Discussion of "Hybrid Financial Instrument: An International Examination from the IFRS 17 and Solvency II Perspective

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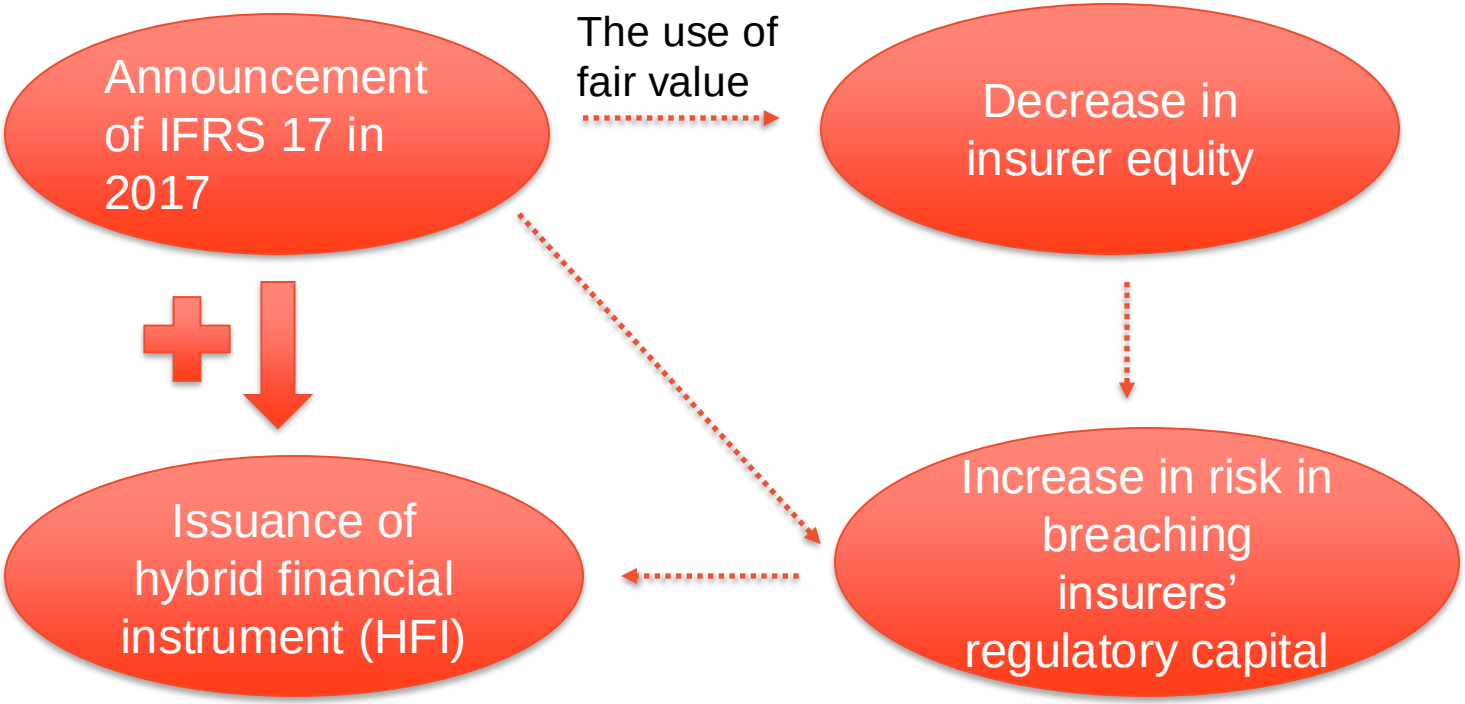
Discussant: Associate Professor Shan Zhou
Discipline of Accounting, Governance and Regulation
Business School
University of Sydney

