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Report of the EFRAG IAWG Chairman – EFRAG IAWG meeting held on 11 September 2019

Agenda of the EFRAG IAWG

- 1 The following topics were discussed at the meeting:
 - (a) Q1 - Credit card: how to improve the scope criterion;
 - (b) Q3 – CSM: how to improve the definition of investment service;
 - (c) Q4 - Proportionate reinsurance: how to improve the offsetting criterion;
 - (d) Q6 - Disclosure needs about asset quality until IFRS 9 is in force;
 - (e) New/other issues; and
 - (f) Annual cohorts.
- 2 Due to lack of time, EFRAG IAWG has been asked for feedback in writing, by 13 September noon, on **Question 9: Minor Amendments** and **Question 10: Terminology**. An oral feedback will be provided to EFRAG TEG in session 6.
- 3 This report presents the feedback of IAWG members on the topics discussed and EFRAG Secretariat recommendations and proposed changes to the Letter, in addition to those already in paper 06-04, which is the marked-up version of the comment letter.

Q1 - Credit card new criterion

- 4 Members did not have a view on how to define a better principle to scope our payment cards and to avoid unintended consequences of the scope exclusion, as this is primarily an issue for the banking industry.

EFRAG Secretariat recommendations to EFRAG TEG

- 5 The EFRAG Secretariat proposes to:
 - (a) add the following sentence in paragraph 7: “In EFRAG’s view, the standard should provide a scope exclusion based on the underlying principle of not reflecting an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer, rather than referring to specific product types.’
 - (b) amend the summary box accordingly.

Q3 - CSM new criterion for definition of investment service

- 6 Members generally agreed that the requirements for investment-return services should be principle-based and should reflect the economics of the transactions. The investment activity needs to be performed for the policyholder, in order to generate an investment return for them.

- 7 Members considered paragraphs 46 and 47 of the Analysis of Comment Letters in order to identify a possible principle to define “investment-return-services”. Paragraph 46 was considered as providing a better answer, however with an integration.
- 8 Members considered appropriate not to object to the inclusion of the disclosure about the forecasts of the release pattern of the CSM.

EFRAG Secretariat recommendations to EFRAG TEG

- 9 EFRAG Secretariat proposes to include the following proposed definition as a possible way forward, after paragraph 17 of the Comment Letter:

“Insurance contracts without direct participation features may provide an investment-return service if, and only if:

- (i) The contract provides (on an expected basis at group level) a positive return to the policyholder (which could be below zero, for example in a negative interest environment); and*
- (ii) The entity expects to perform investment activity to generate that positive investment return.”*

Q4 - Proportionate new criterion for offsetting

- 10 Members considered paragraphs 89 and 90 of the Analysis of Comment Letters in order to identify a possible principle to better define “proportionate coverage” thus scoping-in contracts that incorporate the “link” between losses on the underlying contracts and gains from the proportionate reinsurance contract. Paragraph 89 (a) (ii) was considered as providing a better answer.

EFRAG Secretariat recommendations to EFRAG TEG

- 11 EFRAG Secretariat proposes to include the following, after paragraph 32 of the Comment Letter, as a possible way forward for the definition:

- 12 *“EFRAG proposes as a possible way forward that a reinsurance contract held provides “proportionate coverage” when it provides an entity with the right to recover from the issuer a contractually specified proportion of each claim incurred on individual underlying insurance contracts within a group of contracts.*

Q6 - Disclosure of asset quality until IFRS 9 is in force

- 13 Members considered that additional disclosure of asset quality was not appropriate for the following reasons:
- (a) There is already detailed information published about the asset quality, including sovereign bonds, as required by the standard *Applying IFRS 4 Insurance Contracts with IFRS 9 Financial Instruments* (Amendment to IFRS 4 for deferral of IFRS 9);
 - (b) Stress tests are usually conducted and reported in the financial statements;
 - (c) Information on IFRS 9 in isolation can be misleading. It is necessary to read it together with information on IFRS 17. As such, potential impact of expected credit losses would be offset or spread overtime through the run-off of the CSM; and
 - (d) Upon the deferral of IFRS 9, additional disclosures were introduced about credit risk.

EFRAG Secretariat recommendations to EFRAG TEG

14 The EFRAG Secretariat proposes no changes to the Comment Letter.

New/other issues

15 Excluding items in the list of 25 IASB issues that are out of scope of EFRAG's letter, EFRAG IAWG was asked to identify new interpretational issues separately from conceptual issues, in order to focus possible integration of the technical analysis to conceptual issues only, at this stage.

