

Mr Jean-Paul Gauzes
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European Financial Reporting Advisory Group
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2 September 2019

Dear Mr Gauzes

EFRAG Draft Comment Letter on the IASB's ED/2019/4 Amendments to IFRS17

I am writing to provide comments on behalf of Prudential plc which is a major multinational group with insurance and fund management operations in the UK, Europe, Asia, and the USA.

We wish to express our thanks to the EFRAG staff for preparing its draft comment letter to such a short timeline and hope that our comments are helpful for the next stage of changes for the final version for submission to the IASB.

Prudential is a member company of the European Insurance CFO Forum. The Forum is in the process of finalising its response to EFRAG and we concur with the expected content. However, supplementary to the CFO Forum response we wish to emphasise the matters discussed below and in the attached note of comments.

Comparison of IFRS17 incorporating proposed ED amendments vis a vis volume of concerns raised by industry

We concur with your observations in the second paragraph of the draft EFRAG covering letter. Clearly, as the detailed analysis by the EFRAG Board against the criteria for endorsement has yet to be undertaken it would be premature for EFRAG to opine in its comment letter to the IASB on the suitability of the standard. Nevertheless, it would be helpful if the EFRAG comment letter could:

- a) in the covering letter, include summary observations of how the limited amendments proposed in the ED compare with the significantly larger number of amendments requested by industry representatives and other stakeholders that the EFRAG Board will need to consider as it undertakes its endorsement work when the adjusted standard is issued; and
- b) include in an appendix a list of areas where amendments have been proposed by industry that EFRAG will need to consider when undertaking its detailed analysis.

Issues to be resolved

The CFO Forum response notes that there are 3 areas of concern which are pervasive to most, or all, of the Forum members. These areas are for level of aggregation, transition, and presentation issues. We note that the draft EFRAG response is silent on several of the aspects covered under these headings and ask that the final version includes requests of the IASB to make changes in those areas, for example, at transition

- the need for relief against the annual cohort requirement so that the fully retrospective basis is not so onerous; and
- the criteria for the modified retrospective basis is less demanding so that it can be applied in practice.

Furthermore, we note that although these three subjects are important there are many other topics that, if not resolved will give rise to significantly flawed IFRS17 basis results for companies. The topics will vary between companies for types of business written and individual circumstances and may not be pervasive to all companies. Nevertheless, it is important that they are fixed.

Whilst there is a collective desire of many stakeholders to draw the IFRS 17 debate to a conclusion it is important that all involved continue to recognise that the prize is to have a high-quality standard that can be implemented at a reasonable cost.

In our opinion, with only the limited amendments proposed by the IASB, we are not yet at that stage, and by some margin. We encourage the EFRAG to ensure that all points of concern as noted in the CFO Forum comment letter, this response, and in all likelihood the responses of other industry participants, are kept firmly as part of the EFRAG work programme and that they are drawn to the attention of the IASB.

In addition, please also see an attached appendix of more detailed comments on the draft EFRAG comment letter.

We would be happy to have further engagement with the EFRAG staff on these matters.

Yours faithfully



David Martin
Director of Group Financial Reporting Developments

Cc
Ms Chiara del Prete – Chair EFRAG Technical Expert Group
Mr Roger Marshall – UK Financial Reporting Council

Appendix

Detailed Prudential plc comments on the draft EFRAG comment letter

Prudential plc comments on the draft EFRAG cover letter to the IASB

Page 1 paragraph 3

We would propose either deleting or rewording this paragraph.

At present the draft text concentrates on the willingness of the IASB to consider the points raised in EFRAG's letter of 3 September 2018. Whilst it might be true that the IASB had a thorough process the emphasis on this view in the cover letter seems inappropriate. It remains undoubtedly true that a very considerable number of points have been raised and continue to be raised by the industry for issues for which, despite its internal process, the IASB has chosen to make no change. Opinions may differ as to the reasons for this position but nevertheless despite the IASB process there remain a considerable number of issues that need correction and/or further analysis by the IASB. At the moment the letter reads subliminally that the IASB outcome is good by virtue of a thorough process, which is misleading.

Page 1 paragraph 4

The prominent positioning of the sentence on the need for the "retrospective application of risk mitigation on transition is worthy of further attention" is welcome. However, it would be better if it was embellished for two aspects, namely

- (i) to make clear that the retrospective application of the hedge adjustment is what is being sought, and
- (ii) how changes to enable a change might be persuadable to the IASB.

