QIS5 results:
Valuation of Assets and Other Liabilities

March 2011

EIOPA has published the results of the fifth Quantitative Impact Study conducted across reinsurance and insurance undertakings throughout Europe in 2010. While the report demonstrates increased participation in the study it also highlights significant work which needs to be done in order to reduce complexity in the guidance and to ensure consistency across territories.

INTRODUCTION

On 14 March 2011 EIOPA issued its report on the fifth Quantitative Impact Study (QIS5) for Solvency II. The study was conducted during the second half of 2010 in order to assess the impact and practicability of the potential quantitative requirements under the new insurance directive Solvency II.

To assist you in digesting this report, Milliman has produced the following short summary highlighting the key results and findings surrounding the valuation of assets and liabilities other than technical provisions. This is part of a series of Milliman summaries covering the key areas of QIS5.

OVERVIEW

Overall, EIOPA believes that the market consistent approach used for the QIS 5 balance sheet is generally supported. This can be attributed to the fact that many firms already have experience with the methods from the current international accounting standards or other similar local accounting principles. Unsurprisingly, those participants who did not currently report on an IFRS basis or similar encountered more issues with the QIS5 balance sheet methodology.

A comparison between the current accounting regimes and the QIS5 balance sheet is detailed below along with a number of key issues requiring further guidance and development highlighted by EIOPA.

BALANCE SHEET – QIS5 VS CURRENT ACCOUNTING REGIME

For solo undertakings changes in the valuation of assets between the two regimes have only a limited impact, whereas there is a more significant drop in liabilities, largely driven by a decrease in technical provisions. Groups see a greater drop in the value of assets, and a smaller, but still significant, fall in the value of liabilities; however they too have a material increase in own funds.

The principle asset categories are unit-linked assets, corporate bonds, sovereign debt and equities. The more significant changes in asset structure between the two regimes include the increased proportion made up by unit-linked assets and sovereign bonds under QIS5, the drop in investment funds, and a decrease in other assets.

Note that goodwill forms part of the current asset structure, but does not appear under QIS5, something which has a greater impact for groups.

The liabilities side of the balance sheet is unsurprisingly dominated by technical provisions, in particular for life and unit-linked business. There is an increase in the value of deferred tax liabilities (more significant than the corresponding increase in deferred tax assets) which results from differences between the QIS5 balance sheet and the one used under the tax regime.

MATERIALITY

Respondents highlighted that more guidance was needed around the application of the materiality principle in relation to the valuation of assets and liabilities, with some indicating that it was barely applied, if at all. In order to determine whether an item was material, some firms used explicit benchmarks such as a percentage of the total balance sheet or SCR.

MARK TO MODEL

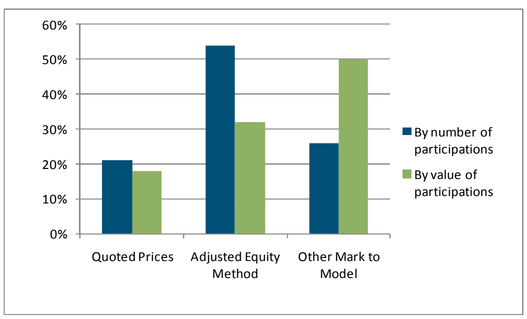
Several cases were mentioned where it was not possible to use the mark-to-market method either because a market did not exist or it was not sufficiently liquid. This was the case for a range of investment assets and the valuation of participations (and in particular subsidiaries).

Where a mark-to-model method was used instead, little detail was provided by participants on the exact method used or the size of any resulting model error.

Participations refer to an insurer's holdings in other entities. The valuation of participations was shown to have a significant impact on the total balance sheet. The QIS5 technical specification allows three valuation methods:

- market value at quoted price;
- the adjusted equity method; and
- other mark-to-model approaches.

The table below shows a breakdown of the methods used by participants in QIS5.



It is interesting to note that while just over half of the QIS5 participants used the adjusted equity method, larger companies generally used mark-to-model methods, potentially due to issues around collecting sufficient data.

INTANGIBLE ASSETS

Intangibles were usually given a nil value in the QIS5 balance sheet. Some intangibles, such as software and customer relationships, were valued in line with IAS38 or other local accounting principles. In some cases, a cost basis was used even though this is against the QIS5 valuation principles of market consistency.

DEFERRED TAXES

The proportion of total assets represented by deferred tax assets rose slightly. This was more than offset by the increase in deferred tax liabilities as a proportion of total liabilities. Deferred tax liabilities increased from 0.2% of liabilities on the current solo balance sheets to 1.3% of liabilities on the QIS5 solo balance sheets (0.7% to 1.2% for groups).

The treatment of deferred taxes under Solvency II is an important issue as it has an impact on the loss absorbing capacity of companies' solvency capital requirements (SCR). Despite this, many firms had great difficulty assigning a value to both deferred tax assets and deferred tax liabilities. The techniques used varied widely between participants and in some instances respondents chose to make no allowance for either in their balance sheet.

A key question surrounding this was whether the realisation of a deferred tax asset was probable in a reasonable time frame. Various approaches were adopted, with many firms concluding that the assessment:

- was not possible;
- resulted in no adjustment; or
- resulted in a downward adjustment, perhaps even to nil value.

CONTINGENT LIABILITIES

The majority of participants reported that the contingent liabilities (such as commitments, guarantees and pledges) did not form a material part of the balance sheet, though difficulties still arose when the QIS5 valuation method was used.

FINANCIAL LIABILITIES

While financial liabilities did not make up a large part of the total liabilities for the majority of firms under QIS5, there were a number of issues around their valuation. Some firms stated that the guidance was unclear and so used other methods in line with IFRS principles such as an amortised cost method or fair value basis. The use of the risk-free curve raised questions, particularly around whether an illiquidity premium should be included or not.

PENSION LIABILITIES

Many participants reported that they had no pension obligations. Where an obligation did exist it was generally valued in line with IAS19 or local accounting principles. However, the elimination of smoothing (corridor) was either not mentioned or not considered. No mention was made as to whether firms used internal economic models in the valuation of these liabilities. Further discussion on pension liabilities was requested.

INVESTMENT FUNDS

Some undertakings used a look-through approach when reporting assets in investment funds, others did not. This may have an impact on any interpretation of the differences between the Solvency I and QIS5 balance sheets and on deferred tax assets.

SUMMARY

Overall, the increased participation for QIS5 relative to QIS4 demonstrates that the industry is engaging with EIOPA on the development of Solvency II. This should help to create a final Solvency II solution that is better aligned with a wider range of companies' needs and expectations.

In general, participants had few issues with the valuation of assets and liabilities under the QIS5 specifications, particularly in countries such as the Ireland where market consistent practices are already in place. Despite this, the report highlights a number of issues where further guidance is expected from EIOPA including:

- Application of the materiality principle;
- Treatment of deferred taxes;
- Recognition and valuation of contingent liabilities;
- Valuing financial liabilities and pension liabilities.

QIS5 is expected to be the last in the series of impact studies and, as such, any further improvements to the Solvency II regime will be through ad hoc work and tests leading to the finalisation of the Level 2 delegated acts (formerly the Implementing Measures) later this year and the subsequent consultation on the Level 3 guidance.

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