IFRS 17 – *Insurance Contracts* – DEA – Procyclicality Issues Paper

Objective

1   The purpose of this session is to receive EFRAG IAWG comments on the chapter relating to procyclicality in the IFRS 17 DEA.

2   This paper was discussed by EFRAG IAWG on 25 June 2020. A verbal update of the discussion will be provided at the TEG meeting.

Questions for EFRAG TEG members
3   Does EFRAG TEG have comments on the text below to be included in the DEA?

4   The motion of the EP asks to EFRAG to consider the recommendations outlined in its resolutions of 7 June 2016 on IAS evaluation and 6 October 2016 on IFRS 9 for the endorsement of IFRS 17, most notably regarding the impact of new standards on financial stability and long-term investment in the EU, but also the risks entailed by the propensity of accounting provisions to cause pro-cyclical effects and/or higher volatility, particularly as IFRS 17 will shift the focus from historical cost to current values.

5   There are two main approaches to looking at cyclical behaviour of economic variables. The first defines procyclicality mainly in terms of financial variables moving together with and in the same direction as the financial cycle, as opposed to countercyclicality (which implies that the variables move in the opposite direction). The second approach sees procyclicality as embedding the idea of amplifying the financial cycle, i.e. not merely going in the same direction, but reinforcing it. The second approach is associated with behaviours that can affect the depth and duration of financial crises[1].

6   It is noted that the request addressed to EFRAG focuses on the insurance liabilities (impact of discount rates) while the request addressed to the EC focuses on the investments of insurers (assets and treatment of unrealised gains on these). EFRAG acknowledges that there are inherent links between the procyclical effect on assets and on liabilities. While discount rates for the insurance liabilities reflect in the first place the characteristics of those liabilities, they are influenced by the interest rates that are valid for the assets.

7   In order to focus the analysis, hereunder only the procyclical effects of the accounting treatment of insurance liabilities are being discussed. As such, the analysis does not address the question whether changes in market conditions affect the (type) of investments insurers do throughout the economic cycle (this relates to the application of IFRS 9). Instead, the question addressed is whether a current

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[1] ESRB 2019, The cyclical behaviour of the ECL model in IFRS 9.

measurement of insurance liabilities impacts the availability of insurance solutions to the economy.

Analysis

8   In accordance with IFRS 17, insurance liabilities are discounted using current rates, which implies that when interest rates go down, the recognised amount of the insurance liabilities increases and vice-versa. In this sense, the standard is pro-cyclical in so far the value of the liabilities increases (with negative impact on profits and retained earnings) when interest rates go down (normally in a downturn).

9   Insurance business is characterised by an inverted business cycle, i.e. generally premiums are received (long) before payments of claims are due. This steady stream of cash inflows makes insurers less dependent on short-term funding. It also has the effect of disconnecting the current measurement of the liability from the actual moment of when the claims need to be paid (i.e. the moment when the liability is due). In other words, while the current measurement of the insurance liability may increase the absolute value of the liability today, the payment of claims may only happen years later in a different interest rate environment and hence under a different value of the liability. EFRAG acknowledges that this finding is less relevant in an economic scenario where interest rates remain low for long.

10   Also, in contrast to banks, liquidity risk is less prominent for insurers. Due to the extended claim payment period insurers are generally able to prepare better the funding required to absorb the claims. For the same reason, insurers are far less likely to suffer from 'a run on the company' than banks.

11   The main risk from a financial stability point of view will therefore be solvency risk (does an insurer have sufficient capital available to cover the risks created by its activities) which is addressed through the Solvency II requirements. A critical transmission mechanism for a standard that is pro-cyclical in the second meaning of the definition illustrated above, would be to disincentivise the retention of profits matured in the positive phases of the cycle, such as overstating profits and thus allowing dividends and bonus distributions in good times. As there is no linkage between the accounting equity (cumulative retaining earnings) and the Solvency ratios and the distribution of dividends is subject to limits defined under Solvency II, the transmission mechanism through the distribution of profits is not in place. In other terms, irrespective of what any accounting standard would require, an insurer will not be allowed to pay dividends that bring its reserves below the requirements of Solvency II. This has been demonstrated during the Covid-19 crisis, where EIOPA has put strong restrictions on European insurers for paying out dividends (similarly as done by EBA for European banks).

12   The Solvency II requirements foresee a number of measures to dampen procyclical effects. Two of these relate to discount rates: the volatility adjustment and the matching adjustment. The difference between Solvency II and IFRS 17 discount rates is discussed in paragraph x.

13   The volatility adjustment allows insurers to adjust the relevant risk-free interest rate term structure for the calculation of the best estimate of technical provisions to mitigate the effect of exaggerations of bond spreads. The matching adjustment seeks to avoid changes of asset spreads from impacting on the amount of own funds of insurers. Subject to supervisory approval, insurers are allowed to adjust the relevant risk-free interest rate term structure for the calculation of the best estimate in line with the spread movements of their assets. Both measures protect the regulatory capital from insurers from extreme procyclical effects.

14   EFRAG adds that the use of a current measurement is not new. In fact, already today some insurance business in some Member States apply current discount rates, while in other Member States and insurance business historical rates are being used. Current practices on discount rates are being discussed in paragraphs

xx to xx in Annex 1. EFRAG has no indication that – as a result of those differences in accounting treatment between insurance business – the availability of insurance solutions between Member States has been affected.

15   Finally, EFRAG notes that thanks to their current measurement basis under IFRS 17 insurance liabilities can be at least partially aligned with the current measurement of [financial] assets, to the extent that they are not measured at amortised cost under IFRS 9. Similarly, the finance expenses relating to the insurance liabilities reduce the finance income created by the financial assets. Only the net effect of both affects profit or loss and subsequently equity. As the discount rate incorporates an estimated asset return, the unwinding of the insurance liability as services are provided to the policyholder compensates partly the actual effect that is affecting profit or loss in the period. So the net effect is creating volatility the degree to which will partly depend on the ability of the insurer to reliably estimate future asset returns. Hence, the current measurement of the insurance liabilities has the result, at least partially, of dampening potential procyclical effects. In addition, the contractual service margin is allocated to profit or loss spread over the coverage period of the insurance contracts involved. This has a smoothening and thus anti-cyclical effect on the profit recognition. In addition to this, the deferral of profit through the CSM mechanism has also a smoothening effect. It avoids overstating revenues in good times when many premiums are written and spreads the effects over a longer term, thereby mitigating pro-cyclicality.