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EFRAG's Draft Letter to the European Commission Regarding Endorsement of *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts: Amendments to IFRS 4*

Olivier Guersent
Director General, Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Brussels

[dd Month] 2016

Dear Mr Guersent,

Adoption of *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts: Amendments to IFRS 4*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards, EFRAG is pleased to provide its opinion on the *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts: Amendments to IFRS 4* (the Amendments), which was issued by the IASB on 12 September 2016. An Exposure Draft of the Amendments was issued on 9 December 2015. EFRAG provided its comment letter on that Exposure Draft on 15 February 2016.

The objective of the Amendments is to provide options for an entity to select to address, in its particular circumstances, the effects of the misalignment of the effective dates of IFRS 9 *Financial Instruments* and the forthcoming insurance contracts Standard until the forthcoming insurance contracts Standard is effective.

The Amendments become effective for annual periods beginning on or after 1 January 2018. A description is included in Appendix 1 to this letter.

In order to provide our endorsement advice as you have requested, we have first assessed whether the Amendments would meet the technical criteria for endorsement, in other words whether the Amendments would provide relevant, reliable, comparable and understandable information required to support economic decisions and the assessment of stewardship, lead to prudent accounting and are not contrary to the true and fair view principle. We have then assessed whether the Amendments would be conducive to the European public good.

We provide our conclusions below.

Do the Amendments meet the IAS Regulation technical endorsement criteria?

EFRAG has concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship and raises no issues regarding prudent accounting. EFRAG has also assessed that the Amendments do not create any distortion in their interaction with other IFRS, especially in that the Amendments are designed to address a problem identified in our endorsement advice on IFRS 9 that arises from that Standard and the forthcoming insurance contracts Standard becoming effective on different dates. EFRAG has also concluded that all necessary disclosures are required. Therefore EFRAG has concluded that the Amendments are not contrary to the true and fair view principle. EFRAG's reasoning is explained in Appendix 2 to this letter.

Are the Amendments conducive to the European public good?

EFRAG has assessed that the Amendments would serve to reduce the negative financial reporting and cost consequences for the insurance sector that would otherwise arise from implementing IFRS 9 before the forthcoming insurance contracts Standard and would reach an acceptable cost-benefit trade-off.

EFRAG's analysis is that the Amendments address the main concerns of groups whose activities are predominantly related to insurance ("predominant insurers"). EFRAG further notes that predominant insurers are the most significantly affected by the issues arising from the misalignment of the effective dates of IFRS 9 and the forthcoming insurance contracts Standard. On that basis, EFRAG assesses that adopting the Amendments would be conducive to the European public good. EFRAG's reasoning is explained in Appendix 3 to this letter, which includes certain elements of an impact analysis.

EFRAG is aware that the Amendments do not fully address the concerns of some groups that undertake significant insurance activities. This is because the Amendments do not permit financial conglomerates with significant insurance activities to defer the application of IFRS 9 in relation to their insurance divisions in their consolidated financial statements. EFRAG has accordingly considered whether this could give rise to competition issues within the European insurance sector. This assessment is set out in Appendix 3.

To what extent do the Amendments address the concerns raised in EFRAG's endorsement advice on IFRS 9?

EFRAG's conclusion on whether endorsement of IFRS 9 would be conducive to the European public good was positive, except for the impact on the insurance industry of applying IFRS 9 before the finalisation of the forthcoming insurance contracts standard. EFRAG's endorsement advice stated:

> *EFRAG has confirmed its preliminary view that the benefits to users of consistent financial reporting until IFRS 9 and the future insurance contracts standard are both applied, together with the cost savings for preparers and users, made a strong case for having the IASB defer the effective date of IFRS 9, so as to align it with the effective date of the future insurance contracts standard, albeit only for entities undertaking insurance activities and as an option. … Furthermore, in the absence of uniform accounting policies for insurance liabilities, and considering that some insurance activities are conducted in the context of conglomerates, the impact of the non-alignment of the effective dates of IFRS 9 and the future insurance contracts standard varies from one company to the other. Therefore any remedy provided to mitigate the negative impact of the non-alignment of effective dates should be granted on an optional basis.*

EFRAG assesses that the Amendments go a significant way towards addressing the concerns raised in its endorsement advice on IFRS 9. In particular, the Amendments provide an optional, temporary exemption from the application of IFRS 9 for entities whose activities are predominantly insurance at the reporting entity level.

The Amendments also provide an alternative approach (the overlay approach) that would be available to financial conglomerates and which substantially mitigates the financial reporting-related concerns. Accordingly, some form of solution is available to the entire insurance industry. The main drawback of the overlay approach is that it does not address the cost-related concerns and would in fact increase costs for preparers compared to implementing IFRS 9 in the normal way.

In making these observations, EFRAG notes that the misalignment of effective dates is a unique and short-term situation. This situation gives rise to a complex set of issues, the impact of which varies from one entity to another. There is unlikely to be any single, perfect solution to these issues (especially given the short time available to develop one) and any solution put forward would inevitably reflect certain trade-offs between competing factors. In this context, EFRAG considers that, although the Amendments do not fully address the issues in our endorsement advice on IFRS 9, and do not achieve a completely level playing field within the insurance sector, they nonetheless go a long way towards addressing them and represent a reasonable trade-off. EFRAG's reasoning is further explained in Appendix 3.