On point (ii) we understand that the IASB acknowledges the merits of the case for retrospective application of the risk mitigation option but has difficulty with how such an approach could not be open to "cherry picking" by companies. In our view, these concerns are misplaced, and it should not be difficult to include requirements that set hurdles to retrospective application by reference to documented risk mitigation programmes prior to Transition.

Page 1 paragraph 5

The draft EFRAG comments on the annual cohort requirement are welcome in highlighting the issue for certain types of participating business. However, an important missing ingredient is that relief from the annual requirement for business in force at Transition is very necessary for business accounted for under the fully retrospective basis.

Furthermore, the criteria for the modified retrospective basis needs to be made less demanding so that it can be applied in practice.

To not have such relief Companies' cost of implementation and subsequent maintenance of systems will be very severely increased with, at worst, only a modest deterioration in

the quality of the calculation of the Contractual Service Margin and shareholders' equity at the date of Transition.

Page 2 first full paragraph

We agree with the draft EFRAG comment letter proposal that the use of estimates be allowed so that the modified retrospective basis can be applied more in practise. We also concur with the CFO Forum view that a more principles-based approach for the use of the modified retrospective basis should be developed by the IASB. We are however nervous that the IASB has already chosen not to accede to such requests by the Forum.

It would be helpful if the EFRAG letter to the IASB could reinforce that whilst there may need to be some levels of criteria for the IASB to permit the use of reasonable approximations, the overriding objectives must be one of trying to achieve as far as possible consistency with the basis to be applied post Transition to new business. Since the fair value basis is not available to new business written post transition an approximate modified retrospective basis that is close to being consistent to the prospective required basis must surely be better than a definitely inconsistent fair value basis, which is what will be forced on companies if the current IFRS7 wording continues to apply.

Page 2 additional closing paragraph proposed

We believe the messaging of the EFRAG response would be improved if an extra paragraph could be added to the cover letter to highlight that although EFRAG has identified a short list of issues that have been addressed by the IASB there remain a considerable number of topics on which further amendment will or may be needed before the standard can be finalised to a satisfactory standard.

We note that, whilst opinions within EFRAG may differ on this request, there needs to be an acknowledgement that a realistic assessment of topics that have not been proposed by the IASB for change in the ED will conclude that the measurement, presentation and cost implications will undermine any merits of the standard when it is implemented.

Examples of such difficulties are not necessarily always from the major topics that have already been the subject of much debate and some, as is inevitable for a project of this complexity, are only now emerging as companies' implementation programmes are underway. Some difficulties may be seen as low level technical issues but nevertheless are important to undermining the performance reporting under the standard. For example, the issue of taxes borne by policyholders has not been satisfactorily addressed. Without amendment the Contractual Service Margin will be gross of taxes borne by policyholders with material misleading effects on the income statement presentation.

Prudential plc comments on Appendix 1 of the draft EFRAG comment letter

Question 1 Scope exclusions

The IASB's amendments are helpful in scoping out equity release mortgage contracts. The revised basis better reflects the underlying nature of those contracts.

Q2 Recovery of acquisition cash flows

Pages 7 and 8

We agree with the IASB's proposed amendments. However, to alleviate unnecessary implementation costs, we wish to emphasise the need for the asset for deferred acquisition costs to be capable under the modified retrospective basis of being measured by use of estimates.

Q3 CSM attributable to investment-return service

Page 10 paragraph 34

In our opinion the draft EFRAG response goes further than it should and more than was intended. The draft EFRAG letter considers that "disclosures on the weighting of the benefitsshould be disclosed" whereas in para 24 which summarises the IASB proposals it is stated that "The IASB also proposes to require an entity to disclose the approach used to assess the relative weightings" . In our opinion it would be better if the EFRAG letter merely agreed with disclosing the approach.

Additional comments regarding the measurement of the CSM

There is a risk that the focus of attention in responding to the IASB on question 3 is solely on the narrow topic of investment return related services. Whilst we concur that the IASB amendments are useful changes we note that the CFO Forum response includes proposed amendments on other aspects in respect of the CSM and request EFRAG include such proposals or similar in its comment letter to the IASB.

We wish to emphasise the additional point included in the CFO Forum response regarding the use of locked in discount rates under the general model. This issue is of particular importance to us as without amendment there will be material distortions to the income statement and shareholders' equity for business where the expected cash flow component of the insurance liability is an asset and the CSM component is a liability.

The effect of inconsistencies arising due to the different discount rates for the BEL (current rate) and CSM (locked in rate) will be highly distorting and not useful to users of the financial statements. To resolve this issue all components of the liability should be measured consistently at the current rate. We acknowledge that this issue is not new and has been discussed by the IASB on several occasions. Nevertheless, because of its importance, we urge that this issue is kept on the table for resolution in the future.

