CEIOPS
Committee of European Insurance and Occupational Pensions Supervisors

CEIOPS-DOC-31/09

CEIOPS' Advice for Level 2 Implementing Measures on Solvency II:

Valuation of Assets and "Other Liabilities"

(former Consultation Paper 35)

October 2009

CEIOPS e.V. – Westhafenplatz 1 - 60327 Frankfurt – Germany – Tel. + 49 69-951119-20
Fax. + 49 69-951119-19 email: secretariat@ceiops.eu; Website: www.ceiops.eu

Table of contents

1.Introduction

1.1. Background

1.1. In its letter of 19 July 2007, the European Commission requested CEIOPS to provide final, fully consulted advice on Level 2 implementing measures by October 2009 and recommended CEIOPS to develop Level 3 guidance on certain areas to foster supervisory convergence. On 12 June 2009 the European Commission sent a letter with further guidance regarding the Solvency II project, including the list of implementing measures and timetable until implementation[1].

1.2. As stated in this letter, the work to be developed in this area should be in line with the adopted Level 1 text and should take into account the results of the Quantitative Impact Studies (QIS3 and QIS4) and international supervisory and accounting developments.

1.3. This Paper aims at providing advice for Level 2 implementing measures on the valuation of assets and liabilities other than technical provisions that is essential to build a "Solvency II balance sheet". This is done in accordance with Article 75[2] of the Solvency II Level 1 text[3] ("Level 1 text").

1.4. When approaching valuation, it is essential to bear in mind that one of the cornerstones of the Solvency II project is to develop a risk sensitive solvency regime for the (re)insurance industry. According to this new regime, capital requirements will reflect the specific risk of every (re)insurance undertaking, and encourage them to properly manage the risks they are exposed to.

1.5. In order to properly consider an undertaking's financial position, it is necessary to evaluate its assets and liabilities. It can be inferred that a system based on sound economic valuation principles is crucial throughout this process. In this regard, recital (45) of the Level 1 text foresees explicitly that "the assessment of the financial position of insurance and reinsurance undertakings should rely on sound economic principles". The Level 1 text defines the main principles applicable to valuation of assets and liabilities, which is generally consistent with the definition of fair value under IFRS[4] with the notable exception of the treatment of own credit standing for liabilities.

[1] See http://www.ceiops.eu/content/view/5/5/

[2] Article 75 is applicable both at solo and group level (see Article 224).

[3] Latest version from 19 October 2009 available at http://register.consilium.europa.eu/pdf/en/09/st03/st03643-re01.en09.pdf and http://register.consilium.europa.eu/pdf/en/08/st16/st16237-co01.en08.pdf.

[4] The Advice refers to IFRS as endorsed by the European Union published before 1 January 2009 (see the publication of standards adopted so far in the Official Journal: Commission regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, OJ L 320/1, 29.11.2008. For further information on this as well as recent amendments to Commission regulation (EC) No 1126/2008 please refer to: http://ec.europa.eu/internal_market/accounting/ias_en.htm. CEIOPS is aware of the revised definition of fair

1.6. The principles set out in this paper are for the valuation of assets and liabilities other than technical provisions under Solvency II. Therefore, they should not be seen as recommendations and even less prescriptions for the setting up of general purpose financial statements under local GAAP or IFRS.

1.7. CEIOPS acknowledges that public disclosure is a key element of the Solvency II framework. In the field of valuation, disclosure is crucial to properly understand the solvency and financial condition of a (re)insurance undertaking. Public disclosure requirements on valuation of assets and other liabilities will be included in the Solvency and Financial Condition Report, in accordance with the CEIOPS Level 2 Advice on Supervisory Reporting and Disclosure Requirements.

1.2. Valuation issues in QIS4

1.2.1. Valuation approach tested in QIS4

1.8. From April to July 2008 CEIOPS conducted the fourth Quantitative Impact Study on Solvency II (QIS4), based on the definition included in Article 75 of the Level 1 text. While in QIS3 only limited guidance was provided to undertakings on how to undertake an economic valuation of their assets and liabilities, in QIS4 CEIOPS gave further guidance and requested for more information on the valuation principles used and on the differences between accounting figures and solvency figures, where relevant.

1.9. QIS4 proposed a valuation hierarchy, ranging from mark to market methods, where possible, to mark to model procedures, and exclusively for the purpose of that exercise, also allowing for the use of local GAAP figures under very specific circumstances.

1.10. Moreover, specific guidance was provided on the use of IFRS balance sheet figures as a reasonable proxy for economic valuations under Solvency II.

1.2.2. Main findings regarding valuation issues in QIS4

1.11. Most of the market participants and supervisory authorities expressed their support for the methodologies and for the general approach proposed in QIS4, namely that Solvency II should be based on an economic valuation of assets and liabilities. There was a broad support for the general design and the methodologies of the proposed approach (market consistent valuation already used for a number of other purposes – i.e. internal model, European Embedded Value, risk management).

---

value included in the ED on Fair Value Measurement released by the IASB in June 2008. As for the previous one, this definition is deemed to be consistent with Article 75.

1.12. The proposed valuation approach did not create major difficulties for most participants. This was especially true for undertakings that either use IFRS or local GAAPs which are based on an economic approach and for medium to large undertakings.

1.13. In addition, a number of participants in QIS4 as well as some supervisory authorities stressed the need for the Solvency II valuation approach to develop consistently with the international accounting developments (IFRS). IFRS are deemed to be, in most cases, a suitable approximation of the economic valuation, and respondents stated a clear need for the Solvency II valuation system to develop consistently with the international accounting developments.

1.14. Differences between the two regimes were accepted by the participants insofar as they were justified by different underlying principles for general purpose accounting and Solvency II purposes. Furthermore feedback from the exercise showed that cost-benefit constraints need to be taken into consideration by CEIOPS.

1.15. Finally, some participants stressed that they would welcome a market consistent valuation for regulatory purposes as this was already the basis for internal risk management purposes.

1.16. In line with the Level 1 text, this paper takes into account the results and comments from the QIS4 exercise in order to identify the best approach to valuation. At the same time, it deals with valuation difficulties noted in specific areas.

2. Extract from Level 1 Text

2.1. According to the guiding principles referred to in the Commission's letter, the main basis for the advice presented in this paper is primarily found in Article 75 of the Level 1 text which states:

1. Member States shall ensure that, unless otherwise stated, insurance and reinsurance undertakings value assets and liabilities as follows:

(a) assets shall be valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction;

(b) liabilities shall be valued at the amount for which they could be transferred, or settled, between knowledgeable willing parties in an arm's length transaction.

When valuing liabilities under point (b), no adjustment to take account of the own credit standing of the insurance or reinsurance undertaking shall be made.

2. The Commission shall adopt implementing measures to set out the methods and assumptions to be used in the valuation of assets and liabilities as laid down in paragraph 1.

2.2. These provisions should be read in connection with Recitals 15, 45 and 46 which state:

(15) In line with the latest developments in risk management, in the context of the International Association of Insurance Supervisors, the International Accounting Standards Board and the International Actuarial Association and with recent developments in other financial sectors an economic risk-based approach should be adopted which provides incentives for insurance and reinsurance undertakings to properly measure and manage their risks. Harmonisation should be increased by providing specific rules for the valuation of assets and liabilities, including technical provisions.

(45) The assessment of the financial position of insurance and reinsurance undertakings should rely on sound economic principles and make optimal use of the information provided by financial markets, as well as generally available data on insurance technical risks. In particular, solvency requirements should be based on an economic valuation of the whole balance sheet.

(46) Valuation standards for supervisory purposes should be compatible with international accounting developments, to the extent possible, so as to limit the administrative burden on insurance or reinsurance undertakings. standards for supervisory purposes should be compatible with international accounting developments, to the extent possible, so as to limit the administrative burden on insurance or reinsurance undertakings.

