



MARKT/2524/04-EN
Orig.
November 2004

Update on Accounting Developments

The IAS endorsement and possible impact on Insurance Directives

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Purpose of the note

The purpose of this note is to serve as basis for an exchange of views in the Insurance Committee on

- The status of the IAS endorsement procedure, particularly concerning IAS 39 and IFRS 4.
- What consequential changes to the prudential Directives may be needed?

Potential changes related to the reclassification of “equalisation reserves/provisions”.

Questions to the Members of the Insurance Committee:

Part 1:

- ***Do Members have comments on the IAS endorsement regarding IAS 39 and IFRS 4?***

Part 2:

- ***Do Members have comments on the tentative conclusions from the CEIOPS report concerning the need for changes of the Directives?***

Part 3:

- ***Do Members have comments on the suggested changes to the Directives related to equalisation provisions?***

Part 1: Status of the endorsement procedure, particularly concerning IAS 39 and IFRS 4

1. The Accounting Regulatory Committee (ARC) and the Commission Services are currently finalising the work on the endorsement of the package of IAS and interpretations that should be applicable from 1 January 2005.
2. The next meeting of the ARC is planned for 30 November 2004, and it is foreseen that all (or most) unendorsed standards and interpretations will be endorsed at this occasion. If needed, a further meeting of the ARC could take place on 20 December 2004.
3. The endorsement process concerning IAS 39 and IFRS 4 is commented on in detail below.

IAS 39

4. The IASB adopted a significantly revised version of IAS 39: "Financial Instruments: Recognition and Measurement" in December 2003. Further amendments concerning hedging were included in March 2004.
5. After long discussions, the ARC endorsed IAS 39 for mandatory use in the EU at its meeting on 1 October 2004. It was not possible for the Commission to propose a full endorsement due to financial stability concerns expressed by the European Central Bank as well as technical problems in applying the proposed hedging rules. Therefore certain provisions related to the so-called "fair value option" as well as to hedging were "carved-out" and hence not endorsed for mandatory use.
6. The Commission particularly highlighted that the carve-out should be as limited as possible, both as regards scope and time. The IASB has committed to adopt an amended version of IAS 39 including a limited fair value option as soon as possible. Significant work is also underway on amendments to the hedging rules in order to achieve a full endorsement of IAS 39 as soon as practicable.
7. The "carve-out" of the fair value option has raised the issue of the treatment of unit linked contracts. Liabilities stemming from such contracts are today normally market valued. The Commission has stated in the explanatory memorandum to the Commission Regulation endorsing IAS 39 that such contracts can continued to be market valued due to rules in the Insurance Accounts Directive¹.

¹ Explanatory Memorandum dated 24 September 2004. The legal reasoning behind this conclusion is the following: The rules in the Insurance Accounts Directive are applicable, and would enable Member States to permit or require companies reporting under IAS/IFRS to value liabilities - where the policyholders bear the investment risk or where benefits are determined according to an index - according to the value of the underlying units, assets, share index or reference value. It is however important to carefully analyse the product features in each case to determine whether the criteria in the Insurance Accounts Directive would be fulfilled. The recent amendments to the Fourth Council Directive following the fair value Directive (2001/65/EC) provided a further valuation option (Article 42a), but did not replace the valuation rules in the Insurance Accounts Directive.

IFRS 4

8. The IASB adopted IFRS 4 “Insurance Contracts” in March 2004. The standard applies to insurance contracts that an entity holds, not to all contracts issued by an insurance company. It does not apply to other assets and liabilities of an insurer, such as financial assets and liabilities in the scope of IAS 39. The draft standard permits an insurance undertaking to continue with current practices for the valuation of insurance liabilities during phase 1. However, certain practices (for example equalisation provisions) are no longer allowed.
9. On 4 June 2004 EFRAG recommended the endorsement of IFRS 4 in a letter to the Commission (8 TEG members voted in favour, 2 abstained). The EFRAG Insurance Subcommittee had debated the issues involved in great detail, and the views among its members were about equally split between those who favoured and those who opposed endorsement.
10. It is foreseen that IFRS 4 will be included in the package of IAS and IFRS standards (as well as interpretations) that will be proposed for endorsement on 30 November 2004. The Services’ best assessment is that a majority for a positive endorsement decision is likely to be achieved.