Q4 Reinsurance contracts held

Pages 12 and 13 paragraphs 41 to 44

We request that that the drafting of these paragraphs be reconsidered. At present the focus of the text is solely on the narrow problem identified by the IASB. There are several other reinsurance issues that really do need to be addressed, notwithstanding the IASB's decision to not change. In our own case we have concerns that

- (i) Distortions caused by the requirement that reinsurance contracts will always be measured under the general measurement model, even when underlying direct contracts are measured under the Variable Fee Approach (VFA). The

inappropriateness of this approach is made particularly stark for back to back reinsurance arrangements. Two examples emphasise this issue:

- (a) It will be particularly prevalent in groups where subsidiaries routinely transfer the commercial substance of direct VFA business written in one subsidiary to another where, absent the IFRS17 constraint, the reinsurance contract meets the criteria for qualification for the VFA. Such reinsurance is common within the UK insurance industry. The Group results will, we think, incorporate adjustments to eliminate the accounting inconsistency but the accounts of the subsidiary writing the direct business will be materially distorted; and
 - (b) Reinsurance of risk elements of contracts accounted for under the VFA will give rise to accounting mismatches due to the different measurement methods for contracts accounted for under the General Measurement Model and those accounted for under the VFA;
- (ii) Contract boundary requirements will in many cases result in reinsurance assets including direct contracts not yet written giving rise to accounting mismatches between direct and reinsurance contracts.

These are common examples which will affect our IFRS17 basis results to a material extent. We understand these are emblematic of broader pervasive issues with reinsurance accounting under IFRS17 that apply to others which deserve to be aired in the EFRAG comment letter.

Q5 Presentation in the statement of financial position

Page 14 paragraphs 51 to 53

We request that these paragraphs be substantially rewritten. Two points in particular need to be incorporated in our opinion.

- (i) On the separate asset and liability point, the IASB proposed change is a step in the right direction. However, to be useful in reducing implementation and maintenance costs, but without losing important information, relief needs to be at a higher level than portfolio.
- (ii) We also propose that the EFRAG comment letter include discussion of the wider aspects of presentation than just the statement of financial position, in particular the dual accounting point for subsidiaries versus groups for interim reporting. Under the current IFRS17 requirements the CSM is “locked-in” for Groups publishing interim results. This will give rise to inconsistencies between the CSM at Group and standalone subsidiary company level where the subsidiary has a different reporting frequency.

Whilst this inconsistency may be technically supportable, and we recognise that there are other examples for different non-IFRS17 related matters where differences between Group and subsidiary reporting arise, an exception should be made on this point. The system and process costs of maintaining dual records for the CSM issue will be very significant and completely at odds with any theoretical benefit. We urge that EFRAG support relief on this point.

We concur with the proposals included in the CFO Forum comment letter which would resolve this issue by requiring an annual “year to date” approach to be taken in the calculation of the CSM, irrespective of the frequency of the reporting.

Q6 Risk mitigation option

Pages 15 and 16

Consistent with the CFO Forum response we wish to emphasise the need for the risk mitigation option to also include the effects of the use of non-derivative financial instruments. Companies may use a combination of derivatives, other financial instruments and reinsurance to manage the level of net risk accepted and it is important that the risk mitigation option be comprehensive so that all component elements are taken into account.

We also note that in response to question 8(c) the draft EFRAG comment letter includes mention of the need for retrospective adjustments for risk mitigation in prior periods that should logically be taken into account in determining the CSM at Transition. We are encouraged that the IASB appears to understand that there is an important technical point for this issue and pleased that EFRAG appears supportive of the issue being re-examined.

Resolution of this issue is absolutely key to the overall performance reporting by insurers and would propose that this point is also covered in the response to Question 6 as well as question 8 on transition.

Q7 Effective date

Pages 17 and 18

In answer to the EFRAG question in para 73 we welcome the one-year delay (2021 to 2022) but note that it is likely to be an insufficiently long extension of the deadline.

We also note that we are not convinced by the factors noted in paragraph 74 of the EFRAG document as being sufficient reason for keeping to the 1 January 2022 deadline. We note also that the solution of some commentators of providing relief from the need from full comparative results will not be sufficient. The idea may be of use to a limited constituency of companies with particular circumstances but not for the generality.

Also, as regards reasons for extending the deadline, in addition to the items noted in paragraph 75 of the EFRAG document, In our opinion there remain a significant number of issues that remain unresolved and which should be addressed in the final version. It is important that getting the issue resolution and text right is more important than the required latest adoption date. On that logic the IASB should review the timing issue as to whether further delay is needed as the process for final amendments to the Standard becomes clearer.

