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Decision Document – Economic study **IFRS 17 *Insurance Contracts***

Objective

- 1 The objective of this paper is to assess whether the economic study commissioned by EFRAG in 2018 should be updated in order to be used in the draft endorsement advice on IFRS 17 *Insurance Contracts* as amended.

Background

- 2 The EFRAG Secretariat commissioned an economic study as a supporting tool for developing the endorsement advice on IFRS 17 *Insurance Contracts* ('IFRS 17'). Its purpose was to provide several analyses to inform EFRAG's ex-ante impact assessment on IFRS 17. The final report is dated 24 September 2018 and can be found in Agenda paper 04-06A. The economic study has not been updated since. A summary of the executive summary of the economic study can be found in Appendix.
- 3 The topics covered by the economic study included the following:
 - (a) Competition from non-EU insurers faced by EU insurers in product and capital markets;
 - (b) Development of the EU insurance markets since 2005;
 - (c) Developments in the asset allocation of European insurers; and
 - (d) The cost of capital faced by EU insurance undertakings and investors' perception of the clarity of the financial reports of EU insurance undertakings.

Competition from non-EU insurers faced by EU insurers in product and capital markets

- 4 This chapter provides an assessment of the extent to which EU insurance undertakings face competition in product and capital markets from non-EU insurance undertakings and provides the views of stakeholders on the potential impact of IFRS 17 on competition in these two markets.
- 5 As well, the chapter discusses potential additional costs that listed EU insurers may face due to the one-off and on-going compliance costs with IFRS 17.
- 6 Data on the extent of competition was mainly based on stakeholders interviewed and an online survey that was carried out. Trends in market shares of EEA/non EEA insurers in the EU capital markets drew information primarily from the Thomson Reuters database from 2000-2018 H1.

EFRAG Secretariat analysis

- 7 The analysis was performed one year ago and focussed on the current competition situation. Since then, there has not been a radical change within one year relating to IFRS Standards/regulation. Therefore, the EFRAG Secretariat does not consider that updating this area would significantly add to the analysis that has already been performed.

- 8 This Chapter also included information on potential additional costs due to IFRS 17. The EFRAG Secretariat will perform a limited case study which includes questions relating to this. Therefore, the EFRAG Secretariat does not consider that this information needs to be updated in the economic study.
- 9 This Chapter included, as well, potential impact of IFRS 17 as issued on competition based on interviews with industry stakeholders. Industry stakeholders expressed a concern that the adoption of IFRS 17 may increase the volatility of the P&L due to accounting mismatches and this may distort a company's financial position and performance. Since then, an IASB Exposure Draft was issued in June 2019 on the Amendments to IFRS 17. This ED proposed solutions to accounting mismatch issues relating to reinsurance contracts held - recovery of losses from underlying contracts and the extension of the risk mitigation to reinsurance contracts held. The impact of these proposed amendments will be evaluated as part of the limited update of the case study. In the user outreach conducted by the EFRAG Secretariat, it was also noted that users do not have a problem with volatility as long as information disclosed are transparent.

Trends in market shares of EEA/non-EEA insurers in the EU capital markets

- 10 This Chapter contained the following sections:
- (a) Trends in insurance product mix;
 - (b) Trends in insurance prices;
 - (c) Factors explaining the observed trends; and
 - (d) Potential impact of IFRS 17 on insurance product mix and prices.

Trends in insurance product mix

- 11 This section presented some key facts about the evolution since 2005 of the product mix in the EU insurance market. These key facts were taken from EIOPA insurance statistics Solvency I from 2005 to 2015.

Trends in insurance prices

- 12 This section presented some facts about the evolution since 2005 of the insurance prices in the EU insurance market. This information was obtained from Eurostat HICP from 2005-2017.

Factors explaining the observed trends

- 13 This section discussed the key factors which explain the observed trends. Many sources of information were considered including Global insurance trends analysis 2017 by E&Y, Moody's 2017, Munich Re 2011 and Accenture 2016.

- 14 The sources information ranged from 2010 to 2017.