Part 2: Consequential changes to the Insurance Directives

General approach

11. This subject has been discussed several times in the IC, and at the meeting on 30 June 2004 the approach described below was widely supported by Member States:
 - There seems to be general consensus that ***changes to the EU financial reporting and supervisory directives for the interim period 2005-2007/2008 should be kept to a minimum.***
 - ***IASB phase 2 and Solvency II*** are likely to lead to major changes. This fact also calls for limited changes due to phase 1.
 - It is a reasonable starting point to ***intend to maintain a status quo for the interim period.***
 - The fact that a Member State has opted for a stricter use of a "one set of account" solution may also affect the amount of amendments that may be necessary. Certain current proposals by the IASB could ***make it more difficult to keep a single set of multipurpose accounts during the interim period.***
12. Consequential changes following the introduction of IAS standards may be needed in financial reporting as well as in prudential rules. The substantial amount of options included in the EU Directives may reduce – but not eliminate – the need for changes at EU level, but adaptations are likely to be needed at national level.

13. In the meeting of the IC Accounting Subgroup on 17 May 2004 it was agreed to avoid double work to the greatest extent possible. The Commission Services therefore intend to make maximum use of the work currently underway in the CEIOPS pillar III/accounting subgroup concerning the need for adaptation to prudential rules.

CEIOPS pillar III/accounting subgroup

14. On its own initiative, CEIOPS has included the issue of implications of the use of IAS rules in the draft terms of reference for this group. The subgroup has finalised a report that is currently out for public consultation (download from www.ceiops.org)². An observer from the Commission Services has participated as an observer in the process of elaborating the paper.
15. The general conclusion of the paper is that most supervisory adjustments, or “prudential filters”, can and should be applied at Member State level. The amount of amendments needed in a jurisdiction depends on different aspects, such as accounting tradition, use of options in the directive and the extent to which the same set of accounts are used for financial reporting and supervisory purposes.
16. On the need for changes to the insurance directives, the working group concludes the following:

103. In the analysis, only one point has arisen where changes to Directives seem necessary. This relates to the Equalisation provisions, which are generally regarded as provisions in the EU and are normally covered by assets as other technical provisions. The main purpose of the adjustments is to bring legal certainty about the differentiation between the prudential and the accounting treatment. Possibly the following adjustments would be needed:

- i. Clarify in the Prudential Directives that “equalisation reserve” is a technical provision.*
 - ii. Clarify in the Prudential Directives that equalisation reserves included under equity cannot be used to cover the solvency margin.*
 - iii. Remove the caption “equalisation provision in the IAD [Insurance Accounts Directive] and create a new sub-caption “equalisation reserve”.*
17. Annex 2 to the CEIOPS report discusses the potential need for changes to the Directives concerning a number of major insurance accounting themes. The CEIOPS Annex 2 is enclosed to this IC note.

² The Commission Services are aware that changes to the report may come as a result of the consultation process.

Commission Services' considerations on need for changes to the Directives

18. The Commission Services broadly agree with CEIOPS analysis that most of the supervisory issues resulting from the introduction of IAS can and should be dealt with at national level. The Services however stress once again that caution must be made that such national “prudential filters” remain within the provisions of the prudential Directives.
19. The Services share the view that the future treatment of “equalisation reserves” may call for changes to the prudential Directives.

Part 3: IFRS 4 and equalisation provisions/reserves

Introduction

20. One of the few material changes introduced in IFRS 4 concerns “equalisation provisions”. Insurance companies have to build up provisions in good years in order to pay claims during worse periods. Equalisation provisions were historically a part of technical provisions in most jurisdictions, and consequently in most cases tax exempt.
21. For that reason, the IASB argues that these provisions do not relate to past events and they should consequently not be labelled “provisions” but rather be a “segregated part of equity”. Most Member States and industry agree with this argumentation, even if there are fears of possible tax consequences.