3. Advice

3.1. Solvency II principles on valuation

3.1.1. General approach to valuation under Solvency II

Explanatory text

3.1. The Level 1 text sets out a primary objective in requiring an economic approach to valuation of assets and liabilities under Article 75 whilst including in the recitals a secondary objective of ensuring that solvency valuation rules to the extent possible should be compatible with international accounting developments. This will result in similar valuation infrastructure for both accounting and solvency purposes, thereby limiting the administrative burden on (re)insurance undertakings. The advice in this paper aims to satisfy, as far as possible, both the legal requirements of Article 75 and the additional objective described in Recital 46.

3.2. Further objectives introduced by the Level 1 text were also considered when outlining the preferred valuation approach for Solvency II purposes. In particular, the proportionality principle outlined in Article 29(3) requires that the requirements laid down in the Level 1 text are applied in a manner which is proportionate to the nature, complexity and scale of the risks inherent to the business of each (re)insurance undertaking.

3.3. In addition, Article 75 explicitly refers to valuation of assets and liabilities. On this basis, for solvency purposes the assessment should be made on the individual balance sheet items instead of valuation of the transfer price of the whole entity.

3.4. This advice was prepared on the assumption, derived form the level 1 text, that the undertaking will carry on its business as a going concern and not on a "stress scenario" assumption.

3.1.2. Valuation principles under Solvency II

3.5. The market-consistent approach applied in the Level 1 text as well as in the technical specifications for QIS4 advocates an economic balance sheet.

3.6. Analysis of QIS4 results confirmed CEIOPS to continue with its proposed valuation approach when developing Level 2 advice, also bearing in mind that undertakings which responded to QIS4 generally reported no major difficulties in the application of the economic valuation principles stated in QIS4.

3.7. IFRS provide principles and guidance for the calculation of fair value for almost all assets and liabilities that are significant to (re)insurance undertakings. As a result, referring to IFRS as a proxy for the determination of an "economic" valuation seems more efficient than developing CEIOPS' own valuation principles, devoting huge efforts to develop (and later maintain) implementing measures with a level of detail and extent comparable to that of IFRS. It further takes advantage of the fact that IFRS are well known and applied standards applied at the EU level and is considered to be a robust reporting framework.

3.8. On this basis, CEIOPS recommends to adopt IFRS as endorsed in the EU as a reference framework with a view to building a coherent balance sheet to the extent it reflects the economic valuation principles of Solvency II. This approach implies that additional specifications need only be provided where IFRS are not compatible with Article 75 of the Level 1 text. This would be the case, for instance, for items that under IFRS can be measured at cost or required to be measured at cost.

3.9. The Level 1 Text is silent on the definition of assets and liabilities and the principles for their recognition in the Solvency II balance sheet. IFRS addresses these issues in relation to the preparation of general purpose financial statements by providing general definitions of assets and liabilities and specifying the recognition criteria for individual items. CEIOPS recommends that, consistent with the economic valuation approach highlighted above, the definition of assets and liabilities and the recognition criteria under IFRS are, unless stated otherwise, applied to the Solvency II balance sheet also.

3.10. Based on this approach, CEIOPS recommends that Level 2 implementing measures should include mainly high level principles with detailed supplementary guidance under Level 3 on valuation issues that may probably need frequent updates and covers the detailed technical aspects on valuation. Consequently CEIOPS is of the opinion that Level 2 implementing measures should only include a reference to the general IFRS framework avoiding references to individual IAS/IFRS. This would allow CEIOPS a greater flexibility in dealing with future amendments and developments under IFRS.

3.11. CEIOPS believes that a monitoring mechanism should be set up to ensure implementing measures are appropriately updated based on changes in IFRS. Consistent with the general Solvency 2 framework, the basic valuation principles laid down in the Level 1 text will be the foundation of the monitoring mechanism.

3.12. In this context, CEIOPS will, if appropriate, provide in the future level 3 guidance to reflect developments, such as changes in IFRS relevant to valuation under Solvency II.

3.13. The adoption of IFRS as a reference framework to determine economic valuation does not in any way interfere with the accounting principles, standards and procedures that undertakings are allowed to use when preparing their general purpose financial statements (local GAAP). In order to build a Solvency II balance sheet, undertakings shall use IFRS as a reference point and determine if the accounting figures based on local GAAP provide for an economic valuation. If not, they have to adjust the accounting figures, unless under exceptional situations the balance sheet item is not significant to reflect the financial position or performance of an (re)insurance undertaking or the quantitative difference between the use of accounting and Solvency II valuation rules is not material. The proportionality principle will be taken into account in such cases.

3.14. In order to clarify the meaning of materiality in the context of valuation, CEIOPS proposes using the following definition of materiality under IFRS[5]:

3.15. "Omissions or misstatements of items are material if they could, by their size or nature, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements." Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."

3.16. The expression "economic decisions of users" included in the definition above should be read in the context of the risk-based calculations to be performed by the undertaking on the basis of the Solvency II balance sheet and on the assessment to be undertaken by supervisory authorities when performing the Supervisory Review Process.

3.1.3. Additional considerations for valuations under Solvency II

a. Economic valuation and fair value

3.17. The Level 1 principles on valuation of assets and liabilities largely coincides with the current definition of fair value under IFRS, with the notable exception of the treatment of own credit standing for liabilities. The words 'economic value' and 'fair value' are used intermittingly throughout this paper and imply the same.

b. Methodology for the determination of economic values

3.18. Wherever possible, the fair value of assets must be based on a mark to market approach, based on readily available prices in orderly transactions that are sourced independently.

3.19. Where marking to market is not possible, mark to model procedures should be used (marking to model is any valuation which has to be benchmarked, extrapolated or otherwise calculated as far as possible from a market input). When marking to model, undertakings will continue to

[5] Materiality is defined in IAS 8.5. This definition is consistent with the one used in CEIOPS Advice on Level 2 Implementing measures for Solvency II: Supervisory Reporting and Disclosure Requirements.

maximise the use of relevant observable inputs and minimise the use of unobservable inputs[6].

3.20. It should be underlined that, even when marking to model, the objective remains to determine the amount at which the assets and liabilities could be exchanged between knowledgeable willing parties in an arm's length transaction.

3.21. When marking to model, an appropriate degree of qualification is needed on the selection of the model and parameters. Undertakings must have adequate systems and controls, sufficient to give management and supervisors the confidence that their valuation estimates are appropriate and reliable. The following elements will notably be considered:

- There should be documented policies and procedures for the process of valuation, including the description and definition of roles and responsibilities of the personnel involved in valuation, as well as the relevant models and sources of information to be used.

- The assets subject to mark to model should be well identified and the reasons for marking them to model should be clearly explained.

- The valuation uncertainty, for example caused by using unobservable inputs should be properly evaluated and reported to the senior management so that they are well aware of the situation.

- There should be an internal review process of compliance with policies and procedures applied on valuation.

- Undertakings should demonstrate that they employ personnel with the skills and knowledge necessary to properly develop and calibrate models based on historic and current data

- There should be a proper 'four-eye' review of the valuations performed, with clear description of the sign-off process including accountability and the process in place to resolve any challenge from any independent source.

- The models used should be subject to periodic verification to determine their appropriateness for the set objectives. Valuation adjustments should be made as appropriate, for example to cover the uncertainty of the model valuation.

c. Independent value verification

3.22. The undertaking is primarily responsible for the performance of economic valuations for Solvency II purposes, and for their reporting to supervisors. CEIOPS highlights that governance requirements apply when performing

[6] It is worth noting that the IASB, on 31 October 2008, published guidance on the application of fair value measurement when markets become inactive. The educational guidance takes the form of a summary document prepared by IASB staff and the final report of the expert advisory panel established to consider the issue.

these tasks[7]. It may also be important to obtain external, independent value verification in a number of cases as indicated below.