Potential impact of IFRS 17 on insurance product mix and prices

- 15 This section was based on industry stakeholders that were interviewed.

EFRAG Secretariat analysis

- 16 The EFRAG Secretariat notes that information used to derive the trends in insurance product mix was based on Solvency I and did not include the impact of Solvency II. However, the EFRAG Secretariat notes that another source of information was the EFRAG extensive and simplified case studies where there were questions on the impact on product mix.

- 17 The economic study summarised that IFRS 17 is not expected to have a noticeable impact on the product mix except for 'life' and 'credit suretyship'. For life insurance the reasons were that the P&L would be exposed to market fluctuations. In addition,

the majority of industry stakeholders believed that reinsurance contracts were not dealt with appropriately.

- 18 The EFRAG Secretariat does not consider that this Chapter needs to be updated because the issues for life insurance relates to the model(s) in IFRS 17 which has not changed. Regarding the second concern, the EFRAG Secretariat notes that the IASB proposes to address the accounting mismatch issues regarding reinsurance contracts in its ED.

Developments in the asset allocation of European insurers

- 19 This Chapter contained the following sections:

- (a) Trends in the allocation of investment assets held by insurance undertakings;
- (b) What factors drove the observed trends in asset allocation of European insurers; and
- (c) Potential impact of IFRS 17 on asset allocation of European insurers.

Trends in the allocation of investment assets held by insurance undertakings

- 20 This section focussed on changes since 2005 in the European insurers' allocation of investments to different asset classes. A number of different data sources were used: OECD 2017, Moody's 2017; 2005 to 2015 data from EIOPA on asset allocation of European undertakings subject to Solvency I and the last quarter in 2017 for those subject to Solvency II.

What factors drove the observed trends in asset allocation of European insurers?

- 21 This section provided information on the factors which explained the observed trends. Information was obtained from Thompson Reuters (2000-2018), Financial Times 2017, Moody's 2017, Standard Life Investments 2015, The Actuary 2017/2018, EIOPA 2017 survey of European insurers and GSAM's 2016 insurance survey.

Potential impact of IFRS 17 on asset allocation of European insurers

- 22 This section presented the views of stakeholders on the potential impact of IFRS 17 on the insurers' asset allocation based on interviews conducted.

EFRAG Secretariat analysis

- 23 The EFRAG Secretariat does not consider that this section should be updated because of the following:

- (a) Data analysed spanned over 10 years (from EIOPA) and over 18 years (from Thompson Reuters). The number of years gives an insightful indication of the trend in asset allocation. The EFRAG Secretariat considers that this analysis was performed only one year ago. Since then there has not been big changes to regulation or IFRS Standards which could impact the asset allocation. Therefore, we do not expect a radical change from the information presented in this Chapter, e.g., we do not expect a significant change from the conclusion that the aggregate data on the investments of EU insurers do not show a significant movement out of the debt securities at the EU wide level.
- (b) There is updated information from EIOPA on statistics about assets under Solvency II (both for solo (2018) and group (2017))¹ such as investment mix, main categories of total assets by insurers per country; and
- (c) The economic study indicated that the majority of industry stakeholders interviewed expressed the view that the effect of applying IFRS 17 in

¹ Source : <https://eiopa.europa.eu/Pages/Financial-stability-and-crisis-prevention/Insurance-Statistics.aspx>

conjunction with IFRS 9 *Financial Instruments* may have an impact on asset allocation. The EFRAG Secretariat, as part of Appendix 3 of the DEA, will be analysing the interaction between IFRS 9 and IFRS 17. In addition, a hedge accounting questionnaire was conducted by the EFRAG Secretariat in order to collect information on the current hedging activities and hedge accounting practices of insurers and the future possibilities of applying hedge accounting when applying IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9.

The cost of capital faced by EU insurance undertakings and investors' perception of the clarity of the financial reports of EU insurance undertakings

24 This Chapter contained the following sections:

- (a) The cost of capital faced by EU insurance undertakings; and
- (b) The views of investors on the potential impact of IFRS 17.

