IFRS

Investment implications of IFRS 9 and IFRS 17 for insurance companies

The International Financial Reporting Standards (IFRS) are a set of uniform accounting principles which are particularly relevant for publicly listed companies. Some major IFRS standards have been completely revised in recent years. In 2018 the introduction of IFRS 9, the accounting principles for financial instruments, already had a profound impact on many companies. On January 1 2023, IFRS 17, the reporting standards for insurance contracts, will also become obligatory for listed insurance companies in the EU. Many insurance companies have decided to adopt IFRS 9 simultaneously with IFRS 17 to avoid accounting mismatches on their balance sheet. This means that on January 1 2023 the accounting standards for both the assets and liabilities of listed insurance companies in the EU will change. In this article we summarize these changes and the impact on strategic asset allocation and specific investment structures, like investment funds, segregated mandates or special purpose vehicles (SPVs).

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IFRS are a comprehensive set of accounting principles governed by the IFRS Foundation and the International Accounting Standards Board (IASB). IFRS was applied in Europe on January 1, 2005, to provide uniform accounting standards for publicly listed companies. Following the lead of the European Union, IFRS has since been adopted by many other countries as well, see Figure 1.

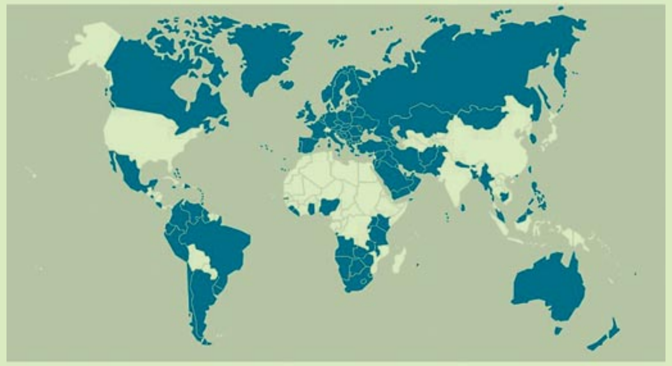

Figure 1: Adoption of IFRS. Source: IFRS, as of 2018.

The United States has not adopted IFRS but uses its own generally accepted accounting principles (US GAAP).

IMPACT ON FINANCIAL STATEMENTS

IFRS 17 will give more insight into the profitability of insurance contracts and the effect of market rate changes on their current value, see Van Bragt (2022) and De Actuaris (2018) for more information. To absorb these changes on the asset side, it is natural to use a similar accounting treatment for the assets under IFRS 9 to avoid a large profit and loss (P&L) volatility. In practice this means that an amortized cost (i.e., book value) classification of the assets will not match well with the current value classification of the liabilities, see Table 1. For this purpose, an insurer can invoke the "fair value option" and reclassify the amortized cost assets to fair value through P&L.

Accounting options for assets and liabilities under IFRS 9 and 17

	Liability through OCI	Liability through P&L
Asset: Amortized cost	✗	✗
Asset: Fair value through OCI	✓	✗
Asset: Fair value through P&L	✗	✓

Table 1: Combinations of accounting choices for assets and liabilities under IFRS.
Source: Aegon Asset Management.

With liability through OCI resp. P&L we here mean that the effect of changes in market rates is attributed to the other comprehensive income (OCI) respectively P&L. Note that insurance companies can choose to classify all assets as fair value through P&L and not use the OCI option on the liability side at all. This would better align their accounting balance sheet with the economic balance sheet. The alignment with Solvency II also improves in this case because Solvency II basically uses a fair value through P&L approach for all assets and liabilities. Given that the IFRS balance sheet will move closer to market consistency, an IFRS analysis might also be incorporated in asset & liability studies in the future.

IMPACT ON ASSET ALLOCATION

An important question is if the asset allocation of insurers will shift due to these accounting changes. In practice, the strategic asset allocation decision is most often based on a forward-looking and economic risk/return analysis, with the required capital under Solvency II being a major constraint. This is not to say that accounting standards have no effect: both profit generation and P&L volatility are important metrics, especially over shorter horizons.

Recent industry surveys (e.g., by EFRAG) indicate that IFRS 17 alone will not significantly impact the asset allocation of insurance undertakings, as this activity is more driven by risk management and asset & liability management. However, the industry stakeholders expressed the view that the combined effect of applying IFRS 17 and IFRS 9 may have some impact on asset allocation, although many other factors (like regulations, taxes and prudential requirements) play a role as well.

ROLE OF SPECIFIC INVESTMENT STRUCTURES

We now make the step to an insurance company who invests (part of) its assets via an external asset manager. Such an investment can for example be structured via a segregated mandate. In this case, the client owns the individual securities, which are managed on behalf of the client by the external asset manager. In a fund structure, the individual securities are owned by the fund and the client owns shares in the fund. Another approach is via a special purpose vehicle (SPV), which also owns the underlying instruments but issues a note to the end investor. Investment funds and SPVs receive a special treatment under IFRS, see Van Bragt (2022) for more details. It is important to consider these aspects, given the changing accounting treatment on the liability side under IFRS 17.

Table 2 shows that segregated mandates and SPV structures offer most flexibility to match the assets' classification with the liabilities. Open-end investment funds also lead to a similar treatment as the liabilities, except when the effect of changes of the market rates needs to go through the OCI instead of the P&L.

Treatment of different investment structures versus liabilities under IFRS

	Liability through OCI	Liability through P&L
Open-end investment fund	✗	✓
Segregated mandate	✓	✓
SPV	✓	✓

Table 2: Combinations of accounting choices for different investment structures and liabilities under IFRS.
Source: Aegon Asset Management.

CONCLUSIONS

The accounting principles for listed European insurance companies will change significantly on January 1 2023 with the phasing in of IFRS 9 (for the assets) and IFRS 17 (for the liabilities). In this article we summarized these changes and the impact on strategic asset allocation and specific investment structures (like investment funds, segregated mandates or SPVs).

The main conclusions are:

- IFRS 17 will provide more insight into the profitability of insurance contracts and the effect of market rates.
- It is natural to use a similar accounting treatment under IFRS 9 on the asset side, to avoid a large P&L volatility. An amortized cost classification of the assets will not match well with the current value of the liabilities under IFRS 17. For this purpose, an insurer can invoke the "fair value option" under IFRS 9, to reclassify the amortized cost assets to fair value through P&L.
- The impact on asset allocation is expected to be limited, as this is more driven by risk management and asset & liability management.
- Segregated mandates and SPV structures offer most flexibility to match the assets' classification with the liabilities. Open-end investment funds also lead to a similar accounting treatment as the liabilities, except when the effect of changes of the market rates needs to go through the other comprehensive income (instead of the P&L). ■

References

De Actuaris, "# IFRS 17", October 2018.

Van Bragt, D. (2022), "Impact of IFRS 9 and IFRS 17 on Insurance Companies", *Aegon Insights*, March 4, 2022. Available via https://www.aegonam.com/globalassets/aam/news--insights/news-article-pdfs/impact-of-ifrs-9-and-ifrs-17-on-insurance-companies.pdf.