Equalisation provisions/reserves in the EU and in the Directives

22. The establishment of equalisation provisions is only required in credit insurance due to its volatile business patterns. However, Member States can require such provisions also in other lines. In fact, several countries have very developed systems for the establishment of such provisions (for example France, Germany and Finland).
23. For historical reasons there is a certain terminological confusion between the accounting and prudential directives. The third generation Directive (92/49/EEC) Article 18 requires the establishment of equalisation *reserves*, but the Insurance Accounts Directive uses the notion equalisation *provisions*. In the IAD, the equalisation provisions are furthermore listed under the heading “technical provisions”. This is the only place in the Directives where it is explicitly said that equalisation provisions are a part of technical provisions. The complication is increased further by Article 22 of Directive 92/49/EEC that uses “assets covering technical provisions”.

What amendments should be made in the Directives

24. CEIOPS has suggested amendments to the third generation non-life Directive³ as well as the Insurance Accounts Directive. In the following, the Commission Services discuss how these issues could be addressed in the Directives.
25. Non-life directive 73/239/CEE
26. Two important changes would have to be made to the non-life Directive (as well as the proposed Reinsurance Directive):
- Clarify that equalisation reserves are included in the prudential notion “technical provisions” in order to assure that also equalisation amounts are covered by matching assets.
 - Clarify that equalisation reserves reported as equity should not be eligible capital for covering the solvency margin requirement.
27. The Services propose the following amendments to address these issues:

Non-Life Directive 73/239/EEC

Article 15

Paragraph 2, first sentence should be replaced by:

“2. The home Member State shall require every insurance undertaking to cover the technical provisions **and the equalisation reserve referred to in Article 15a** by matching assets in accordance with Article 7 of Directive 88/357/EEC.”

Article 16

Paragraph 1, second sub-paragraph, second indent should be replaced by:

“- reserves (statutory and free reserves) not corresponding to underwriting liabilities **or classified as equalisation reserves;**”

³ In addition changes to the draft reinsurance directive may be needed.

Insurance Accounts Directive (91/674/CEE)

28. Certain changes to the Insurance Accounts Directive may seem desirable:
- Use IAS-consistent terminology throughout the Directive. This implies replacing “equalisation provision” by “equalisation reserves”.
 - Clarify the treatment of these reserves in the balance sheet and in the profit and loss account.
29. After careful considerations, the Commission Services have concluded that amendments to the IAD are not absolutely necessary, although they may be desirable from a clarity point of view.
30. The formats in the IAD concerning the balance sheet and the profit and loss account are subject to Article 4 of the Fourth Directive (78/660/EEC). This Article states that new captions can be added provided that they are not covered by existing line items in the formats. This would be the case for “equalisation reserves” to be presented in the balance sheet under “equity”. Similarly the Fourth Directive does not require that unused captions are presented in the formats (such as the line item “equalisation provisions”).
31. Changes in order to clarify the wording of the IAD could be undertaken later on in the context of a larger revision of that Directive.

The process to achieve these amendments

32. The Services believe that the proposed changes are basically uncontroversial, and that they should be processed as expediently as possible.
33. As indicated above, we also need to amend the proposal for the Reinsurance Directive currently negotiated in the Council. As equalisation reserves have a crucial importance to reinsurance business, the Dutch Presidency has indicated its willingness to include the necessary changes in the Reinsurance Directive⁴. It should also be possible to do the amendments to the direct Non-Life Directive as a part of this legislative package. This would considerably increase the possibilities of a timely adoption of the amended Directives.
34. Due to the different legal bases, changes to the Insurance Accounts Directive cannot be included in the legal package connected to the Reinsurance Directive⁵.

Excerpt from the CEIOPS report “Implications of IAS/IFRS introduction for the prudential supervision of Insurance Undertakings”

The CEIOPS report is currently out for consultation, and changes may follow due to comments received.

⁴ For discussion purposes the above proposals have been included in the compromise Directive text prepared by the Dutch Presidency (text version dated 5 November 2004).

⁵ Article 47:2 and 55 of the Treaty for the Prudential Directives; Article 54 of the Treaty for the Accounting Directives.

ANNEX 2 – IMPLICATIONS FOR THE EUROPEAN DIRECTIVES

In carrying on the analysis of the implication of IAS/IFRS introduction for prudential supervision, the Working Group also pointed out any possible changes to the EU financial reporting and Prudential Directives that may be needed or desirable. This analysis which should be brought to the attention of the Commission Services is presented below.