3.23. It is expected that economic values stemming from statutory financial statements are subject to external audit as per the applicable auditing standards. The extent to which reports to supervisors are subject to external verification will be dealt with separately in the CEIOPS Level 2 Advice on Supervisory Reporting and Public Disclosure under Solvency II.

3.24. CEIOPS is furthermore of the opinion that undertakings should obtain regular external, independent value verification for assets for which there are no homogenous markets, and in situations where application of different models are possible. For example, this will be the case for investment properties and property for own occupation. In specific cases of complex instruments and valuation techniques, external independent value verification may also be appropriate.

3.25. In the cases highlighted above an external, independent value verification should be obtained when significant changes occurred in the relevant reference market or in the economic environment that directly influences the value of these assets. In any case, such external, independent value verification should be carried out at least every 3 years.

3.26. Furthermore, where there are concerns on valuations, the supervisor may require additional valuation from an independent expert.

3.27. The external, independent value verification can consist in either the performance of a new valuation by the external, independent party from the (re)insurance undertaking, or the review (and validation) by that party of the valuations performed internally by the undertaking.

d. Valuation adjustments for solvency purposes

3.28. The basic principle of economic valuation is to determine the amount at which an asset could be exchanged or a liability transferred or settled between knowledgeable willing parties in an arm's length transaction.

3.29. Furthermore, as previously mentioned, the valuation should be based on a going concern assumption. This is the case for all assets and liabilities, irrespective of their liquidity characteristics. Nevertheless, this does not mean that the liquidity characteristics of the asset or liability should not be taken into account when determining the value on a going concern basis (e.g. bid/offer spreads).

3.30. According to the risk-based approach of Solvency II, when valuing balance sheet items on an economic basis, undertakings should consider the risks that arise from holding a balance sheet item, using assumptions that market participants would use in valuing the asset or the liability. While some of them will be included in the valuation of the item itself, other risks

[7] See for further information CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: System of Governance, CEIOPS-DOC-29/09, see http://www.ceiops.eu/index.php?option=content&task=view&id=581

will be dealt with in Pillar I or in Pillar II. The following are notable examples:

- The illiquidity of the asset due to entity specific constraints. For example, when the entity is subject to approval before the realisation of the transaction, implying possible delays and variations of market prices in the meantime. Another example is when the size of a position in a particular instrument is a multiple of the daily volume of transactions in that instrument. In this case, the entity may have to accept discounts for selling the whole position in one go, or to dispose of the position through different transactions at possibly different prices including additional administrative and transaction costs. It is expected that this risk will be dealt with in Pillar II if not covered by Pillar I

- The uncertainties ascribed to individual items as economic value depending on the type of item and conditions for its measurement. IFRS sets out a spectrum relating to the uncertainty of economic valuations. At level 1 the fair value is directly observable as a listed price in a liquid market while at level 2 and 3 the fair value must be determined by the use of models with either observable market data as input (level 2) or unobservable data as input (level 3). The spectrum represents an increasing degree of uncertainty from level 1 to level 3 regarding whether the value arrived at actually represents the economic value at the measurement date. It is expected that this risk will be dealt with in the valuation of the item.

CEIOPS' advice

3.31. For solvency purposes the assessment shall be made on the individual balance sheet items, and shall not be intended as a valuation of the transfer price of the whole entity.

3.32. CEIOPS recommends adopting the IFRS as endorsed in the EU as a reference framework with a view to building a coherent balance sheet to the extent it reflects the economic valuation principles of Solvency II. Additional specifications shall be provided where IFRS is not compatible with Article 75 of the Level 1 text. This would be the case, for instance, for items that under IFRS can be measured or required to be measured at cost.

3.33. CEIOPS recommends that consistent with the economic valuation approach, the definitions of assets and liabilities and the recognition criteria under IFRS are, unless stated otherwise, applied to the Solvency II balance sheet also.

3.34. According to this approach, CEIOPS recommends that Level 2 implementing measures shall include mainly high level principles with detailed supplementary guidance under Level 3 on valuation issues that may probably need frequent updates and covers the detailed technical aspects on valuation. In this context CEIOPS will where appropriate, provide further Level 3 guidance in future that will include amongst other things the developments in IFRS of relevance to the Solvency II valuation rules.

3.35. The adoption of IFRS as a reference framework for the determination of the economic valuation does not in any way interfere with the set of accounting principles, standards and procedures that undertakings are allowed to use when preparing their general purpose financial statements (local GAAP). In order to build a Solvency II balance sheet, undertakings shall use IFRS as a reference point and determine if the accounting figures based on local GAAP provide for an economic valuation. If not, they have to adjust the accounting figures unless under exceptional situations the balance sheet item is not significant to reflect the financial position or performance of an (re)insurance undertaking or the quantitative difference between the use of accounting and Solvency II valuation rules is not material. The proportionality principle will be taken into account in such cases.

3.36. Wherever possible, the fair value of assets must be based on a mark to market approach, based on readily available prices in orderly transactions that are sourced independently.

3.37. Where marking to market is not possible, mark to model procedures shall be used (marking to model is any valuation which has to be benchmarked, extrapolated or otherwise calculated as far as possible from a market input). When marking to model, undertakings will continue to maximise the use of relevant observable inputs and minimise the use of unobservable inputs.

3.38. When marking to model, an appropriate degree of qualification is needed on the selection of the model and the underlying assumptions. Undertakings must have adequate systems and controls sufficient to give senior management and supervisors the confidence that their valuation estimates are appropriate and reliable.

3.39. The following elements will be considered:

- There shall be documented policies and procedures for the process of valuation, including the description and definition of roles and responsibilities of the personnel involved in valuation, as well as the relevant models and sources of information to be used;

- The assets subject to marking to model shall be identified and the reason for marking them to model approach shall be explained;

- The valuation uncertainty, for example caused by using unobservable inputs shall be properly evaluated and reported to the senior management so that they are well aware of the situation;

- There shall be an internal review process of compliance with policies and procedures applied on valuation;

- Undertakings shall demonstrate that they employ personnel with the skills and knowledge necessary to properly develop and calibrate models based on historic and current data;

- There shall be a proper ‘four-eye’ review of the valuations performed, with clear description of the sign-off process including accountability and the process in place to resolve any challenge from any independent source; and
- The models used shall be subject to periodic verification to determine their appropriateness for the set objectives. Valuation adjustments shall be made as appropriate, for example to cover the uncertainty of the model valuation.

3.40. The undertaking is primarily responsible for the performance of economic valuation for Solvency II purposes, and for their reporting to supervisors.

3.41. Undertakings shall obtain regular external, independent value verification for assets for which there are no homogenous markets and in situations where application of different valuation models is possible. In specific cases of complex instruments and valuation techniques, external independent value verification may also be appropriate.

3.42. In the cases highlighted above an external, independent value verification shall be obtained when significant changes occur in the relevant reference market or in the economic environment that directly influences the value of these assets. In any case, such external, independent value verification may need to take place at least every 3 years.

3.43. Furthermore, where there are concerns on valuations, the supervisor can require additional valuation from an independent expert.

3.44. According to the risk-based approach of Solvency II, when valuing balance sheet items on an economic basis, undertakings shall consider the risks that arise from holding a balance sheet item, using assumptions that market participants would use in valuing the asset or liability.

3.2. Specific valuation rules for certain assets and liabilities under Solvency II

3.2.1. Goodwill on acquisitions

Explanatory text

Definition:

3.45. Goodwill acquired in a business combination is defined under IFRS 3. IFRS 4.31 and IFRS 4.32 refer to expanded presentation for insurance contracts acquired in a business combination or transfer.