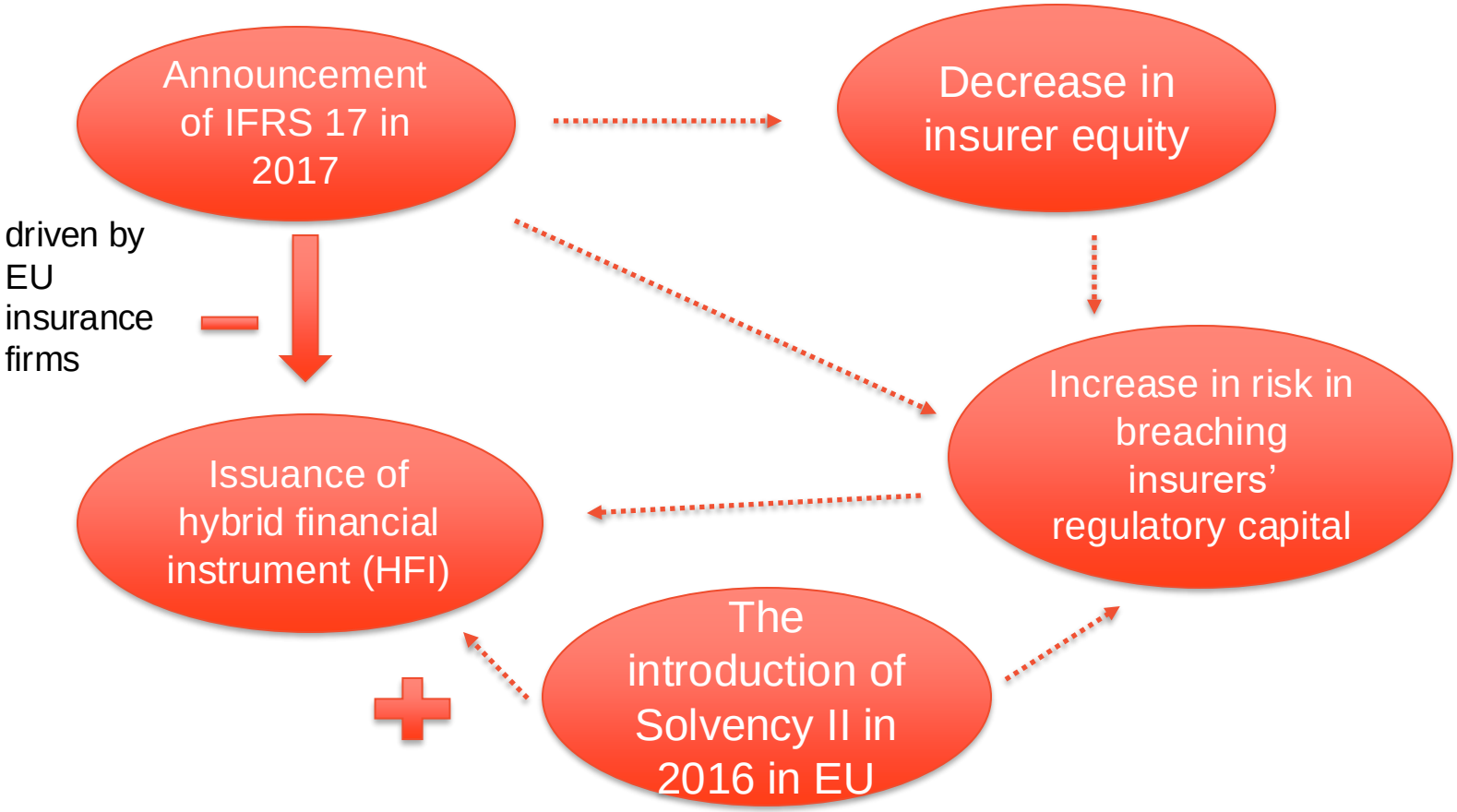
THE UNIVERSITY OF SYDNEY
Business School

The research question

- Whether the announcement of IFRS 17 influences the volume of hybrid financial instrument (HFI) issued by insurance companies.



