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Implications of IFRS 17 in European financial stability: accounting methodology and evaluation modelling

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Abstract

The purpose of this document is to provide an overview of IFRS 17 and its possible practices according to a context analysis conducted by EIOPA and ESMA. Furthermore, the implications of the standard will be evaluated with respect to a traditional life and pension products. This requires a deeper insight into the standard, the construction of fictive insurance product and the determination of measurements techniques. With the recent release of the standard, IFRS 17 is unexplored to many within the insurance industry. Thus, the effects of the standard on the financial statements of insurance companies and strategies for reaching objectives such as profit smoothing are yet unknown. Furthermore, the standard is principle based and does hence not specify a practice. Therefore, to determine a practice that complies with the standard and enables achievements of desired objectives is vital. In conclusion, IFRS 17 is expected to bring substantial benefits to financial stability in the EU, mainly through the transparency channel; the requirements in IFRS 17 may push insurance corporations to improve internal processes, including enhancing their internal risk management frameworks.

Keywords*:* Accounting Methodology and Evaluation Modelling, European Financial Stability, IFRS 17.

1. Introduction of IFRS 17

In the second quarter of 2017, the *International Accounting Standards Board* (IASB) published a new *International Financial Reporting Standard*: *IFRS 17 Insurance Contracts,* here referred to as IFRS 17 or the standard. The standard presents principles for recognition, measure, presentation and disclosure of insurance contracts (Tutino 2016). The goal is to provide accurate information to stakeholders and investors according to a context analysis conducted by EIOPA and ESMA. Furthermore, the standard will harmonize how risks are recognized and measured (PricewaterhouseCoopers 2020). Thus, the accounting principle is believed to increase the comparability of insurance companies. The standard will be mandatory from the year of 2023 and will apply to all insurance contracts including reinsurance contracts held and issued by entities.

Important impacts of the standard are how to value insurance contracts and when to recognize profits and losses. By the principles of the standard, the financial statements of insurance companies will be largely affected (Nissim 2010).

The standard proposes a hybrid of market consistent valuation and book value accounting (Tutino and Pompili 2017). Specifically, insurance contracts are valued by their fulfillment cash flows which are derived from:

a. the best estimate of future cash flows;
b. an adjustment to time value of money and financial risks;
c. an adjustment to non-financial risk.

The best estimate of future cash flows refers to an unbiased estimation of them using the probability weighted average The adjustment to time value of money and financial risks is carried out by means of a discount rate that should be consistent with the liquidity characteristics of the future cash flows. Thus, the return from bearing financial risks is captured by the discounted estimated future cash flows. Similarly, the return from bearing non-financial risks is captured by the non-financial risk adjustment.

Under IFRS 17, profits are not recognized in a first initial step. Instead, any surplus in is captured in an item of the financial statement named *contractual service margin* (CSM). The CSM is subsequently adjusted for changes in fulfillment cash The CSM is also gradually released as the service is being fulfilled. Similarly, the risk adjustment is released as the contracts are released from non-financial risks. Profits are in turn recognized as the release of the CSM and the risk adjustment. The fact that surplus is captured by the CSM gives to the issuer a possibility of smoothing profits over time. Contrary, when there is a deficit in fulfillment cash flows a loss should be recognized instantly.