The cost of capital faced by EU insurance undertakings

25 This section described the evolution of the cost of capital faced by EU insurance undertakings (in absolute terms and relative to other economic sectors). Information on actual cost of capital of EU insurers from 2005 to 2017 was obtained from the Thomson Reuters Datastream.

The views of investors on the potential impact of IFRS 17

26 This section reported the views of stakeholders on whether IFRS 17 would impact the EU insurers' cost of funds. These views were obtained from interviews conducted and an online survey. Information was also obtained from BlackRock 2017, FITCH 2017, S&P 2018 and Deloitte 2018.

EFRAG Secretariat analysis

27 The EFRAG Secretariat does not consider that this Chapter needs to be updated because:

- (a) This analysis was performed one year ago and the data that was analysed spanned over 12 years. The EFRAG Secretariat does not expect that there has been a radical change within one year on the current trends;
- (b) This Chapter also looks at the views of investors on the potential impact of IFRS 17. The EFRAG Secretariat refers to the decision document on EFRAG's User Outreach where we suggest for this not to be updated; and
- (c) In addition, the conclusions made regarding the potential impact of IFRS 17 on cost of capital focussed on IFRS 17 as a whole. The EFRAG Secretariat does not consider that the IASB ED would significantly modify the conclusions because the amendments were mainly to aid implementation. Also, in parallel with the economic study on the potential impact of cost of capital, we had responses from the EFRAG extensive and simplified case studies on this.

Overall EFRAG Secretariat recommendation

28 Based on the EFRAG Secretariat analysis and reasons for each of the Chapters of the economic study stated above, the EFRAG Secretariat recommends not to update the economic study.

Question for EFRAG Board

29 Does EFRAG Board have any comments? Please explain.

Appendix: Executive summary of economic study

Introduction

1 This appendix summarises the executive summary of the economic study commissioned by EFRAG.

Competitiveness landscape and IFRS 17

2 In general, insurance undertakings from the EEA face little competition from non-EEA undertakings in EU insurance markets.

3 However, for some, business focused and more niche insurance products, the market is a worldwide market. In such cases, EU insurance undertakings compete with insurance enterprises from major insurance centres outside the EU.

4 Insurance undertakings from the EU face little competition from non-EEA undertakings in EU capital markets but they do when raising funds internationally.

5 Industry stakeholders mentioned two factors which may impact on their competitive position in capital markets following the implementation of IFRS 17.

6 First, the financial bottom line of some insurers, especially life insurance undertakings may become more volatile. The limited empirical literature on the issue of P&L volatility and cost of funds suggest that the cost of capital of undertakings showing greater P&L volatility may face higher debt costs in international debt markets.²

7 Second, industry stakeholders are also concerned that IFRS 17 may make it more difficult to compare the financial statements with those of insurance undertakings from countries not adopting IFRS 17 although it is not clear whether the situation would be worse than at the present time.

8 Finally, the information provided by the insurance undertakings to EFRAG suggests that the ongoing costs are unlikely to have a very marked impact on expenses, in contrast to the one-off costs which may have a more substantial impact on the total expenses of insurance undertakings subject to IFRS 17 in the period or periods in which such costs are incurred.

Trends in the business models of EU insurance undertakings and IFRS 17 - insurance product mix and insurance prices

9 The key fact to note in terms of the evolution of the product mix in the EU insurance market since 2005 is the decline of the market share of life insurance in the total insurance market (measure by gross premiums) from 2005 to 2008 and the increase in the market share of non-life. Life insurance, however, remains still by far the largest insurance segment.

10 The overall price of insurance grew faster than the general consumer price index over the period 2005 to 2017. In particular, the annual rate of growth of price of insurance connected with health was markedly higher than overall inflation while the price of insurance connected with transport increased only marginally faster than the overall consumer price index.

11 Stakeholders reported that, in general, financial reporting does not play a big role in product mix and pricing. Thus, IFRS 17 is not expected to have a noticeable impact on the product mix except "Life" and "Credit Suretyship"

12 IFRS 17 is not expected to have significant impacts on short-term insurance contracts measured using the premium allocation approach, as the amount

² This is analysed in more detail in the "Investor perception of the insurance sector, cost of capital and IFRS 17" section.

recognised as insurance revenue need not be adjusted for the time value of money. The main changes for short-term insurance contracts will depend upon companies' existing insurance accounting practices.