Key findings



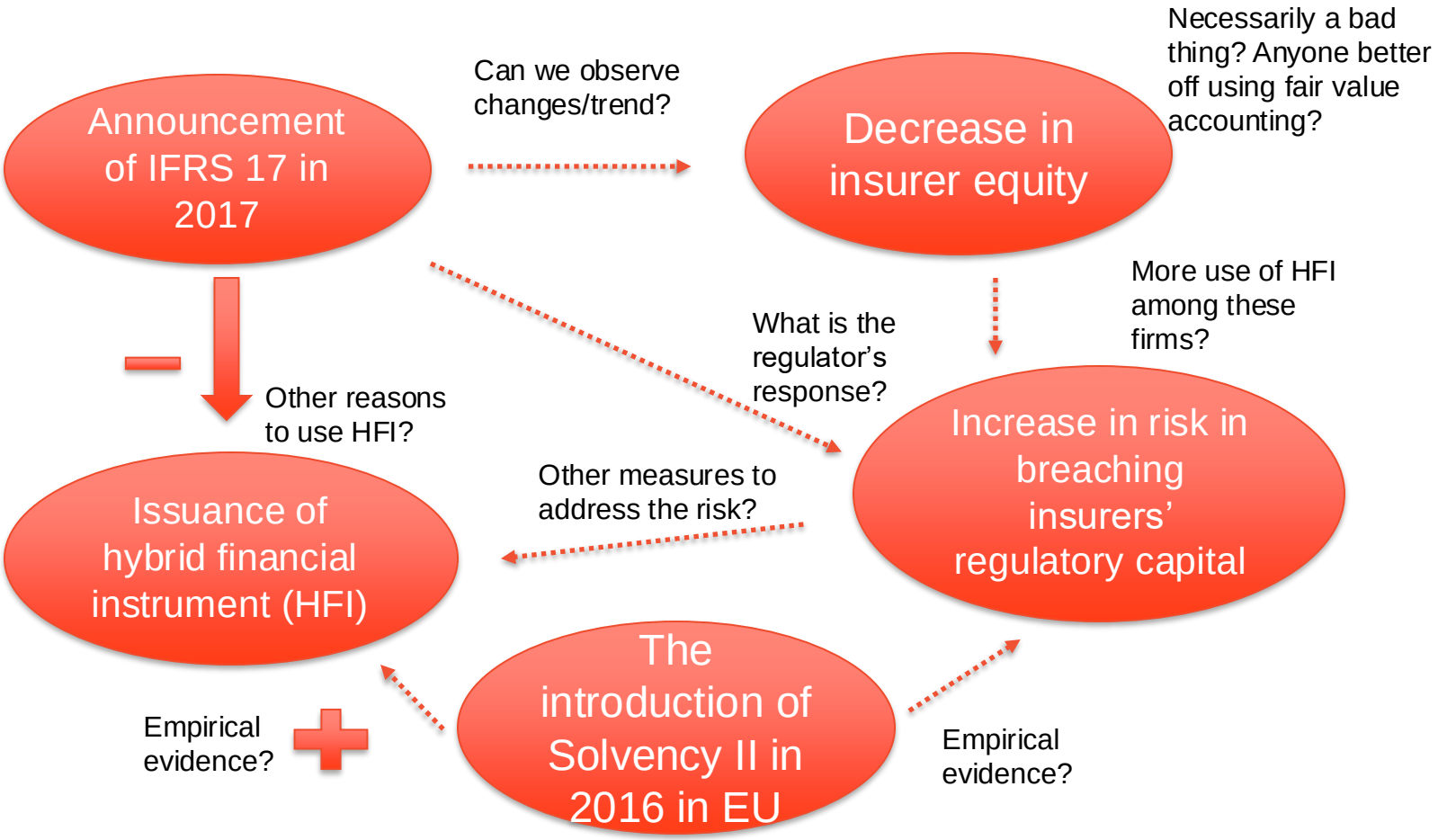
What I like about this paper

- Significant topics under researched
    - The impact of IFRS 17, fair value accounting, use of HFI
    - Insurance companies under researched in academic studies
    - Potential interaction in the impact of accounting standards (IFRS 17) versus the regulatory capital requirements (e.g. Solvency II).

How could the paper be a better one?