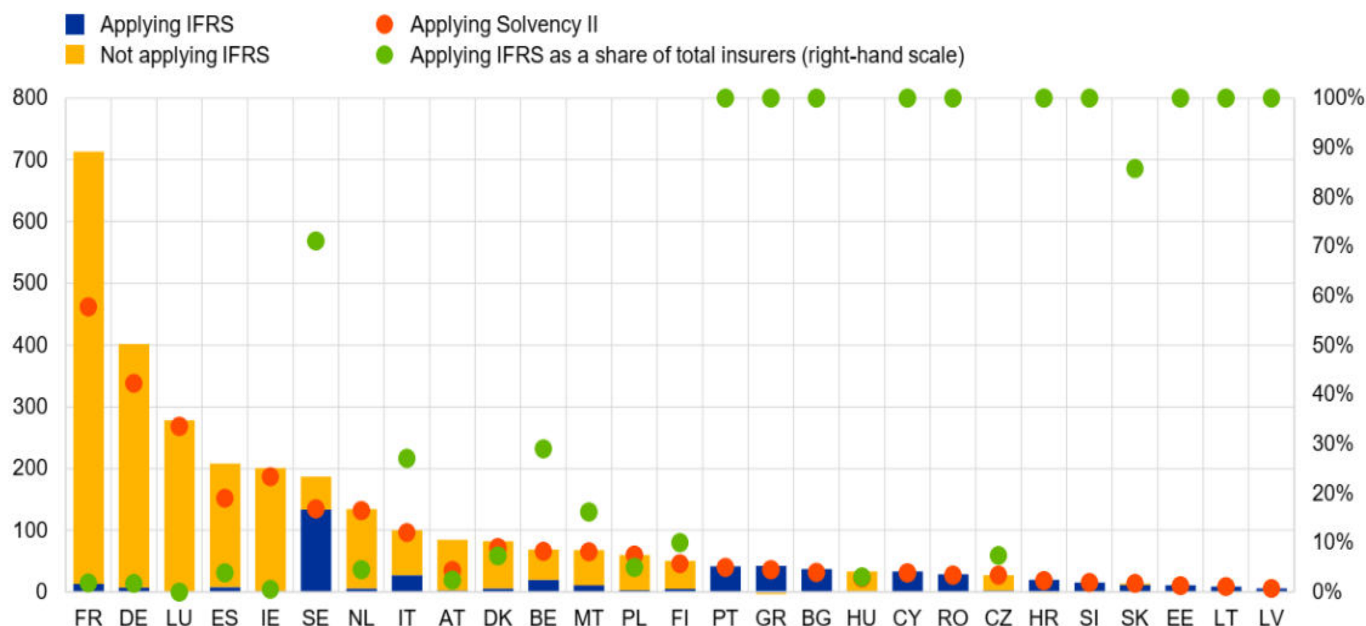
2. Methodology: forecasting of early adoption of IFRS 17

The implications of the standard will be analyzed and evaluated with respect to a traditional life and pension products. This requires a deeper insight into the standard, a construction of fictive insurance product and a determination of measurements techniques that compiles with the standard. A discussion of the data and methodology used by EIOPA and ESMA on the financial stability of IFRS 17 in its early adoption follows.

IFRS 17 will be applied to subpopulation of mainly large EU insurance corporations, as the requirement to apply IFRS 17 in the EU will cover consolidated financial statements of listed insurance corporations (European Financial Reporting Advisory Group 2020). In general, IFRS are required only for the consolidated financial statements of listed reporting entities across the EU. However, Member States can require or allow the use of IFRS for the consolidated financial statements of unlisted reporting entities and/or for their individual (separate) financial statements. According to data collected by the European Financial Reporting Advisory Group, only 500 insurers had been using IFRS at the end of 2018, out of a population of almost 3,000 insurance corporations in the EU (of

which 2,402 had been applying Solvency II), with substantial cross-country heterogeneity (Figure 1). In general, it can be expected that smallest insurance corporations will not apply IFRS 17, with some exception in certain EU Member States that also allow or require IFRS for individual financial statements (Dobler, 2020). Consequently, in terms of size of their financial statement, those insurance corporations applying IFRS 17 can be expected to be the largest, representing a large share of the total financial statement of insurance corporations in the EU. The total financial statement of the 340 groups reporting regularly to the European Insurance and Occupational Pensions Authority (EIOPA) was approximately €10.477 trillion at the end of 2019, while the 2,716 insurance corporations reporting to EIOPA on a solo basis had a total balance sheet of €12.706 trillion. This shows that stand-alone insurers that are not part of a consolidated group accounted for no more than about €2.2 trillion (or about 20% of the size of those insurers that are part of a group).

Figure 1. Application of IFRS by insurers across EU countries at the end of 2018



Source: European Financial Reporting Advisory Group (2021)