- 13 However, long-duration contracts (such as life insurance) or product features which expose the P&L to market fluctuations (such as participating contracts evaluated using the general model) may be affected by the adoption of the new standard.
- 14 In addition, the majority of industry stakeholders believe that reinsurance contracts are not dealt with appropriately, as the treatment of reinsurance in the standard could add a non-economic pricing constraint to mitigate perceived losses in the financial reporting due to accounting mismatches. In addition, any implications to the pricing of reinsurance will also impact on the pricing of the underlying contract to the policy holder.

Trends in the business models of EU insurance undertakings and IFRS 17 - allocation of the investment assets

- 15 Although there is considerable discussion about insurers moving away from debt securities towards new asset classes and /or equity, the aggregate data from EIOPA on the investments of EU insurers do not show a significant movement out of the debt securities at the EU wide level.
- 16 The majority of stakeholders interviewed (i.e. supervisory authorities, insurers and external investors) agree that IFRS 17 alone will not impact the asset allocation of insurance undertakings, as this activity is more driven by risk management and/or asset/liability management.
- 17 However, industry stakeholders expressed the view that the effect of applying IFRS 17 in conjunction with IFRS 9 may have an impact on asset allocation. This is because a company is required to account for insurance contracts issued applying IFRS 17 and financial assets held applying IFRS 9. Investments in equity and structured funds may become less attractive following the adoption of IFRS 17 and IFRS 9, as assets characterised by higher volatility that may expose a company's P&L to market fluctuations.

Investor perception of the insurance sector, cost of capital and IFRS 17

- 18 In Germany, France, and the UK, the global financial crisis increased the cost of capital in the insurance sector more than in any other of the comparator industries. The difference was particularly sizeable in the several months following the collapse of Lehman Brothers in September 2008, when the effect can be observed even in Italy.
- 19 Moreover, in Germany, France, and the UK, the comparatively higher capital costs in many cases did not fully reverse. The difference between the cost of capital faced by insurance companies and the other sectors was in 2017 still greater than the difference in 2005. An exception is the banking sector, where the difference in WACC between insurance and banking returned broadly to its 2005 levels.
- 20 Among the stakeholders interviewed and surveyed, there was a general agreement about the difficulties that analysts face when evaluating the financial report of an insurance companies. Almost all the respondents indicated a level of difficulty in the top tier of the scale.
- 21 However, there are differing views on the potential impact of IFRS 17 on the cost of capital for EU insurance undertakings
- 22 Most stakeholders interviewed (i.e. the majority of supervisory authorities and some insurance undertakings) agreed on the fact that in the long run, the new accounting standards will bring increased transparency on the financial report practises of European insurance companies, improving their ability to raise capital on the market. Furthermore, it was stressed this change could make the insurance industry

more attractive to a generalist investor, which would reduce the cost of equity in the long run.

- 23 The majority of life insurance undertakings interviewed, instead, stressed that IFRS 17 implementation will negatively affect the life insurance industry and strongly disagree that there are any potential positive outcomes for the industry itself. Those stakeholders commented the increased complexity of accounting rules associated with IFRS 17 will not bring the intended transparency, but on the contrary, it will make the sector even less open to non-highly specialised investors.
- 24 The education of external investors and analysts is a major concern for industry stakeholders interviewed (both life and non-life). The challenge will be to explain the balance sheets and underlying financial assumptions to the external investors in the transition time.
- 25 Therefore, it is possible that IFRS 17 could lead to a perceived weakening of the financial strength of companies due to changes in the level of retained earnings. IFRS 17 could, at least temporarily, increase the cost of capital for European insurers while investors familiarise themselves with the new standard).
- 26 In terms of rating, two major rating agencies (FITCH and S&P) commented that IFRS 17 is unlikely to directly affect insurers' ratings because the economic substance of their balance sheets will not change.