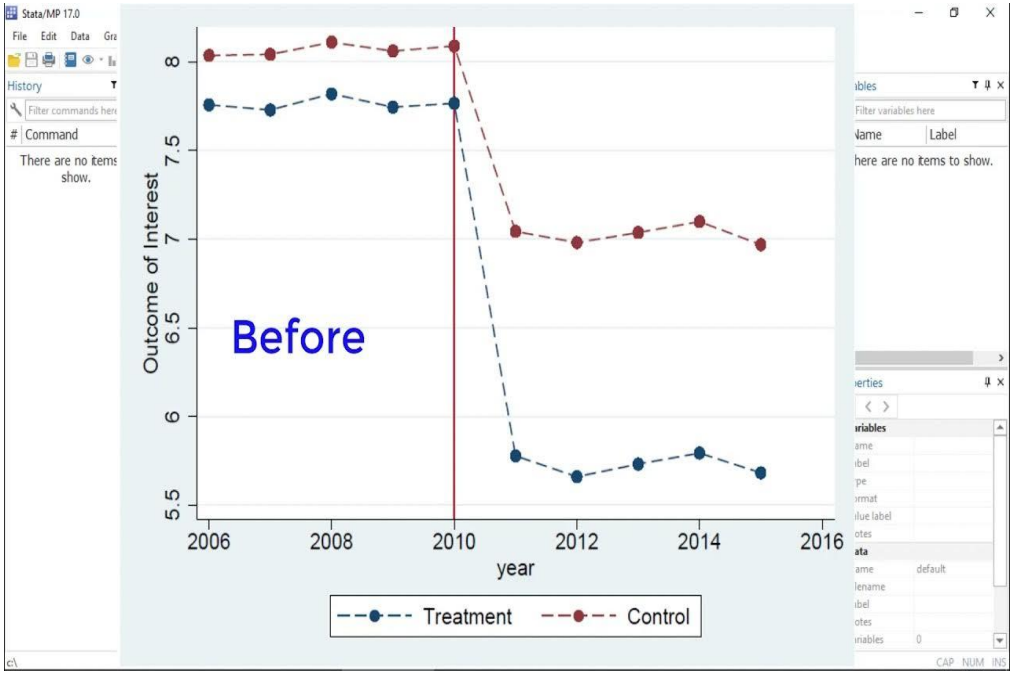
- Supporting evidence of the mechanisms
  - Can we observe changes/trends in insurer equity and/or increased risk of breaching regulatory capital requirement in some insurance firms?
  - Is it necessarily a bad thing for all insurance firms? Anyone better off from using fair value accounting?
  - Can we observe the change in use of HFI among firms with decreased insurer equity and/or increased risk of breaching regulatory capital requirement (cross-sectional test)?
  - Can we observe the potential effect from regulators' reactions? For example, in Australia, the Australian Prudential Regulation Authority (APRA) issued a discussion paper "Integrating AASB17 into the capital and reporting frameworks for insurers and updates to the LAGIC framework. They conclude to keep the capital framework largely unchanged as the LAGIC framework remains appropriate.
  - Any other means to address the increased risk of breaching regulatory capital? What's the relative cost of benefit of using HFI in doing so? How common it is to use HFI?
  - What are the common reasons for insurance companies to use HFI? For example, to reduce cost of capital?
  - Why not directly test the effect of Solvency II on the use of HFI?

Supporting evidence of the mechanisms



The use of HFI and the DID design

- Treatment group: Insurance companies from Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Netherlands, Norway, Qatar, Slovenia, South Africa, South Korea, Spain, Taiwan, United Kingdom.
- Control group: Insurance companies from China, United States, Japan and Switzerland.
- The use of HFI by amount (Table 2): China (0.58%), United States (17.15%), Japan (14.24%) and Switzerland (9.75%).



Noises in the research design/setting

- Announcement versus implementation
  - 2017 vs 2023 and often staggered

- China as a control group: "*China's national standards are substantially converged with IFRS Standards, and China has committed to adopt IFRS Standards for reporting by at least some domestic companies although there is no timetable for completion of the process. Chinese companies representing more than 30 per cent of the total market capitalisation of the domestic market produce IFRS-compliant financial statements as a result of their dual listings in Hong Kong and other international markets*".

- Why not study the impact of Solvency II directly which offers a much cleaner setting? The paper seems to claim so without providing evidence.