Valuation for solvency purposes:

3.46. Goodwill is a specific asset recognised solely when an acquisition takes place and there is a positive difference between the purchase consideration paid and the fair value of the net assets acquired on the date of acquisition. The acquisition can cover another undertaking or a business activity.

3.47. Based on the above definition of goodwill, it is not an identifiable and separable asset in the market place. As a result it does not represent an 'economic value' that can be separately sold or transferred if necessary to a third party

3.48. IFRS prohibits recognition of internally generated goodwill as an asset. The consequence of this is that two undertakings with similar tangible assets and liabilities could have different basic own funds because one of them has grown through business combinations and the other through organic growth without any business combination. From an economic point of view both undertakings have similar tangible assets and liabilities independent of how they were acquired. It would inappropriate if both undertakings were treated differently for regulatory purposes.

3.49. Based on the rationale explained above, the economic value of goodwill for solvency purposes is nil.

CEIOPS' advice

3.50. CEIOPS considers that the economic value of goodwill on acquisitions for solvency purposes is nil.

3.2.2. Intangible assets

Explanatory text

Definition:

3.51. IAS 38.8-17 provides the definition of intangible assets.

Valuation for solvency purposes:

3.52. In contrast to goodwill, some intangible assets may be acquired individually or generated internally.

3.53. Apart from intangibles acquired in a business combination, cf. below, IAS 38 requires an entity to recognise an intangible asset if, and only if, specified criteria are met for identification and recognition. Some of those assets can only be recognised according to IFRS based on their cost price because there is no active market where they are traded.

3.54. Among the intangibles that – according to IFRS - can be recognised in the absence of a business combination are those that are separable and for which there is a history or evidence of exchange transactions for the same or similar assets, indicating that they are saleable in the market place. CEIOPS considers in such cases, a fair value measurement under IAS 38 to be compatible with Article 75 of the Level 1 text. As a result, IAS 38 is considered a good proxy if and only if intangible assets can be fairly valued according to this IAS.

3.55. If a fair value measurement under circumstances explained above is not possible, intangible assets should be valued at nil for solvency purposes.

3.56. Other intangibles are - like goodwill – only able to be recognised when they are acquired in a business combination. Identifiable assets that are not allowed to be recognised in the normal course of business should, according to IFRS, be recognised when acquired in a business combination. For example customer lists, brand names and other intangibles are not allowed to be recognised unless they are acquired in a business combination (IAS 38). An intangible whose value is only observable on a business combination should be valued at nil for solvency purposes. The same arguments as for goodwill apply equally to intangibles.

CEIOPS' advice

3.57. The IFRS on Intangible assets is considered to be a good proxy if and only if the intangible assets can be recognised and measured at fair value as per the requirements set out in that standard. The intangibles must be separable and there shall be an evidence of exchange transactions for the same or similar assets, indicating it is saleable in the market place.

3.58. If a fair value measurement of an intangible asset is not possible, or when its value is only observable on a business combination as per the applicable international standard, such assets shall be valued at nil for solvency purposes.

3.2.3. Property, plant and equipment

Explanatory text

Definition:

3.59. IAS 16 deals with property, plant and equipment. In particular, according to paragraph 6, property, plant and equipment include tangible items that are:

– held for use in the production or supply of goods or services; and

– expected to be used during more than one period.

3.60. All property, plant and equipment items are accounted in accordance with IAS 16 except when another standard requires or permits a different accounting treatment (e.g. property, plant and equipment held for sale (IFRS 5).

3.61. Property, plant and equipment are recognised as assets if, and only if (IAS 16.6,7,37):

– it is probable that future economic benefits associated with the item will flow to the entity; and

– the cost of the item can be measured reliably.

3.62. As a result, spare parts and servicing equipment are to be recognised immediately in profit or loss. Moreover, renovations, extension and other aspects should be included in the value of the asset when completed, i.e. when likely to produce additional economic benefits.

Valuation for solvency purposes:

3.63. In accordance with IAS 16.15, property, plant and equipment are initially measured at cost. For the subsequent measurement, undertakings have the choice between:

– cost model: cost less any depreciation and impairment loss;

– revaluation model: fair value at date of revaluation less any depreciation or impairment. This model can be used for property, plant and equipment whose fair value can be measured reliably.

The choice must be explained in the accounting policy and applied to an entire class of property, plant and equipment.

3.64. The revaluation model is not as such a fair value model, since the revaluation is not required to be made systematically at each reporting date (see paragraph 31 of IAS 16: it is fair value less any subsequent accumulated depreciation and impairment). However, revaluation must be "*made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period*" (paragraph 31 IAS 16).

3.65. IAS 16 guidance on revaluation is generally in line with the principles of Article 75. If necessary, the undertaking should use additional guidance under IAS 40 to calculate the fair value of property, plant and equipment (in accordance with IAS 8.11.a).

3.66. The revaluation model could be considered as a reasonable proxy for Solvency II purposes provided IAS 16.31 is applied scrupulously, i.e. where revaluations are made with sufficient regularity (which is a question of professional judgment, depending on the nature of the asset, the methodology used for measurement and development of the relevant market).

3.67. Consequently, property, plant and equipment that are not measured at economic value should be re-measured at fair value for solvency purposes.

3.68. CEIOPS would furthermore require undertakings to obtain regular independent external valuation or verification of valuation of property. External valuations on property should take place when significant changes occur in the real estate market or changes in assumptions on which previous valuations were based, but at least every 3 years.

3.69. Information on the methodologies used for valuation of property and the date of the last revaluation (as well as the date of hypothesis and data used in the last revaluation) shall be provided to supervisors on request.

CEIOPS' advice

3.70. Property, plant and equipment that are not measured at economic value shall be re-measured at fair value for solvency purposes.

3.71. The revaluation model under the IFRS on Property, Plant and Equipment could be considered as a reasonable proxy for solvency purposes.

3.72. CEIOPS would require undertakings to obtain regular independent external valuation or verification of valuation of property. External valuations on property shall take place when significant changes occur in the real estate market or changes in assumptions on which previous valuations were based, but at least every 3 years.

3.73. Information on the methodologies used for valuation of property and the date of the last revaluation (as well as the date of hypothesis and data used in the last revaluation) shall be provided to supervisors on request.

3.2.4. Investment property

Explanatory text

Definition:

3.74. In accordance with IAS 40.5, an investment property is a property held to earn rentals, or for capital appreciation, or both, rather than for:

- use in the production or supply of goods or services or for administrative purposes; or
- sale in the ordinary course of business.

This principle is considered to be in line with Article 75 of the Level 1 text.

Valuation for solvency purposes:

3.75. According to IAS 40, at initial recognition investment properties are measured at cost (including transaction costs). After recognition IAS 40 admits cost (initial cost less depreciation and impairments) or fair value measurement. The adopted policy must be applied to all investment properties until disposal, even if market transactions become less frequent or if market prices become less readily available. If the entity is unable to determine fair value reliably, then it shall use the cost model in IAS 16 (IAS 40.53). IAS 40 expects this situation to be exceptional. It could occur when comparable market transactions are infrequent and alternative reliable estimates of fair value (e.g. based on discounted cash flow projections) are not available.

3.76. IAS 40 defines fair value as the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. This definition is consistent with Article 75 for the valuation of assets and liabilities.

3.77. CEIOPS believes that the fair value model of IAS 40 is consistent with Article 75 of the Level 1 text. Therefore investment properties that are measured at cost in financial statements should be re-measured at fair value for solvency purposes.

3.78. As for property, plant and equipment, undertakings should obtain regular independent external fair valuation or verification of internally calculated fair values. External valuations may need to take place when significant changes occur in the real estate market or changes in the assumptions on which previous valuations were based, but at least every 3 years.

