the gross of reinsurance and reinsurance cash flows.**

Appendix A: Insurance contracts *continued*

Solvency II

Residual margin

- No concept of a residual margin.

IFRS

- 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 calculated within a portfolio by similar date of inception and by similar period of coverage. **The level of granularity in the residual margin will need to be managed from a data perspective.**
- The residual margin is recognised over the coverage period in a systematic way that reflects the exposure from providing insurance coverage. This is on the basis of passage of time or on the basis of the timing of expected claims and benefits (or fair value of assets under management for certain participating business), if this pattern differs significantly from the basis of passage of time.
- There is no adjustment for changes in estimates of both financial variables (such as discount rates and equity prices) and other estimates (such as expenses and lapses).
All variances flow directly through to profit or loss.

Participating business

- A Discretionary Participating Feature is a contractual right to receive additional benefits:
 - Whose amount or timing is contractually at the discretion of the insurer; and
 - Which are contractually based on: (i) the performance of a specified pool 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.
- There is no distinction between the treatment of contracts with participating features and those without. The best estimate includes all future discretionary benefit cash flows, except those relating to surplus funds where this has been authorised under national law. The only countries where significant amounts of surplus funds were identified at the QIS4 stage were Germany, Denmark and Sweden. Management actions and policyholder behaviour are included in the assessment.
- The basic definition of a participating feature is the same as Solvency II. The treatment of a participating contract under IFRS depends on whether the contract falls within the scope of the insurance contracts standard. Participating contracts are classified within the scope of the insurance contracts standard if either they transfer significant insurance risk or they are investment contracts which participate in the same performance pool as insurance contracts.
- For participating contracts in the scope of the insurance standard, the measurement model is the same as for other insurance contracts. All payments 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 including management actions and policyholder behaviour. There is no concept of surplus funds in IFRS.
- The requirements regarding the 'contract boundary' discussed below would preclude any cash flows expected to become payable to future policyholders from the measurement of the contractual liability. Some might argue, however, that if investment returns earned on assets backing existing contracts are expected to be paid to future policyholders then those cash flows could be considered to arise from the existing contracts. In particular, the insurance contracts ED makes explicit reference to including cash flows relating to future policyholders within the measurement of the contract. However, it is unclear how the 'estate' within a proprietary or mutual entity will be allocated between equity and the contract liability. While there is no equivalent reference to future policyholders in the draft Solvency II guidance, this is an area where further clarification of the proposed treatment is needed under both Solvency II and IFRS.

Appendix A: Insurance contracts *continued*

Solvency II

IFRS

Participating business *Continued*

- The boundary of a participating contract depends whether it transfers significant insurance risk or whether there is just pooling with other insurance contracts:
 - Where there is significant insurance risk, the boundary is as for other insurance contracts discussed previously.
 - Where there is pooling with other insurance contracts and no significant insurance risk transfer, the boundary of the contract is the point where the policyholder no longer has a contractual right to receive the participating benefits.

In Solvency II, there is no distinction in the contract boundary between participating and non-participating contracts.

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 the uncertainty in amount and timing of the liability cash flows in all possible scenarios. Cash flows depending on underwriting risk cannot be reliability 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.
- 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 in the use of replicating portfolios. **However, the term ‘exactly’ may result in a similar level of restriction in the use of replicating portfolios 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 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.

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.
- The reinsurance related cash flows include the risk of expected reinsurer 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 include the risk of non-performance by the reinsurer, which is included on an expected value basis when estimating the fulfilment cash flows of the reinsurance asset.
- There is an explicit reinsurance risk adjustment, which excludes reinsurer credit risk.
- There is an explicit residual margin calibrated to the reinsurance premium and set to avoid a loss at inception. However, if the net cost of the reinsurance is less than the expected value of the recovery (including a risk adjustment), then this is recognised as an immediate gain.
- The reinsurance-related residual margin is released using the same method as the residual margin relating to the gross cash flows.