  - p.18: "*Our findings also align with the hypothesis that the implementation of the Solvency II framework in January 2016 significantly affected the industry, particularly for European insurers*".
  - p.19: "*This preparedness is evidence from the significant issuance of subordinated debt securities, including hybrid financial instruments, under the Solvency II framework*".

The strategic use of HFI

P.19: "*Insurers appear to use hybrid instruments, which combine debt and equity characteristics, strategically to improve solvency positions and manage regulatory capital requirements*".

- Why the use of HFI to address deficiency in regulatory capital is strategic? What's the dark side of using HFI?
- What kind of insurance companies tend to use more HFI?
- What is the cost and benefit of using HFI, and compared to other means of addressing deficiency in regulatory capital?
- Can we graph the changes/trends in issuance of HFI over the sample period?
- Can we take into account the amount, not just the volume of HFI? Can we use scaled measure of HFI?

Key issues in the research design

- It is not clear to me the level of analyses (insurance company level or instrument level or both?) and the sample size (N) is all over the place from a few hundreds to thousands (2 N in Table 7, which is different to the N in Table 1, 3&4 and in any other numbers described in the method section).

- Treatment group is significantly different from control groups (Table 5)which question whether the purpose of the PSM approach has been achieved, highlighting the self-selection nature of the issue of HFI.

- Table 3-5 should present also pre and post comparisons as a direct descriptive evidence to demonstrate trend.

Other issues with the research design

- Not sure if the Libby-Box Design is helpful (p.7). Probably replace with a graph/table clearly demonstrating how treatment/control groups are defined and the pre-post timeline.
- It is not clear to me how the treatment and control groups are selected and why they have to be obtained from different databases, i.e. treatment from Bloomberg and control from Capital IQ (from my interpretation of the method section).
- The sample selection process if not properly justified as to why excluding some insurers e.g. with an average total asset value below $100 million for the previous five fiscal years. Some are unclear for example excluding companies headquartered in tax havens for control firms only or for both?
- A sample selection table with detailed steps and reconciliation of various sample sizes (N) is necessary.

Other issues with research design

- Table 2 presents the breakdown by jurisdictions by amounts of HFI, but the empirical tests uses volume, not amount. Need a breakdown of the volume by jurisdiction and time, and use the amount in the empirical tests.
- The description of defining the treatment and control groups by the accounting standards applied in each 'firm-year" observation suggest that this value may change during the sample period? Can you provide some descriptives and utilize these changes to perform more powerful empirical tests?
- The variable definition needs to be more comprehensive and clearer including the key variables and the control variables (why including certain control variables not others, and what are the expected signs?).
- Table 3,4,5,6 need to have the column of sample size (N). It is not clear which sample is used in constructing these tables, the one with PSM or the one with all control firms? What are the additional tests using the alternative sample?