3. Evidence of investigation: transparency, stability and risk management reporting

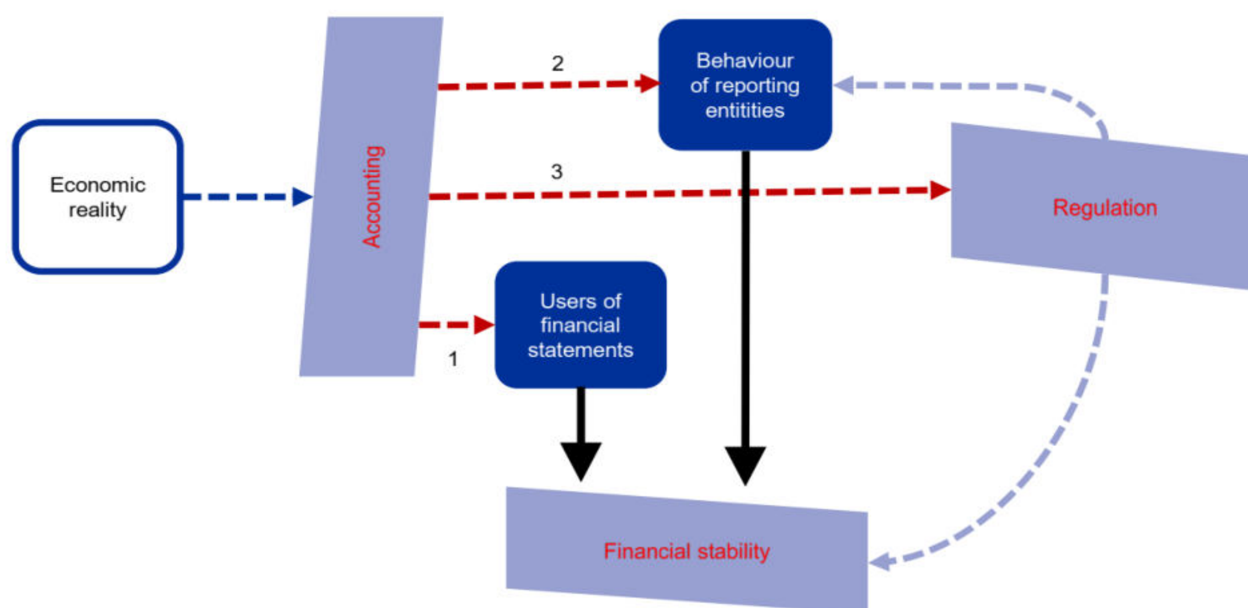
In 2018, EIOPA and the European Securities and Markets Authority (ESMA) have analyzed the impact of IFRS 17, touching upon financial stability considerations. EIOPA issued a report analyzing IFRS 17 from a financial stability perspective (European Financial Reporting Advisory Group 2021a). The paper concluded that IFRS 17 is expected to increase transparency and comparability in the insurance sector (Bertolotti and Van Wyk de Vries 2019), as it:

(i) provides stakeholders with better insights into insurers' business models, exposures and performance;
(ii) better reflects economic reality;
(iii) supports efficient risk management.

Overall, IFRS 17 was found to potentially strengthen financial stability in the EU. More recently, ESMA and EIOPA responded to EFRAG's draft endorsement advice. ESMA referred to financial stability aspects, highlighting that the provision of more transparent information has a beneficial effect on ensuring that financial market participants receive comparable and timely information. In addition, ESMA started that the effectiveness of IFRS 17 in depicting economic mismatches that may arise from the interplay between insurance liabilities and financial and non-financial assets backing those liabilities is particularly beneficial for financial stability (European Securities and Markets Authority, 2021). Similarly, EIOPA highlighted the benefits of IFRS 17 in strengthening financial stability in the EU (European Insurance and Occupational Pensions Authority, 2021). Regarding annual cohorts, EIOPA noted that, even though several ideas to replace this requirement were tentatively explored by EFRAG, none of them were found to be viable. Furthermore, EIOPA warned that an endorsement advice to exclude "intergenerationally-mutualised and cash-flow matched contracts" from the annual cohort requirement in IFRS 17 could lead to undesired (negative) consequences. ESMA expressed similar concerns and warned against any attempt to simply remove the annual cohort requirement without an appropriate replacement, noting that the requirements on the level of aggregation, including disaggregation into annual cohorts, are integral to the functioning of the entire standard.

Although the accounting process is not primarily meant as a tool to foster financial stability (Crenca 2017), there are at least three channels through which relevant and reliable financial information from the accounting process can affect financial stability through transparency (1), the behavioral response of the reporting entities (2), and regulation (3) (Figure 2).

Figure 2. Accounting and financial stability



Source: Author's elaboration, based on European Central Bank (2006) and International Accounting Standards Board (2017)

Transparency in accounting (EIOPA 2018), understood as the access to relevant, reliable and timely financial information about an economic agent, enables users of financial statements to make informed decisions of economic nature. It discourages economic agents (the reporting entities) from engaging in risky behaviors, transactions and supports internal and external decision-making processes. These are all beneficial to financial stability.

In this respect, financial statements prepared in accordance with a given set of accounting standards must provide information to financial market participants on the risks being taken on by the reporting entity and their impact in terms of financial position, performance and cash flows. Financial statements are helpful when they fairly depict the underlying economic reality of the reporting entity, thus reflecting the best objective evidence that is available at a certain reporting date, while not omitting any relevant information. Accounting standards can be seen as a "reporting language", translating economic reality into standardized metrics, such as assets and liabilities, and profits and losses. Changes in the "reporting language" can also change the translation of the economic reality.