Appendix A: Insurance contracts *continued*

Solvency II

IFRS

Business combinations and portfolio transfers

- There is no concept in Solvency II of business combinations or portfolio transfers. All contracts are treated as organic, and follow the same recognition, measurement and presentation approach.
- 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.

Transitional arrangements

- A transitional arrangement to grandfather existing rules over the discount rate is being tested under QIS5, as previously discussed. Currently, there are no other transitional arrangements proposed for the measurement of contract liabilities under Solvency II.
- There is full retrospective application of the insurance standard, except that there is no recreation of the residual margin. **There is no grandfathering of existing rules.**
- On implementing the new insurance contracts standard, each portfolio of insurance contracts is measured as the best estimate plus risk adjustment, excluding the residual margin. Any existing intangible assets or liabilities (e.g. DAC) are derecognised (excluding customer relationships that relate to future contracts). The change in measurement is presented in shareholder equity and is not recognised in the income statement. **The proposal to exclude the residual margin may negatively impact future profit emergence compared to existing accounting frameworks.**

Appendix B

Appendix B: Investment contracts

Solvency II

Relevant standards

- QIS5 Technical Specification
- Solvency II Level 1 Directive

IFRS

- IAS 32 – Financial Instruments: Presentation
- Fair Value Measurement ED
- IFRS 9 – Fair Value Option for Financial Liabilities ED
- IFRS 9 – Amortised Cost and Impairment ED
- IAS 39 – Financial Instruments: Recognition and Measurement (in relation to financial liabilities where not replaced by the above-mentioned IFRS 9 ED)
- IAS 18 – Revenue
- Revenue from Contracts with Customers ED
- Insurance Contracts ED (in defining the scope of insurance contracts and therefore implicitly the scope of investment contracts)

There is considerable uncertainty as to treatment of investment contracts in IFRS due to the range of EDs currently under consultation.

Scope

- Solvency II applies to all insurance and reinsurance contracts written by the issuer in the EEA or branches of EEA based insurers outside the EEA. There is no distinction between insurance and investment contracts.
- 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 (other than participating contracts that participate in the same performance pool as other insurance contracts) are accounted for as financial instruments under IFRS.
- Account balances and embedded derivatives unbundled from insurance contracts are within the same financial instruments standards.

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, calibrated to ensure that the technical provisions are equivalent to the expected amount required by another insurer to take over and meet the obligations.
- There is no deposit floor.
- The recognition, measurement and presentation of investment contracts are initially governed by IAS 32. This is particularly relevant for participating contracts (not in the scope of the Insurance Contracts ED) as it will determine how such contracts are split between liability and equity components. **The treatment of participating investment contracts is untested in the financial instruments standards. This is an area where market practice will develop over the coming period. However, it is clear that the approach is likely to diverge from Solvency II.**
- 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).
- Further, for those contracts measured at fair value there is a deposit floor. 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 for typical unit-linked contracts, the implications of the Fair Value Measurement ED will need to be considered. **The current staff draft of a proposed IFRS 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.**

Appendix B: Investment contracts *continued*

Solvency II

IFRS

Measurement approach *continued*

- 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. It is not expected that the effective interest rate method for financial liabilities at amortised cost will change significantly as a result of the Amortised Cost and Impairment ED, but there may be some minor changes.

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.

- All day-one gains are eliminated (if not observable in the market) while losses are immediately recognised.

Deferral of origination costs

- Under the Revenue from Contracts with Customers ED, there is no deferral of incremental acquisition costs. All such costs are expensed as incurred. Further, any existing deferred assets on transition are eliminated to shareholder equity. **This represents a significant change compared to the current treatment of investment contracts where deferral of such incremental costs is permitted under IAS 18.** Consequently, there will be a day-one loss from writing such business and a different profit profile for the existing book at transition. **It also contrasts with the Insurance Contracts ED where implicit deferral of such costs is achieved through the reduction in the residual margin.**
- In light of the above, the unbundling of investment management related components under the Insurance Contract ED will be important because acquisition costs cannot be deferred for such an unbundled component.