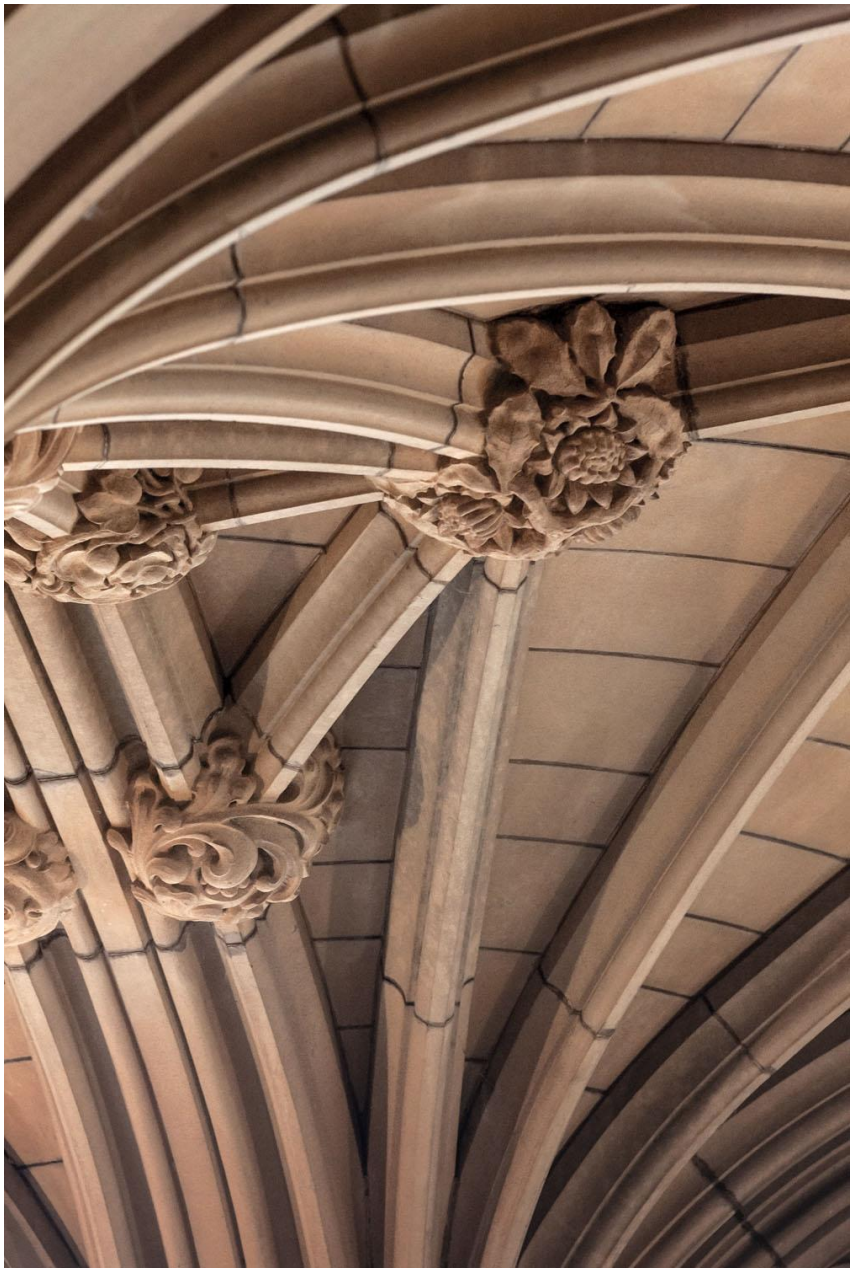
Others

- p.5: I don't follow the arguments on the transition to IFRS17 on investor perceptions of the value as insurers may appear less profitable compared to historical cost accounting. First the investors should be able to factor the impact of IFRS17 in valuation; Second, all insurance companies are using the same method now so they should be more comparable than before which will facilitate investor valuation instead of impairing it.
- p.7: "*They (Ryu and Yu (2020)) demonstrate that insurers choose hybrid instruments to strengthen their capital reserves and enhance returns at lower costs compared to traditional debt financing, which could jeopardize regulatory ratios*". This seems to be opposite to what the paper is arguing, that the use of HFI could alleviate risks of breaching regulatory capital requirement.
- P.18: Not sure the relevance of the discussion on classification of HFI as either liabilities or equity to the study, although it appears to be contradictory to some prior studies.
- p.18: "we posit that issuing hybrid financial instruments serves as a strategic tool for insurers to rebuild their equity base. This is particularly relevant for firms anticipating or experiencing reductions in equity capital". This suggests a cross-sectional test.

Others

- p.18: “Our findings also align with the hypothesis that the implementation of the Solvency II framework in January 2016 significantly affected the industry, particularly for European insurers. But there is no direct evidence on this and no proper hypothesis was developed either. Relatedly, while this may explain an insignificant result, how to explain an opposite result? Why the EU firms *reduce* their use of HFI compared to others after 2017?
- p.19: “This preparedness is evidence from the significant issuance of subordinated debt securities, including hybrid financial instruments, under the Solvency II framework”. There is no empirical evidence to support the statement.
- p.19: “Insurers appear to use hybrid instruments, which combine debt and equity characteristics, strategically to improve solvency positions and manage regulatory capital requirements”. There is no evidence to back up the use of HFI to improve solvency positions, and there is no evidence that this is strategic.

Thank you and good luck with the paper!



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