There may be a trade-off between (individual) short-term effects and (broader) long-term effects of transparency on financial stability. Accounting standards can promote transparency. However, if negative issues relating to economic agents are disclosed to the public, this can trigger episodes of short-term instability. For example, the disclosure of large losses obtained by a financial institution informs investors about its deteriorated economic situation. This information can lead to a decline in its share price and to an increase in the interest rates on its debt securities, triggering second-round and spillover effects for similar institutions. However, these episodes of short-term instability are typically followed by a long-term strengthening of financial markets, as weaker entities are identified in a timely manner and forced to improve their performance. In the long run, transparency prevents the build-up of risks and vulnerabilities, thereby enhancing overall financial stability.

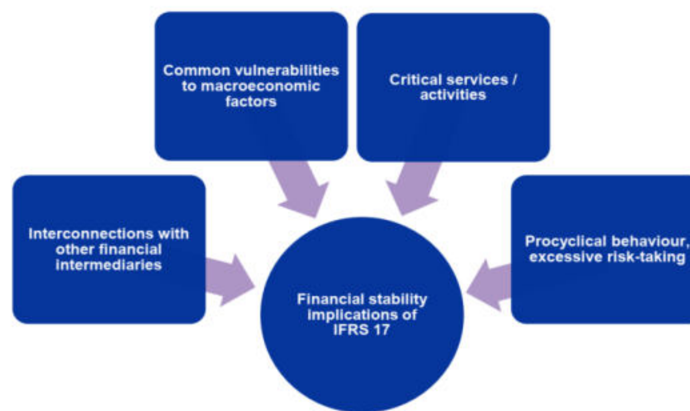
Some behavioral responses can be particularly detrimental to financial stability and should not be incentivized by accounting standards (Bloomer 2004). Behavioral responses that could harm financial stability include (Figure 3), for example:

- (i) Procyclical behaviors (in asset allocation, pricing, recognition of gains and losses, etc.),
- (ii) Excessive concentration of exposures and/or interconnections,
- (iii) Inappropriate or excessive involvement in certain activities and/or products,
- (iv) Discouragement of desirable activities and/or products,
- (v) Excessive risk-taking (particularly when not appropriately addressed by the relevant prudential framework), and
- (vi) Pertaining to investors as users of financial statements, collective behavior that could exacerbate market price movements.

In our assessment, IFRS 17 is expected to make a substantial contribution to financial stability by promoting internationally comparable accounting practices and by increasing transparency in the insurance sector. The current accounting standard for insurance liabilities, that is IFRS 4, is found to be inappropriate by many stakeholders, hampering transparency and comparability with other sectors or within the insurance sector (European Securities and Markets Authority, 2021).

IFRS 17 defines a clear treatment of insurance liabilities and should contribute to providing a fair view of the financial position and performance of insurance corporations. In addition, detailed and consistent disclosures are expected to increase transparency in the sector. There have been concerns as to whether IFRS 17 could disincentivize the use of reinsurance, an activity considered to be desirable from both a safety and soundness and a financial stability perspective.

Figure 3 Sources of insurance-related systemic risk and their impact on financial stability implications of IFRS 17



Source: Author's elaboration, based on European Systemic Risk Board (2015 and 2018)

4. Conclusion

In general, IFRS 17 is expected to bring substantial benefits to financial stability in the EU, mainly through the transparency channel (European Financial Reporting Advisory Group 2021b). By fostering comparable accounting practices and by increasing transparency in the insurance sector, IFRS 17 addresses the shortcomings of the current accounting standard for insurance contracts (IFRS 4). That is particularly important in a macroeconomic environment that is highly challenging for insurance corporations (Chong-Tai Bell, Windsor and Yong 2020). Through the transparency channel, the adoption of IFRS 17 is expected to provide more accurate and timely information to users of financial statements, which they can use to make informed economic decisions. IFRS 17 can also encourage insurance corporations to avoid overly risky behaviors and transactions, such as situations in which losses are not immediately recognized or remain "hidden". In addition, the requirements in IFRS 17 may push insurance corporations to improve internal processes, including enhancing their internal risk management frameworks. At the same time, IFRS 17 is not found to exacerbate systemic risk in the insurance sector through any of the channels previously identified by EIOPA and the ESRB.

However, this research has identified some features of IFRS 17 that deserve particular attention in the implementation of the standard in order to ensure its financial stability benefits.

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