Deferral of origination fees

- Origination fees relating to investment management services are deferred. The fees are earned as services are provided, for example, over the expected term of the policy.

Other matters

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

- Where investment contract liabilities are held at fair value, the change in fair value (including changes relating to own credit risk) is recognised in profit or loss. Under the financial liabilities ED, if a financial liability is designated at fair value the portion of the change in fair value due to changes in own credit is recorded in Other Comprehensive Income (“OCI”).
- For unit-linked insurance contracts, it is proposed that entities recognise treasury shares and owner occupied property at fair value through profit or loss to the extent those changes relate to the interest of unit-linked contract holders in the pool of assets. **It is unclear whether this change will also apply to unit-linked investment contracts.**

Appendix C

Appendix C: Assets and other liabilities

Item	Solvency II	IFRS
Assets		
Goodwill on acquisition	Goodwill is not considered an identifiable and separable asset in the market place. The economic value of goodwill for solvency purposes is nil.	Initial measurement at cost (the excess of the cost of the business combination 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.
Intangible assets	Intangible assets should be measured at fair value only when they are separable and where there is evidence of exchange transactions of the same or similar assets indicating that they are saleable in the marketplace. Where these criteria are met, which is unlikely in practice, the valuation under IFRS may be used for Solvency II. Where the criteria are not met, intangible assets must be valued at nil.	<p>An 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.</p> <p>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.</p>
Property plant and Equipment ("PPE")	PPE should be measured at fair value for solvency purposes. The revaluation model under the IFRS on PPE is considered to be a reasonable proxy for fair value.	Initial measurement is at cost. Subsequent measurement is using either the cost or the revaluation model described in the entry for intangible assets, above.
Finance leases	Finance leases are measured at fair value.	Finance leases are measured initially at the lower of fair value and the present value of the minimum lease payment under IAS 17. An ED proposing amendments to IAS 17 has been published, which would significantly alter the accounting treatment for leases including the valuation of assets and liabilities arising under leases currently classified as finance leases. Under the proposals, an entity would be required to set up a liability for the present value of the lease payments, which should subsequently be amortised using the effective interest method, and reassessed where facts or circumstances indicate that the liability may have changed since the previous reporting period. The entity should also establish a 'right-of-use' asset at inception at the value of the liability to make lease payments plus initial direct costs, which should subsequently be measured at amortised cost.
Investments		
Investment property	Investment property is measured at fair value. The fair value model under the IFRS on Investment Property is considered a good proxy for economic value for Solvency II.	Measurement is initially at cost. Subsequent measurement is using either the cost or the revaluation model described in the entry for intangible assets, above.

Appendix C: Assets and other *continued*

Item	Solvency II	IFRS
Investments <i>continued</i>		
Participations in subsidiaries, associates and joint ventures	<p>Under QIS5, participations are classified into three classes for valuation:</p> <ul style="list-style-type: none"> Listed companies, which should be valued using quoted market prices in active markets; Unlisted subsidiaries, which should be valued on an adjusted equity method (being the parent's share of the excess of the assets over the liabilities of the subsidiary valued in accordance with Solvency II valuation principles); and All other undertakings (not subsidiaries), which should wherever possible use an adjusted equity method with an option to mark to model if the adjusted equity method is not possible. <p>Notwithstanding the above, where an insurer invests in a financial institution (being banks or investment firms) these must be valued at nil for solvency purposes.</p>	<p>Participations 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 below).</p> <p>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.</p>
Financial assets	<p>Financial assets should be measured at fair value for solvency purposes, even when they are measured at amortised cost in an IFRS balance sheet.</p>	<p>Under IFRS9 the following asset measurement categories are set out: -</p> <ul style="list-style-type: none"> 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 asset has not been designated at fair value through profit and loss to eliminate an accounting mismatch. Fair value through OCI: Equity instruments where it has been elected that gains and losses are presented in OCI. Fair value through profit and loss: All other financial assets. <p>The Insurance Contract ED contains an option on implementation to redesignate a financial asset to fair value from amortised cost, but not vice versa. The restriction over the redesignation to amortised cost may result in accounting mismatches given unbundling requirements and changes in the scope of contracts included in the financial instruments standard. However, IFRS 9 allows assets to be redesignated into, and from, fair value through profit or loss on transition, which may resolve such difficulties if the standards are adopted simultaneously.</p>
Other assets		
Non-current assets held for sale or discontinued operations	<p>Non-current assets are measured at fair value less cost to sell.</p>	<p>Non-current assets are held at lower of carrying amount and fair value less costs to sell.</p>