Additional actors that may suggest that further delay would be appropriate are:

- The extent of changes to the standard that companies will need to assimilate into their implementation programmes;
- The timing of when the final amendments are concluded. A delay beyond Q2 2020 for those amendments might suggest a further year's delay will be necessary;
- The incidence of the EU endorsement process. Companies require certainty and if there is the possibility that the EU endorsement process may lag the 2022 deadline the IASB should be willing to delay the mandatory effective date to 2023;

- Lack of skilled actuarial, accounting and IT resources in many territories for the very complex implementation project and reconfiguring of processes for business as usual post adoption of the standard; and
- The need for consensus to emerge between companies and audit firms on the practical application and interpretation of the requirements of the standard.

We wish to emphasise that although some commentators perceive that only a limited number of amendments are needed (as reflected in the ED) in our opinion there is a long list of topics that should be factored into the IASB's work programme. Many of these are included in the detail of the CFO Forum response but there are other points that continue to emerge.

These include items that are below the headline radar level, for example for drafting problems, treatment of policyholder (I-E) tax for participating (with-profits and unit linked) business, accounting for with-profits business (e.g. the treatment of non-participating business written in with-profits funds and the accounting for guaranteed annuity options), the scope of the VFA (in particular its application to contracts with riders) and so on .

We are well aware that the IASB can point to the fact that a number of issues that have been flagged for some considerable time have been considered several times by the IASB in reaching its conclusion that only a small number of points would be covered in its proposals in the ED. However, notwithstanding the transparent IASB process there remains a very likely risk of the net effect on key aspects of the accounting under IFRS17 being fatally undermined unless these and the other less discussed topics are further considered.

For example, we note the following items for which the IASB have still yet to propose changes, that left uncorrected will give rise to materially undermined reporting of shareholders' equity, profit, and the CSM both at transition and for subsequent reporting:

- Lack of ability to calculate the effects on the CSM for retrospective risk mitigation for business written before Transition
- The significant constraints to use the modified retrospective basis at Transition
- The lack of recognition in IFRS17 that profits arising for non-participating business owned by participating business funds are wholly or mainly attributable to participating policyholders and thus it is not appropriate for them to be reflected in CSM.
- Accounting mismatches for reinsurance issues, as discussed above.
- Tax borne by policyholders, typically of with-profit participating business and unit linked funds not being taken into account in determining the CSM

These are just examples. In addition the resulting costs will still be far too high. As a minimum additional simplifications are needed, for example as discussed above in respect of:

- The annual cohort requirement, at least for in-force business at Transition
- Resolving the dual accounting issue caused by different reporting frequency at Group and subsidiary level

All of these and other issues suggest that fixing the standard should take longer than the IASB had in mind for a 2022 latest adoption date and it would therefore be in every one's interest to accept that a further year of delay to 1.1.23 is sensible.

Q8 Transition

Page 20

We suggest that the EFRAG response needs to be edited to make clear that it proposes that the risk mitigation option should apply retrospectively regardless of whether the risk mitigation has been applied by use of derivatives, reinsurance or other non-derivative financial instruments.

Also, a cross reference to Appendix 2 re the need for further relief on the modified retrospective basis would be helpful.

Q9 Minor amendments

The CFO Forum response concurs with most, but not all, of the amendments proposed by the IASB and highlights some other drafting points of concern. We agree with the Forum's analysis.

We wish to emphasise in particular our concerns with the change made in the ED to paragraph B107 which replaces "over the duration of the group of contracts" with "over the duration of the insurance contract".

This amendment has not been explained in the ED. If deliberate it suggests that assessment of the eligibility for the use of the Variable Fee Approach is carried out an individual contract level.

This is clearly not practical from a system and record keeping perspective as to do this literally would require the allocation of cash flows at the contract level. Furthermore, it would be inconsistent with the assumption of the group as the basic unit of account for IFRS17 measurement. The original wording should be reinstated and we request that EFRAG ask for it in its response to the IASB.

Appendix 2

Topic 1 Annual Cohorts

Page 27

We request that the EFRAG comment letter also include the need for relief from the annual cohort requirement for business in force at acquisition. That should be irrespective of the observations in paras 126 and 127 on page 30 which seem like a confusing distraction.

Topic 2 Modified retrospective approach

Page 33

We are unsure that the “use of estimates” will solve the problem of the lack of availability of the modified retrospective approach in practise. We would encourage that the EFRAG comment letter mirror the requested text of the CFO Forum.