3.79. Information regarding the methodologies used for the valuation of investment property and the date of the last revaluation (as well as the date of hypothesis and data used in the last revaluation) should be provided to supervisors on request.

CEIOPS' advice

3.80. Investment properties that are measured at cost in general purpose financial statements shall be re-measured at fair value for solvency purposes. The fair value model under the IFRS on Investment Property is considered a good proxy.

3.81. Undertakings shall obtain regular independent external fair valuation or verification of internally calculated fair values. External valuations shall take place when significant changes occur in the real estate market or changes in assumptions on which previous valuations were based, but at least every 3 years.

3.82. Information regarding the methodologies used for the valuation of investment property and the date of last revaluation (as well as the date of hypothesis and data used in the last revaluation) shall be provided to supervisors on request.

3.2.5. Participations (subsidiaries, associates, joint ventures and SPVs)

Explanatory text

3.83. The Level 1 text (Article 75) requires that principles for valuation of assets and liabilities should be given under Level 2 implementing measures therefore including, among other assets, participations.

3.84. This paper focuses only on the valuation aspect of participations at solo level as the value of participations at group level shall be influenced by the consolidation method applicable. The treatments for own funds and capital requirements are outside the scope of this paper. The text applies equally to all sorts of participations independently of the activity carried out in the owned entity.

Definitions:

3.85. IAS 27, IAS 28, IAS 31 and SIC 12 provide definitions of these elements for accounting purposes.

3.86. Under IAS 27, consolidated financial statements shall include the subsidiaries of the parent (if on acquisition a subsidiary meets the criteria to be classified as held for sale in accordance with IFRS 5, it shall be accounted for in accordance with that IFRS). Under IAS 28 and IAS 31, except if classified as "held for sale" in accordance with IFRS 5, investments in an associate in the consolidated financial statements shall be accounted for using the equity method and the interest in a jointly controlled entity shall be accounted for using the proportionate consolidation or the equity method.

3.87. Under the IFRS Framework, when an undertaking chooses, or is required by national regulation, to present separate financial statements, investments in subsidiaries, jointly controlled entities and associates that are not classified as held for sale in accordance with IFRS 5, must be accounted for at cost or in accordance with IAS 39 (IAS 27, IAS 28 and IAS 31).

3.88. The definition of participation under Solvency II is set out in Articles 13(20) and 212(2) and includes investment in associates, subsidiaries and joint ventures. Undertakings should apply the Solvency II definition of participation for economic valuation purposes.

Valuation for solvency purposes:

Participations are interests in holdings on entities over which an undertaking is in a position to exercise control and significant influence in the financial and operating policy decisions of the investee. Normally participations are long term in nature and are held for various purposes (e.g. strategic investments).

As a result, and given the Directive does not provide any definition of an "asset", a majority of CEIOPS' members consider that in order to properly assess an undertaking's financial position, participations should not be valued as a whole but on the basis of the valuation of the underlying assets and liabilities of the participation, which shall then be valued in the same way (Article 75) as the insurer's own assets and liabilities. This approach is deemed to avoid arbitrage by way of indirect inclusion of goodwill and intangibles which are unable to be fair valued in accordance with IFRS, putting on equal footing undertakings that solely differ in respect of whether or not they have parcelled out their activities in a separate legal undertaking.

Against this background, these members believe that the economic value of participations should be based on the net asset method calculated as the net amount of the economic value (excluding goodwill and other intangibles which are valued at nil in accordance with section 3.2.2) of the participation's assets and liabilities (i.e. equity method adjusted to exclude goodwill and some intangibles).

If however, participations are listed, these members argue that if it can be demonstrated that the prices are independently sourced and readily available in orderly transactions based on which the undertaking could exchange the participation as a whole without any difficulties, then such prices should be used to determine the participation's economic value in accordance with Article 75. Mark to model would in principle be used under the net asset valuation approach and would not be mutually exclusive when there are no market prices on participations.

On the other hand, other members argue that the valuation of participations should depend on whether the undertaking exercises control or only significant influence in the financial and operating policy decisions of the investee.

This distinction is supported by the view that the market value of some participation does not represent a realistic economic value, given the restrictions that an undertaking may face when trying to sell a significant amount of shares in the market. Moreover, market prices generally incorporate goodwill and other intangibles not reflected in the balance sheet of the related undertaking for its activities developed internally. These members argue that such a situation could give rise to an opportunity for regulatory arbitrage. Another point is that participations are generally long-term strategic investments and therefore problems on their transferability may also arise at solo level.

For these members, participations though listed, should be valued based on a net asset valuation where control exists whereby the participation's assets and liabilities are valued in the same way as the undetakings own assets and liabilities, given their activities are generally in continuity of own undertaking activities.

According to this view, participations that are not under the undertaking's control (associates and joint ventures), should be valued under the same principles as those recommended in this advice for financial instruments (mark to market or mark to model depending on availability of prices).

3.89. Concerning the criteria for determining what a participation is and whether the "control" criteria is present, those members believe such criteria should be set at group level as far as group decisions in this matter generally bind undertakings at a solo level.

3.90. Where undertakings hold investments in the form of retained interests in an SPV or other investments in SPVs (whether originated by the undertaking or a third party SPV), the economic valuation should be arrived at using either mark to market or net asset method based on the criteria specified in this section.

3.91. Finally, a minority of CEIOPS members is of the opinion that a market consistent methodology for the valuation of participations should be applied at solo level in the context of Solvency II[8], by applying either a mark to market methodology if market prices are available (e.g. quoted participations) or mark to model methodology, including the equity method, in the absence of market prices. Principles described in section 3.1.3 should be applied.

[8] This treatment would also be in line with IFRS, where IAS 27.38 requires that in the separate financial statement, investments in subsidiaries, jointly controlled entities and associates that are not classified as held for sale in accordance with IFRS 5, must be accounted for at cost or at fair value.

3.92. This view is based on the rationale that mark to market (or mark to model) is the only method that ensures consistency with the level 1 text. [Furthermore, the valuation of the participation is relevant for determining the risk inherent in the participation according to which a capital charge is calculated. Put simply, if the participation is valued based on market price (or in a way that is market consistent), the capital charge will consider the equity risk due to market price movements. Whereas, if a participation is valued based on assumptions other than the market consistent one (i.e. the equity method), some difficulties would arise as to what risk capital charge should be applicable.

3.93. Irrespective of its treatment as part of the own funds, it should be noted that the valuation of the participation is meaningful in itself as the undertaking should be aware of the economic value of the related undertaking for risk management purposes.

3.94. The minority view is also based on the further assumptions that:

- all the risks inherent in the value of a participation (i.e. the strategic investment feature) should be properly addressed through the solvency capital requirement and not in its valuation, consistently with an economic valuation approach;

- the consideration of goodwill and other intangibles, inherent to the participation, should be properly addressed through adjustments in the undertaking's own funds and should not interfere with the valuation of participation at solo level;

- the "group perspective" of all related undertakings is taken into account in the group solvency calculation (based on the Level 1 text requirements, participations will not be treated as normal investments but will be consolidated at group level).

3.95. Where undertakings hold investments in the form of retained interests in an SPV or other investments in SPVs (whether originated by the undertaking or a third party SPV), the economic valuation should be arrived at using either mark to market or mark to method based on the criteria specified in this section.

CEIOPS' advice

3.96. Some CEIOPS members recommend that the valuation of participations depends on whether they are listed or unlisted. Unlisted participations shall be based on a net asset method whereby the participation's assets and liabilities shall be valued in the same way as the insurer's own assets and liabilities. This approach avoids any arbitrage by way of indirect inclusion of goodwill and intangibles that could inflate the value of a firm's participations (i.e. equity method adjusted to exclude goodwill and some intangible assets).