Appendix C: Assets and other *continued*

Item	Solvency II	IFRS
Other assets <i>continued</i>		
Deferred tax assets	Deferred tax is calculated in accordance with the method used under IFRS based on the valuations in the Solvency II balance sheet.	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 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. 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. There are limited exceptions removing the requirement to recognise deferred tax assets in certain situations.
Current tax assets	Current tax assets are valued at the amount expected to be recovered.	Current tax assets are valued at the amount expected to be recovered.
Cash and cash equivalents	Cash is valued at an amount not less than the amount payable on demand.	Cash is a financial asset and is therefore valued under IAS 39 as described above.
Other assets	Under QIS5, all assets where there are no specific valuation rules are valued in accordance with IFRS.	An entity may have other assets, for example prepayments or accrued income, which are subject to specific accounting rules under IFRS.
Off-balance-sheet financing	Subject to supervisory approval, certain items of off-balance-sheet financing (for example, letters of credit) may be recognised as ancillary own funds under Solvency II. Consistent with Solvency II valuation principles, valuation should be at economic value at either an amount or using a method approved by the supervisor.	By definition, items of off-balance-sheet financing are not recognised on the IFRS balance sheet.
Liabilities		
Financial liabilities	Financial liabilities should be valued at fair value in conformity with IFRS upon initial recognition. Subsequent measurement should take account of differences in the risk-free rate but not the insurer's own credit standing. 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 on the IFRS balance sheet.	Financial liabilities should be valued under IFRS at either fair value or at amortised cost. 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. As noted in Appendix B, under the financial liabilities ED it is proposed that changes in the valuation of financial liabilities designated at fair value (using the fair value option), relating to changes in the liability's own credit risk should be reported in OCI rather than profit and loss. Subordinated liabilities are recognised as financial liabilities under IFRS.

Appendix C: Assets and other *continued*

Item	Solvency II	IFRS
Liabilities continued		
Provisions other than technical provisions	Provisions other than technical provisions should be valued in accordance with IFRS.	<p>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.</p> <p>An ED has been published proposing amendments to IAS 37. The ED clarifies that the best estimate should be valued at the lower of the present value of the resources required to settle the obligation taking into account the time value of money and the risk that the actual resources required may differ from those expected, or the amount that the entity would actually have to pay to settle or transfer the obligation.</p>
Contingent liabilities	Material contingent liabilities, as defined under IFRS, should be recognised as liabilities for Solvency II. Valuation should be based on the probability weighted average of future cash flows required to settle the contingent liability, discounted at the relevant risk-free interest rate term structure.	<p>Contingent liabilities should not be recognised under IAS 37, but should be disclosed and continuously assessed. An ED has been published proposing amendments to IAS 37, which aims to align the requirement for recognition of liabilities with other IFRS standards. This would remove the requirement for an outflow of economic resources to be 'probable' (i.e. having a probability of greater than 50%) for the liability to be recognised, so would require contingent liabilities to be recognised in a manner consistent with the requirements for provisions explained above.</p> <p>The ED proposals would take the treatment of contingent liabilities much closer to the approach proposed for Solvency II.</p>
Deferred tax liabilities	Deferred taxes liabilities should be valued in accordance with IFRS (undiscounted) based on the Solvency II balance sheet.	<p>Deferred tax liabilities 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 liabilities should be offset with deferred tax assets if, and only if, the entity has a legal right of set-off, which requires inter alia both the liability and asset to relate to the same taxation authority, and if the entity intends either to settle net or to settle the liability and realise the asset simultaneously. Deferred tax liabilities are not discounted.</p> <p>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.</p>