Issues not to be included in the Comment Letter

16 The following topics were considered not to be included in the Comment Letter:

- (a) Current and prospective measurement model inadequate in some cases;
 - (i) To be considered for impact assessment in the endorsement advice rather than the Comment Letter.
- (b) Presentation of collateral deposits;
 - (i) The issue is a variation of the issue of separate presentation of receivables, where EFRAG agreed with the IASB.
- (c) Non-distinct investment components;
 - (i) This was considered an interpretation issue by some and others did not want more precisions.
- (d) Consequential amendments to IAS 16 Property, Plant and Equipment;
 - (i) This was considered to be an interpretation issue.
- (e) Technical correction to VFA Illustrative Examples;
 - (i) This is not part of the ED, therefore not considered.
- (f) Additional terminology improvements;
 - (i) This was considered to be an interpretation issue.

Issues where EFRAG TEG is required

17 The following are topics where additional input is required from EFRAG TEG as to whether they should be included in the Comment Letter:

- (a) Measurement inconsistencies – IFRS 17 applying a fair value measurement to assets
 - (i) This was not considered material at the moment. However, it was noted that 50% of a building could be owned by a life insurer and the remaining 50% owned by a non-life insurer within the same group. Allowing mixed measurement for the building would address accounting mismatches.
- (b) Re-classification of OCI
 - (i) Members considered the possible mismatch that would result in equity for contracts under the VFA when the underlying item (investment in equity instruments @FVOCI) is derecognized. IFRS 9 requires that upon de-recognition the cumulated amount in OCI is reclassified within equity, in order to be presented as retained earnings.
A similar explicit clarification in IFRS 17 is missing.

It was noted that a reasonable interpretation could be a potential solution but as there was no certainty about such an interpretation being provided, the preferred solution was to require a clarification in IFRS 17.

- (c) Treatment of LIC in contract modifications
 - (i) Members considered the issue described in paragraph 341 and had different views. IFRS 17 is silent with regard to the group to which the LIC of the derecognized contract shall be allocated.

One member thought the LIC needed to be derecognised upon modification, another member thought the standard should remain principles based and offer multiple possibilities to account for this issue.

Issues to be included in the Comment Letter

18 The following issues were considered worthwhile to be proposed to TEG for inclusion in the Comment Letter:

- (a) VFA – unlocking of CSM for changes in non-underlying cash flows;
 - (i) The example considered was a contract that has two phases: a first phase there is a link to the underlying assets; a second phase there is only a payout of fixed annuities (there is no option by the client to switch from a phase to another but two phases defined upfront). When a contract is accounted for under the VFA, a change in financial risk not arising from underlying items adjusts the CSM. When looking at the second phase of the contract, this is considered conceptually wrong, as there is no possibility to split the part that relates to the future and the part that relates to the current period. It affects contracts in a number of countries. For example, deferred annuities in the US (including amounts on balance sheet of European insurers that operate in the US).
 - (ii) Members considered, as well, another example, when items could relate to two different underlying pools of items. The conclusion for this example was that the standard would allow to identify two separate pools and split the underlying items. This second example was not creating an issue.
- (b) Accounting for time value of money in VFA;
 - (i) The concern raised relates to the fact that the simple passage of time should not be considered as affecting CSM, only the change in interest rates does. Members considered that a clarification may be needed.
- (c) Mutual entities.
 - (i) Mutual entities consider that they have equity, in contrast to what the Basis for Conclusions of IFRS 17 states. In several European jurisdictions mutual entities have started actions to move away from IFRS. The impact of IFRS 17 on mutual entities will be further assessed as part of the endorsement activity (i.e. not related to this Comment Letter).
 - (ii) The proposed footnote to paragraph BC218 (b) is considered helpful but the overall Basis for Conclusions not. Members consider appropriate to recommend to the IASB to eliminate BC265/269 and to withdrawal the educational material.

19 Furthermore, EFRAG IAWG members agreed that the requirements for interim reporting (which was part of the 25 IASB issues) are not a simplification and would

increase cost and complexity also on transition. Some suggested to have an option while others did not agree with that.

EFRAG Secretariat recommendations to EFRAG TEG

- 20 If TEG was supportive of including in the Comment Letter a wording to address the issue of IAS 34, EFRAG Secretariat would propose the following wording:
- 21 *“EFRAG acknowledges that the IASB developed the exception to IAS 34 Interim Financial Reporting primarily in order to simplify the measurement requirements in IFRS 17. EFRAG understands that preparers in Europe do not consider this exception to be a simplification and would on the contrary add to complexity and costs. EFRAG, therefore, proposes to eliminate paragraph B137 of IFRS 17 and refer to the principle in IAS 34.”*
- 22 In addition, the EFRAG Secretariat proposes to include the following in the Comment Letter as other issues raised by constituents. They represent unintended consequences that were not anticipated when the standard was written:

VFA – Unlocking of CSM for changes in non-underlying cash flows

- 23 We have been informed about the following relating to contracts under the VFA but that contain also certain non-participating features. The cash flows arising from these features are not covered by underlying items.
- 24 These products qualify for the VFA based on an assessment against the criteria in IFRS 17.B101 at inception, even though there is a non-trivial part of future cash flows which may not vary based on changes in the underlying item. For example, at the time of eligibility assessment the non-variable annuity pay-out phase of the variable annuity may have had less weight compared to the variable cash flows in the participating accumulation phase.
- 25 Applying the current requirements to these contracts containing cash flows not arising from underlying items would result in significant accounting mismatches in profit or loss. Because according to IFRS 17.B113(b), the changes in the time value of money (TVoM) and financial risk not arising from underlying items shall adjust the CSM, while the investment result from the general account investments backing the non-participating future cash flows is directly recognized in profit or loss in the current period. Consequently, the CSM might be eaten up rapidly, giving rise to a loss component, although economically the contract is not onerous.
- 26 Applying the current requirements to these contracts containing cash flows not arising from underlying items would result in significant accounting mismatches in profit and loss.
- 27 The accounting issue presented above is not just a theoretical issue, but it is a “real-world” problem affecting a multitude of common insurance contracts in different jurisdictions.
- 28 Members considered that the IASB should clarify that B113(b) does not concern non-participating contractual cash flows that are not covered by the underlying items.

Accounting for time value of money in VFA

- 29 We have been informed that IFRS 17.B113(b) requires changes in the effect of the time value of money and financial risks not arising from the underlying items to adjust the CSM for contracts with direct participation features. The scope of this paragraph extends to all changes in the effect of the time value of money and financial risks. Some have interpreted this as including the effect of unwinding of the discounting of relevant fulfilment cash flows. Some are concerned that this

interpretation will cause distortions in the financial statements, particularly as a result of the unwinding of the discounting of the insurance contract liabilities being included in the CSM. Some believe this interpretation is conceptually incorrect, as the time value of money effect arising purely as a result of the passage of time (i.e., unwinding of the discounting of the liability) relates to current service and should be included in insurance finance expense for the period.

Annual cohorts

- 30 Members considered the proposals put forward by constituents in their comment letters, in particular proposals in paragraphs 255, 256 and 257 of the Analysis of Comment Letters.
- 31 Members observed that the proposal in paragraph 256 would allow an entity to adopt a different grouping methodology than the annual cohort requirements, such as having a new cohort when there is a new tariff generation every 2 or 3 years. This method would not be intended to give rise to open-ended portfolios but to a number of closed cohorts. Members concluded that the requirement to achieve similar accounting outcome under this proposal would allow to apply the exception when the entity expects that none of the losses will affect the shareholders (in substance when 100% of the risks are mutualised). Members concurred that this approach would not solve the issue for the contracts that substantially share risks and substantially sharing of risks was seen as an essential feature of the contracts for which an exception is needed (“mutualised business”).
- 32 Members observed that an ex-ante test requiring to demonstrate that the accounting outcome achieved without the cohorts would not be significantly different from the outcome achieved with the cohorts would result in similar complexity as using the cohorts.
- 33 Some members observed that in order to have a true and fair view of the mutualised business, the appropriate level of aggregation has to be the level of the mutualised group/s. Only at this level the reporting would reflect the rights, i.e. no generation has specific rights over a slice of the pool.
- 34 It was observed that an aggregation at level of mutualised group/s would achieve a better depiction of how the business was managed, however would provide a less comparable reporting across entities. Members acknowledged as well the feedback from specialised users that they did not consider appropriate to apply the annual cohorts to the mutualised business.
- 35 Members agreed with the proposed additional disclosure proposed in the mark-up of the comment letter, including that in point (d). However, they questioned the operability of disclosing the value of key parameters; they considered a qualitative explanation of the methods more appropriate.

Questions for EFRAG TEG

- 36 Does EFRAG TEG agree with the inclusion in the Comment Letter of paragraphs 5, 9 and 12 above?
- 37 Does EFRAG TEG agree with not including the topic of asset quality disclosure in the Comment Letter (par. 13 above)?
- 38 Does EFRAG TEG agree with not including in the Comment Letter the topics listed in paragraph 16 above?
- 39 Which of the topics listed in paragraph 17 above have merit to be include in the Comment Letter?

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| 40 | Does EFRAG TEG consider appropriate to include items listed in paragraphs 23-28 above in the Comment Letter? |
| 41 | Members are invited to consider the feedback on the annual cohort requirements in paragraphs 30-35 above when discussing the text of the draft of the Comment Letter. |