3.97. The value of quoted participations shall be based on the mark to market approach if it can be demonstrated that the prices are independently sourced and readily available in orderly transactions based on which the undertaking could exchange the participation as a whole without any difficulties.

3.98. Mark to model is in principle used under the net asset valuation approach and is not mutually exclusive in valuing participations when there are no market prices available.

3.99. Other CEIOPS members prefer the approach of applying two different valuation methods for valuing participations depending on whether the undertaking exercises control or only significant influence in the financial and operating policy decisions of the investee.

3.100. The participations that are controlled shall be valued based on a net asset valuation whereby the participation's assets and liabilities are valued in the same way as the insurer's own assets and liabilities.

3.101. This is supported by the view that the market price of some participation does not represent a realistic economic value, given the restrictions that an undertaking may face when trying to sell a significant amount of shares in the market.

3.102. Investments in participations that are associates and joint ventures shall be valued based on the advice developed in this paper for financial instruments.

3.103. Concerning the control criteria for determining what participation is and existence of the control, we believe such a criteria shall be set at group level as the group decision in this matter generally bind undertakings at the solo level.

3.104. Where undertakings hold investments in the form of retained interests in an SPV or other investments in SPVs (whether originated by the undertaking or a third party SPV), the economic valuation shall be arrived at using either mark to market or net asset method based on the criteria specified in this section.

3.105. A minority of CEIOPS members is of the opinion that a market consistent methodology for the valuation of participations shall be applied at solo level in the context of Solvency II[9], by applying either mark to market if market prices are available (e.g. quoted participations) or mark to model including the equity method, in the absence of market prices. Principles described in section 3.1.3 shall be applied.

3.106. This view is based on the rationale that mark to market (or mark to model) is the only method that ensures consistency with the level 1 text. Furthermore, the valuation of the participation interacts with how to determine the risk inherent in the participation according to which a capital charge is calculated.

3.107. This view is also based on the further assumptions that all risks inherent

[9] This treatment would also be in line with IFRS, where IAS 27.38 requires that in the separate financial statement, investments in subsidiaries, jointly controlled entities and associates that are not classified as held for sale in accordance with IFRS 5, must be accounted for at cost or at fair value.

in the value of a participation (i.e. the strategic investment feature) shall be properly addressed through the solvency capital requirement; the consideration of goodwill and other intangibles inherent to the participation shall be properly addressed through adjustments in the undertaking's own funds; the "group perspective" of all related undertakings is taken into account in the group solvency calculation.

3.108. Where undertakings hold investments in the form of retained interests in an SPV or other investments in SPVs (whether originated by the undertaking or a third party SPV), the economic valuation shall be arrived at using either mark to market or mark to model based on the criteria specified in this section.

3.2.6. Financial assets

Explanatory text

Definition:

3.109. Financial assets under this chapter are those defined as such by IAS 39.

3.110. According to IAS 39.14, an undertaking has to recognise a financial asset on the balance sheet when it becomes a party to the contractual provisions of the instrument.

3.111. There are scope exclusions (planned future transactions (AG 35e), some derivatives relating to non-financial assets, assets to be acquired as long as one of the parties has not performed under the agreement (AG 35b)).

3.112. An economic Solvency II balance sheet assumes recognition of financial assets in line with IAS 39.

Valuation for solvency purposes:

3.113. IAS 39.9 defines fair value as "the amount for which an asset could be exchanged, or a liability settled between knowledgeable, willing parties in an arm's length transaction". This definition corresponds to the wording of Article 75 for the valuation of assets and liabilities.

3.114. The IAS 39 definition of fair value and the related application guidance correspond to the valuation principles set out in Article 75 of the Level 1 text. Therefore, all assets recognised as financial instruments in accordance with IAS 39 by (re)insurance undertakings should be measured at fair value. Consequently, financial instruments that are not measured at fair value under accounting should be re-measured at fair value solvency purposes.

CEIOPS' advice

3.115. Financial assets as defined in the relevant IAS/IFRS on Financial Instruments shall be measured at fair value for solvency purposes even when they are measured at cost in an IFRS balance sheet.

3.2.7 Contingent Assets and Liabilities

Explanatory text

Definitions:

3.116. IAS 37[10].10 defines contingent assets as 'a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.'

3.117. IAS 37.10 defines contingent liability as:

- (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- (b) a present obligation that arises from past events but is not recognised because: (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability.

Valuation for solvency purposes:

3.118. The valuation here for Solvency II purposes deals only with contingent assets and contingent liabilities defined under the existing IFRS in force.

3.119. In line with the general principles set out above, CEIOPS recommends using IAS37 criteria for the recognition of assets and liabilities under contingency in Solvency II reporting. Hence, in accordance with IAS 37.31 and IAS 37.27 contingent assets or liabilities will not be recognised for solvency purposes. Contingent assets and liabilities should however be

[10] CEIOPS is aware of the proposed amendments to IAS 37 that was made in 2005 and will be finalised as a standard by end of 2009. Please refer par 3.34 to understand how CEIOPS will deal with changes in IFRS.

reported to supervisors and be subject to continuous assessment in accordance with IAS37 provisions (refer IAS 37, Para. 27 to 35).

CEIOPS' advice

3.120.CEIOPS recommends using the applicable IFRS criteria for the recognition of provisions in solvency reporting. Hence, in accordance with the IFRS, contingent assets or liabilities will not be recognised for solvency purposes. Contingent assets and liabilities shall however be reported to supervisors and be subject to continuous assessment.

3.2.8. Deferred tax assets and liabilities

Explanatory text

Definition:

3.121.IAS 12 provides definitions for the relevant items under this section:

- Income taxes include all domestic and foreign taxes based on taxable profits and withholding taxes payable by a group entity.

- Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

- Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of (a) deductible temporary differences; (b) the carry forward of unused tax losses; and (c) the carry forward of unused tax credits.

- Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.

Valuation for solvency purposes:

3.122.The valuation principles in this paper relate only to deferred taxes and not to current income tax assets and liabilities, which fall under other receivables/payables within one year.

3.123.The following analysis of deferred taxation is also based on the approach that these deferred tax assets/liabilities are adjustments to the underlying assets/liabilities.

3.124.CEIOPS did not approach the assessment of the deferred taxes as totally separable assets/liabilities but as an adjustment of the economic costs or benefits that flow from or to the entity in future periods resulting from the underlying assets/liabilities recognised for solvency purposes. Consequently, deferred tax assets and liabilities will not be taken into account for assets and liabilities which are not recognised in the Solvency II balance sheet.

3.125.CEIOPS considers that the treatment under IAS 12 is an acceptable proxy for valuation of deferred taxes on an economic value basis. While deferred tax assets will be given a value in the Solvency II balance sheet, it is without prejudice to the possibility of requiring an adjustment through Solvency Capital Requirement or own funds.

3.126.Each undertaking should value the deferred tax effect according to the taxation regime which it is subject to, as this is what actually affects the ultimate amount the undertaking is going to pay (receive) when it exchanges the asset or the liability.

3.127.Deferred tax results from the differences between the carrying amount of an asset or liability in the Solvency II balance sheet and its tax base. Regardless of whether undertakings apply local GAAP or IFRS (having or not recognised deferred taxation), for valuation purposes undertakings should adjust figures in their Solvency II balance sheet in order to assess the cash-flow projections of future taxation on temporary differences of assets and liabilities (temporary differences between the tax base of an asset or liability and its amount on the Solvency II balance sheet).

3.128.Consequently the relevant deferred taxes for valuation purposes shall be determined by the differences between the economic valuation of an asset or liability on the Solvency II balance sheet and its tax base (as explained above).