Appendix C: Assets and other *continued*

Item	Solvency II	IFRS
Liabilities continued		
Current tax liabilities	Current tax liabilities should be valued at the amount expected to be paid .	Current tax liabilities are measured at the amount expected to be paid.
Employee benefits and termination benefits	Liabilities for employee and termination benefits should be valued either in accordance with IFRS but with the impact of smoothing eliminated, or in accordance with an internal economic model reflecting Solvency II valuation principles.	<p>Under IAS 19, the fair value of defined benefit plans by reference to a market yield is the net of:</p> <ul style="list-style-type: none"> • the present value of a reliable actuarial estimate of the benefit employees have earned in current and prior periods; • the total amount of actuarial gains and losses to be recognised; • current service costs; and • the fair value of the plan assets recognised. <p>IAS 19 requires an entity to recognise, as a minimum, a specified portion of the actuarial gains and losses that fall outside the range ('or corridor') of best estimate plus or minus 10%.</p> <p>Two EDs have been published proposing amendments to IAS 19. The proposals remove the corridor approach and alter the presentation of gains and losses, meaning that all changes in defined benefit obligations and in the fair value of plan assets would be recognised immediately in OCI with other costs recognised immediately in the profit and loss account. This change would make the treatment of employee and termination benefits closer to the treatment under Solvency II, which does not allow the corridor approach to be used. The EDs also propose the deletion of the current requirement to use market yields on government bonds where deep markets for high-quality corporate bonds are not available, and therefore to use high-quality corporate bond rates at all times, in order to eliminate the current potential for companies to use different rates for reporting similar obligations.</p>

Appendix D

Appendix D: Group reporting

Item	Solvency II	IFRS
Scope of group reporting	<p>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.</p> <p>The scope of group supervision under Solvency II is restricted to insurance groups, so the scope of the group is limited to those entities that are subsidiaries or participations of an insurance company or an 'insurance holding company', which is any company whose main business is to acquire and hold participations in insurers or reinsurers.</p> <p>Entities may be excluded by the group supervisor from the scope of group supervision where they are situated in non-EEA countries where there are legal impediments to the transfer of the necessary information (in this case the book value of the entity must be deducted from group own funds), where they are of negligible interest for group supervision, both individually and in aggregate, or where their inclusion in group supervision would be inappropriate given the objectives of group supervision.</p> <p>For the purposes of assessing the scope of the group, the definitions of 'parent' and 'subsidiary' are consistent with those used under IFRS.</p> <p>Furthermore, a 'participation' relationship is considered to exist whenever one entity controls more than 20% of the capital or voting rights of another undertaking, 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.</p>	<p>The scope of consolidation under IFRS is based on the principle that the accounts should include the results of the parent company and all of its subsidiaries. A subsidiary is considered to be any entity that is controlled by the parent company, either through direct or indirect 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.</p> <p>Holdings in associates, being entities over which the group has significant influence, but which are not controlled by the group, are generally included in the consolidated accounts under the equity method (unless the associate is classified as held for sale). However, where the investor is a venture capital organisation, mutual fund, unit trust or similar entity (such as investment linked insurance fund) it does not use the equity method where the investment in the associate has been designated at fair value through profit or loss or is classified as held for trading.</p>
Level of group reporting	<p>Under Solvency II, the level at which a group is required to prepare consolidated results depends on the structure of the group.</p> <p>Where the ultimate insurance parent company of the group is within the EEA, group reporting is required by default only 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.</p> <p>If the ultimate insurance parent is based in a territory outside the EEA, which has been 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, in order for the ultimate parent's territory to be assessed as 'equivalent', one of the criteria that must be met is that a solvency assessment based on the group is performed. Therefore group reporting will need to be performed at the level of the ultimate parent in accordance with local regulation.</p>	<p>The ultimate parent company of a group is required to prepare consolidated accounts under IFRS.</p> <p>Under IAS 27, an intermediate parent (i.e. one that is itself a subsidiary) is exempt from preparing consolidated financial statements where the following conditions apply:</p> <ul style="list-style-type: none">• The company's owners have been informed about and do not object to its not preparing consolidated financial statements;• The company has not issued debt or equity instruments that are traded in a public market;• The company does not file its financial statements 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 *continued*