In general, amendments to directives are very time-consuming and for practicality reasons must therefore be avoided to the greatest extent possible. In certain cases, however the introduction of IAS/IFRSs as well as related prudential filters may call for amendments to Directives.

The purpose of such an analysis is not to propose further changes to the prudential directives at this point in time, as the matters are discussed in a profound way within the Solvency II project. Instead, it is only focussed on the possible need for Member States to introduce prudential filters that are in line with the minimum harmonisation approach used by the Directives. Full use of all options under IAS/IFRS may require changes to Directives. The Working Group assesses that these adjustments are better done in relation to Solvency II and phase II of the IASB accounting project.

All eleven issues mentioned above in part IV have been analysed from this aspect. Both historical cost and market value approaches have been considered.

Definition of insurance contracts

Neither financial reporting nor prudential directives currently define insurance. Most jurisdictions are considering requiring that all contracts previously included as “insurance” should keep that classification during phase I. Two parallel classification systems may cause problems, but changes to the Directives do not seem needed at this stage. This issue however could be analysed within the EU Solvency II project.

Valuation of financial assets

Supervisors need to define what prudential filters that are needed concerning financial assets, provided that these are within the Prudential Directives.

IASB has outlined certain accounting methods to address the mismatch between the insurance assets and insurance liabilities (for example shadow accounting and change of discount rate). Caution must be taken that these are exercised in a way that is in conformity with the Directives.

Financial derivatives

In principle no changes to the Directives seem necessary. If a prudential filter for cash flow hedges is introduced, this must be constructed in a way that the provisions in the Directives are respected.

Valuation of property

As both the Directives and applicable IASs have a choice between market values or historical valuation, no changes to the Directives are needed.

Valuation of insurance liabilities

Financial reporting rules do not override specific supervisory valuations rules contained in the prudential Directives. This is particularly important for the valuation options contained in IFRS 4. These rules take precedence over the Insurance Accounts Directive (IAD), but the specific provisions in the Third Generation Insurance Directives apply.

Undertakings wanting to use the same set of accounts should only choose such options that are within the Prudential Directives. There are certain options outlined in IFRS 4 that may be exercised in a way contrary to prudential rules. A full use of all options may therefore require changes to the Directives, but this is an item under discussion within EU Solvency II project.

After discussions in the Working Group, it has been agreed not to advocate changes to prudential directives at this stage, as Solvency II work is already underway. The members of the Working Group believe that the current prudential Directives provide sufficient flexibility to allow the intended level of communitality between financial and supervisory statements.

Equalisation provisions

There are some links between the IAD and the Third Generation Non-Life Directive (92/49/EEC). The latter Directive Article 18 requires the establishment of equalisation reserves, but the Insurance Accounts Directive uses the notion equalisation provisions. In the IAD, the equalisation provisions are furthermore listed under the heading “technical provisions”. This is the only place in the Directives where it is explicitly said that equalisation provisions are a part of technical provisions.

In practice, equalisation amounts are generally regarded as provisions in the EU and are normally covered by assets as other technical provisions.

Following its deliberations there may be a need for smaller changes to the Prudential Directives as well as the IAD. The main purpose of the adjustment is to bring legal clarity about the differentiation between the prudential and the accounting treatment. Possibly the following adjustments would be needed:

- Clarify in the Prudential Directive that “equalisation reserve” is a technical provision.
- Clarify in the Prudential Directive that equalisation reserves included under equity cannot be used to cover the solvency margin.
- Remove the caption “equalisation provision” in the IAD and create a new sub-caption “equalisation reserve”

Valuation of financial liabilities

There may be a need for certain prudential amendments following the introduction of IAS/IFRSs. The Working Group believes that these could be done within the borderlines of the current directives. If the full fair value option had been retained, a full choice by companies may not have been possible due to the prudential directives.

Intangible assets

No need for changes to the Directives.

Discretionary participation features

No need for changes to the Directives.

Valuation of subsidiaries

No need for changes to the Directives.

Pension plan

No need for changes to the Directives.