3.129.The recognition and measurement of deferred tax asset in the Solvency II balance sheet on unused tax losses and unused tax credits should be based on requirements in IAS 12. A deferred tax asset on such items can only be recognised to the extent it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised. Therefore, when an entity has a history of recent losses, it is only able to recognise a deferred tax asset arising from unused tax losses or tax credits to the extent that the entity has sufficient taxable temporary differences or there is convincing evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity.

3.130.According to IAS 12, deferred tax assets or liabilities cannot be discounted and are measured at the tax rate expected to apply when the asset is realized or the liability is settled.

3.131.CEIOPS is aware of the difficulties that could arise when trying to discount future tax cash flows that could lead to less meaningful and inconsistent results[11]. For that reason, while recognising that not allowing discounting

[11] When setting out principles for Income taxes, the Board discussed whether an entity should discount deferred taxes. The following paragraph, which CEIOPS agrees on, explains why the Board finally decided not to

may be seen as inconsistent with the valuation of other balance sheet items, CEIOPS recommends that undertakings should not discount deferred taxes to determine their value.

3.132. Annex A presents a simple example in order to facilitate a better understanding of how deferred tax assets and liabilities should be treated for valuation purposes.

CEIOPS' advice

3.133. The IFRS approach to Deferred Taxes is considered an acceptable proxy for valuation under Solvency II.

3.134. Each undertaking shall value the deferred tax effect according to the taxation regime to which it is subject to, as this is what actually affects the ultimate amount the undertaking is going to pay (receive) when it exchanges the asset or liability.

3.135. The relevant deferred tax for valuation purposes shall be determined by the differences between the economic valuation of an asset or liability on the Solvency II balance sheet and its tax base. Consequently, deferred tax assets and liabilities will not be taken into account for assets and liabilities which are not recognised in the Solvency II balance sheet.

3.136. The recognition and measurement of deferred tax asset in the Solvency II balance sheet on unused tax losses and unused tax credits shall be based on requirements in IAS 12.A deferred tax asset on such items can only be recognised to the extent it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised. Therefore, when an entity has a history of recent losses, it is only able to recognise deferred tax asset arising from unused tax losses or tax credits to the extent that the entity has sufficient taxable temporary differences or there is convincing evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity.

3.137. Deferred tax assets (liabilities) shall not be discounted and shall be measured at the tax rates expected to apply when the asset is realised or the liability is settled.

require (nor permit) the discounting: *The reliable determination of deferred taxes and liabilities on a discounted basis requires detailed scheduling of the timing of the reversal of each temporary difference. In many cases such scheduling is impracticable or highly complex. Therefore, it is inappropriate to require discounting of deferred tax assets and liabilities. To permit, but not to require, discounting would result in deferred tax assets and liabilities which would not be comparable between entities* (IAS 12.54).

3.2.9. Liabilities other than insurance liabilities

Explanatory text

Definition:

3.138. In line with IAS 39, other financial liabilities and amounts payables are only recognised when an undertaking becomes a party to the contractual provisions of the instrument.

3.139. Under IAS 37, a provision shall be recognised when:

(a) an entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision shall be recognised.

Valuation for solvency purposes:

3.140. On initial recognition, financial liabilities are measured at fair value plus, for financial liabilities not at fair value through profit or loss, directly attributable transaction costs.

3.141. After initial recognition, financial liabilities are measured at amortised cost using the effective interest method, except for:

a) financial liabilities at fair value through profit or loss;

b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies;

c) financial guarantee contracts - measured at the higher of:

- the amount determined in accordance with IAS 37; and
- the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18.

d) commitments to provide a loan at a below-market interest rate - measured at the higher of:

- the amount determined in accordance with IAS 37; and
- the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18.

3.142.The effect of the above is that according to IFRS any changes in an undertaking's own credit standing is reflected in the fair value of its financial liabilities.

3.143.Article 75 of the Level 1 text states that liabilities will be valued "at the amount for which they could be transferred, or settled between knowledgeable willing parties in an arm's length transaction. When valuing liabilities, no adjustment to take account of the own credit standing of the insurance or reinsurance undertaking shall be made. ".

3.144.CEIOPS believes that the valuation approach set out in Article 75 is clearly appropriate for insurance liabilities (technical provisions) to ensure a consistent approach across the industry. If adjustments were made for own credit standing when valuing insurance liabilities undertakings with lower credit standing would be able to establish lower provisions for the same risk than undertakings with higher credit rating. This would be imprudent from a regulatory perspective.

3.145.However, regarding the valuation of non-insurance liabilities, CEIOPS recommends that undertakings apply an approach which combines the use of the risk free rate for some liabilities and consideration of own credit standing at inception for other liabilities, according to the features of the item being valued. Based on this approach, some liabilities would be valued using the relevant risk-free interest rate. However, some liabilities, due to their particular nature, are treated very differently in the Level 1 text as they are eligible for own funds.

3.146.When such liabilities are clearly designated as own funds subject to the requirements in the CEIOPS Level 2 Advice on own funds, the value of these subordinated liabilities should reflect own credit standing of the (re)insurance undertaking at inception. For these reasons, financial liabilities that are eligible for own funds should be measured using IAS 39 as a suitable proxy at initial recognition in the solvency balance sheet. According to IAS 39, liabilities should normally be valued at initial recognition at their transaction price that includes own credit standing at inception.

3.147.At a subsequent valuation date, the initial own credit standing will be used, with no adjustment for any subsequent changes in the undertaking's own credit standing. This would prevent any subsequent volatility between equity and other own funds that may result from changes in own credit standing. Such changes could lead to the outcome that deterioration of an undertaking's credit rating could result in the value of the liability decreasing and the undertaking's equity increasing, other things being equal. Similarly, any improvement in an undertaking's credit rating would result in an increase in the value of the liability and hence a decrease in equity.

3.148.Against this background, it seems appropriate to split "other financial liabilities" into those that are eligible as own funds i.e. notably subordinated liabilities and those that are not and set different valuation principles. Furthermore, this approach seems to be in line with Article 88 where subordinated liabilities eligible for own funds are kept separate from the excess of assets over liabilities, where it seems that Article 75 is explicitly referred only to the latter.[12]

3.149. This recommendation results in a compromise reached by majority of CEIOPS' Members, including those supporting the view under which all the liabilities should be valued using the risk-free rate (without taking into account credit risk at inception or subsequently).

3.150. The recommended approach is a result of the assessment of two possible interpretations of the wording of Article 75.

3.151. A first interpretation would be to mean that all liabilities (i.e. insurance and non-insurance) have to be valued using the risk free rate, as it does not take into account own credit standing. Article 77 of the Level 1 text on insurance liabilities states that "The best estimate shall be equal to the probability-weighted average of future cash-flows, taking account of the time value of money (expected present value of future cash-flows), using the relevant risk-free interest rate term structure". Then, the value of insurance and financial liabilities should never consider own-credit standing of the (re)insurance undertaking at inception and subsequently.

3.152. According to this view, taking into account own credit standing when valuing liabilities would enable undertakings with lower credit standing to establish lower liabilities for the same obligation than undertakings with higher credit rating, and would hence reduce comparability.

3.153. A second interpretation would be that the Level 1 text does not explicitly distinguish between insurance and non-insurance liabilities when setting out the approach to valuation. Applying this approach to non-insurance liabilities in all situations has a number of disadvantages from a regulatory perspective. Most significantly, applying this approach to non-insurance liabilities at the time of initial recognition means that the liability will be valued in the balance sheet at an amount that is higher than the one raised in the transaction. This difference will always result in a decrease in equity when loan capital is raised. This consequence is even less reflective of the economic value of the liabilities and has a significant impact when the liability is part of the eligible own funds.