Item	Solvency II	IFRS
Level of group reporting <i>continued</i>	<p>If the ultimate insurance parent company is based in a non-equivalent non-EEA territory, consolidation may be required at whatever level the EEA group supervisor considers appropriate.</p> <p>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.</p>	
Method of group reporting	<p>Under Solvency II, groups are required to prepare group reporting to allow an assessment to be performed of the capital adequacy of the group, taking into account the Solvency Capital Requirement (“SCR”) and own funds calculated at the level of the group.</p> <p>The group results with which the assessment is performed, must be based on Solvency II principles, including Solvency II balance-sheet valuation principles, proportional recognition of participations of less than 100%, the elimination of intra-group creation or double use of own funds and adjustments to reflect group own funds that are restricted in their ability to absorb losses elsewhere in the group. Solvency II has two methods by which the group results may be prepared: the accounting consolidation-based method, which is the default method that groups must normally apply, and the deduction and aggregation method, which groups may apply subject to permission from their supervisor:</p> <ul style="list-style-type: none"> • The accounting consolidation based method uses the group’s consolidated accounts as a starting point in the calculation of group SCR and group own funds. However, these must be prepared, based on the Solvency II principles outlined above, so may differ from the IFRS consolidated accounts. The calculation of group own funds is based on the full consolidated balance sheet. However, when calculating the SCR only, the insurance-related subsidiaries are considered on a consolidated basis. The contribution of other members of the group to the SCR are aggregated on an entity-by-entity basis (and so do not reflect any benefits of diversification); • The deduction and aggregation method calculates the group’s results as the aggregation of the results and SCRs of each entity within the scope of the group. Where the group has a participation in an entity of less than 100%, only the group’s proportion of that entity’s results and SCR are brought into the calculation, 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 an entity is based in a non-EEA territory that has been deemed equivalent with Solvency II for this purpose, and adjustments are necessary to eliminate any capital charge on intra-group transactions for individual entities within the group. <p>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.</p>	<p>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 to apply consolidation adjustments to:</p> <ul style="list-style-type: none"> • Adjust individual accounting policies to be consistent with the accounting policies of the group; • Eliminate pre-acquisition reserves; • Recognise material adjusting post-balance-sheet events occurring between the time subsidiary accounts were signed and the finalisation of the consolidated financial statements; • Adjust subsidiary results where the subsidiary’s year-end is not coterminous with that of the parent company; and • Eliminate intra-group balances, transactions, income and expenses, for example those relating to intra-group trading. <p>Where a subsidiary is not owned 100% by the group, an adjustment is also required to recognise the ‘minority interest’/‘non-controlling interest’ of the other shareholders in the company, which forms part of the equity of the parent.</p> <p>Where associates are valued in the consolidated accounts under the equity method, the interest in the associate is initially measured at cost and is subsequently adjusted for the investor’s share of post-acquisition profits or losses.</p>

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