3.154. Furthermore, also apart from initial recognition of non-insurance liabilities, using the risk free rate could lead to a situation where (re)Insurance undertakings would be placed on an unlevel playing field vis-à-vis banks. If (re)insurance undertakings are required to value non-insurance liabilities using the risk free rate then there will be a very strong disincentive for undertakings to raise debt funding.

3.155. Against this background (paragraphs 3.153 and 3.154), a minority of CEIOPS members are of a different view and recommends that irrespective

---

[12] Article 88 states that *Basic own funds shall consist of the following items:*

(1) *the excess of assets over liabilities, valued in accordance with Article 75 and Section 2;*
(2) *subordinated liabilities*.

of whether a non-insurance liability is eligible as own funds or not, the value should reflect own credit standing of the (re)insurance undertaking at inception to the extent the credit risk is embedded in a transaction price (i.e. normally an interest rate). Subsequently the valuation of the non-insurance liability should ignore any changes in own credit standing to be aligned with Article 75. Liabilities arising without an observable transaction price at first recognition (i.e. provisions) should be valued by using the risk-free rate.

3.156. When liabilities under IAS 37 are considered to be material, CEIOPS recommends that undertakings apply the same approach as the one set for financial liabilities, that are not part of the own funds.

CEIOPS' advice

3.157. Regarding the valuation of non-insurance liabilities, CEIOPS recommends that undertakings apply an approach that combines the use of the risk free rate for some liabilities and consideration of own credit standing at inception for other liabilities according to the features of the item being valued. Based on this approach, liabilities would be valued using the relevant risk-free interest rate. However, some liabilities, due to their particular nature, are treated very differently in the Level 1 text as they are eligible for own funds.

3.158. When such liabilities are clearly designated as own funds and subject to the requirements set in the CEIOPS Level 2 advice on own funds, the value of these liabilities shall consider own credit standing of the (re)insurance undertaking at inception. For these reasons, non-insurance liabilities that are eligible for own funds shall be measured using fair value as a suitable proxy at initial recognition in the solvency balance sheet. At a subsequent valuation date no adjustment for any subsequent changes in the undertaking's own credit standing will be made.

3.159. A minority of CEIOPS members are of a different view and recommends that irrespective of whether a non-insurance liability is eligible as own funds or not, the value shall reflect own credit standing of the (re)insurance undertaking to the extent the credit risk is embedded in a transaction price (i.e. normally an interest rate) at inception. Subsequently the valuation of the liability shall ignore any changes in own credit standing to be aligned with Article 75. Liabilities arising without an observable transaction price at first recognition (i.e. provisions) shall be valued by using the risk-free rate.

3.160. When liabilities under IAS 37 are considered to be material, CEIOPS recommends that undertakings apply the same approach as the one for financial liabilities, that are not part of the own funds.

3.2.10. Post employment benefits

Explanatory text

Definition:

3.161. Employee benefits other than termination benefits payable after completion of employment.

3.162. Post-employment benefit plans are classified as either defined contribution plans or defined benefit plan.

IFRS Treatment:

3.163. Defined contribution plan:

Recognition of the contribution payable:

(a) as a liability (accrued expense), after deducting any contribution already paid. If the contribution already paid exceeds the contribution due for service before the balance sheet date, that excess should be recognised as an asset (prepaid expense) to the extent that the prepayment will lead to a reduction in future payments or a cash refund; and

(b) as an expense, unless another Standard requires or permits the inclusion of the contribution in the cost of an asset.

3.164. Accounting for defined benefit plans involves:

- making a reliable actuarial estimate of the benefit employees have earned in current and prior periods;
- discounting that benefit using the Projected Unit Credit Method to determine the PV of the defined benefit obligation and the current service cost;
- determining the fair value of any plan assets; and
- determining the total amount of actuarial gains and losses to be recognised.

Valuation for solvency purposes:

3.165. The valuation premise in this paper follows IFRS as a reasonable benchmark for complex items where it is not possible for CEIOPS to develop separate valuation rules on its own.

3.166.CEIOPS recognises that valuation of pension liabilities is a complex task and there are some conflicts with economic valuation around the use of discount rate and treatment of hybrid contracts when IAS19 is applied

3.167.CEIOPS had requested feedback from the industry on two possible approaches in valuing pension liabilities (post employment benefit obligations):

- Solvency 2 should use IAS 19 valuation rules until IASB amends IAS19. At that time, the approach to accounting valuations should be revisited.

- Solvency 2 should develop its own approach to the valuation of pension liabilities.

3.168.The majority of industry responses were in favour of applying IAS 19 for the purposes of economic valuation under Solvency 2 till its amendment. An exposure draft relating to the proposed amendments is expected to be published in the 2nd half of 2009 and publication of a final document in 2011, which could mean a first application in 2012. The cost benefit analysis was critical in arriving at this consensus from the industry.

3.169.Considering the complex task of preparing separate valuation rules on pension liabilities and from a cost benefit perspective, CEIOPS recommends the application of IAS 19 until its revision. The cost of setting up and complying with a separate solvency valuation rules for post employment obligations will exceed the benefits of an economic valuation under Solvency II.

3.170.Further consideration should be given to this issue once the IASB finalizes the revision. In this regard, CEIOPS will consider the appropriateness of a revised IAS 19 as a basis for economic valuations when it is released.

3.171.An issue that should explicitly be taken into account is the possibility foreseen in IAS 19 for having a deferred recognition of actuarial gains and losses (corridor). This allows undertakings to have different results depending on the treatment chosen for the recognition of actuarial gains and losses.

3.172.This smoothing effect (corridor) should be prohibited for Solvency 2 purposes in order to achieve an economic valuation. This is because all the firms under Solvency 2 shall be subject to common requirements irrespective of the accounting regime they follow. Firms should recognise all the changes in their pension liabilities as well as the value of their plan assets in the period in which such changes occur.

3.173.CEIOPS believes that undertakings shall not be prevented to use their internal economic models for post-employment benefits calculation, provided the models are based on Solvency II valuation principles applied to insurance liabilities, taking also into account the specificities of post employment benefits.

3.174. Considering the complex task of preparing separate valuation rules on pension liabilities and from a cost benefit perspective, CEIOPS recommends the application of the applicable IFRS on post-employment benefits.

3.175. CEIOPS considers that elimination of smoothing (corridor) is required to prohibit undertakings coming out with different results based on the treatment selected for actuarial gains and losses.

3.176. CEIOPS believes that undertakings shall not be prevented from using their internal economic models for post-employment benefits calculation, provided the models are based on Solvency II valuation principles applied to insurance liabilities, taking into account the specificities of post employment benefits.

Annex A

Example (assumption of both undertakings applying IAS 12):

a) An undertaking holds an investment property with the cost of 80 and a carrying amount of 100 since it applied the fair value model. The tax base is 80 and the tax rate is 25% (the tax rate under the national taxation regime) applied to the selling of investment property.

   This undertaking would recognise for accounting purposes a deferred tax liability of 5 (20 at 25%).

   The amount to be considered for the solvency capital assessment would be 95 (100-5). Nevertheless, on the solvency balance sheet the asset would not be reported as a net value but as 100 (with the relevant deferred tax liability of 5 recognised on the liability side).

b) An undertaking holds an investment property identical to (a) with the cost of 80, but measures it for accounting purposes at the cost model (carrying amount = cost = 80)[13]. Also the tax base is 80 and the tax rate is 25% applied to the selling of investment property.

   This undertaking would not recognise any accounting deferred tax liability. However, for solvency purposes, this property would have to be remeasured at fair value (100), which means that the undertaking would also have to calculate the deferred tax liability of 5. If this undertaking were not to recalculate the deferred tax, an amount of 100 would have to be considered for solvency purposes, while for the previous undertaking, only 95 were eligible.

[13] For this exercise the impact of the cumulative depreciation was not considered for tax purposes.