Interaction between our endorsement advice and our comment letter on the Exposure Draft

EFRAG issued a comment letter on the IASB's Exposure Draft that preceded the Amendments (ED/2015/11 *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts*) in February 2016. The Amendments incorporate many, but not all, of EFRAG's recommendations in its comment letter. In particular EFRAG recommended that the scope of the temporary exemption should be widened. The Amendments do indeed reflect a substantial widening. However, EFRAG also recommended that the option to defer the application of IFRS 9 should be available at the level of individual entities that are regulated as insurers for the purposes of the consolidated financial statements of a financial conglomerate. As noted above, the Amendments do not reflect this recommendation.

EFRAG's comment letters are submitted in its capacity of contributing to the IASB's due process. By contrast, EFRAG's endorsement advice is based on its assessment against the criteria for European endorsement. These are explicit criteria which have been designed specifically for application in the endorsement process. For this reason, the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRS or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Our advice to the European Commission

As explained above, we have concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, raise no issues regarding prudent accounting, and are not contrary to the true and fair view principle. We have also concluded that the Amendments are conducive to the European public good for the period for which they are needed. Therefore, we recommend the Amendments for endorsement.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission and the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Contents

Appendix 1: Understanding the changes brought by Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts*: *Amendments to IFRS 4*

A - Background of the Amendments

1 The amendments contained in *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts: Amendments to IFRS 4* ("the Amendments") are designed to address the concerns of insurance companies and users of their financial statements about the different effective dates of both IFRS 9 and the forthcoming insurance contracts Standard. These concerns have been described as follows[1]:

(a) *Accounting mismatches*. If entities undertaking insurance activities were required to change the accounting for financial assets by applying IFRS 9 *Financial Instruments* without a corresponding change in the accounting for insurance liabilities backed by those financial assets, it would result in accounting mismatches for those entities undertaking insurance activities applying the cost model under IFRS 4 *Insurance Contracts*. This is because some debt instruments currently accounted for at amortised cost or at fair value through other comprehensive income and most equity instruments currently accounted for at fair value through other comprehensive income with recycling are likely to be accounted for at fair value through profit or loss when applying IFRS 9. Fair value movements on these assets would be recognised in profit or loss, while insurance liabilities backed by those assets remain measured at cost, resulting in accounting mismatches in profit or loss even where the insurance liabilities are perfectly matched by financial assets.

(b) *Information needs of users of financial statements*. Users will find difficulties in understanding the financial performance and position of entities undertaking insurance activities during the period between the adoption of IFRS 9 and the forthcoming insurance contracts Standard. Entities undertaking insurance activities are likely to provide non-GAAP measures to explain the impact of accounting mismatches caused by a change in the measurement of financial assets that is not accompanied by a change in the measurement of the insurance liability. This is likely to require users to perform complex analyses to understand the results of an entity undertaking insurance activities by linking non-GAAP measures to the financial statements. This difficulty will be exacerbated by users having to change their models twice in a relatively short period of time as the forthcoming insurance contracts Standard is expected to be effective by 2021.

(c) *Costs for preparers*. In the event IFRS 9 is implemented before the forthcoming insurance contracts Standard, entities undertaking insurance activities would incur additional costs for having to first implement IFRS 9 and then reassess that implementation when implementing the forthcoming insurance contracts Standard.

[1] See EFRAG's Endorsement Advice on IFRS 9 *Financial Instruments,* Appendix 3 relating to European public good, dated 15 September 2015, pp. 79-83.

B - How the issues have been addressed

2 The Amendments provide two options that will permit qualifying entities to take alternative approaches to the application in full of IFRS 9 in order to mitigate the concerns described above:

(a) An optional temporary exemption from IFRS 9 which permits an insurer to continue using IAS 39 *Financial Instruments: Recognition and Measurement* if its activities are predominantly connected with insurance ("the temporary exemption from IFRS 9"); and

(b) An optional overlay approach that permits insurers that issue contracts within the scope of IFRS 4 to apply IFRS 9 to designated financial assets and then to reclassify, from profit or loss to other comprehensive income, some of the income or expenses arising from these designated financial assets ("the overlay approach").

3 The result of introducing these options is that an entity that meets the relevant qualifying conditions may apply one of the following approaches to their financial assets:

(a) IFRS 9 – this is available to all entities;

(b) the temporary exemption from IFRS 9 – available to entities whose activities are predominantly connected with insurance; and

(c) the overlay approach – available to all entities that issue contracts within the scope of IFRS 4 and may be applied to financial assets that are not held in respect of an activity that is unconnected with those contracts.

C - What options have been introduced?

Temporary exemption from IFRS 9

4 An entity is permitted to apply the temporary exemption from IFRS 9 when:

(a) The entity has not previously applied any version of IFRS 9 (except for the "own credit" requirements in isolation); and

(b) The entity's liabilities are predominantly connected with insurance, determined at the level of the reporting entity (i.e. at consolidated level for the purpose of the consolidated financial statements). Liabilities connected with insurance comprise:

(i) Liabilities arising from issuing contracts within the scope of IFRS 4 (including deposit components or embedded derivatives that are unbundled from insurance contracts and financial instruments that contain a discretionary participation feature) and these contracts give rise to liabilities whose carrying amount is significant compared to the total carrying amount of all the entity's liabilities;

(ii) Non-derivative investment contract liabilities that are measured at fair value through profit or loss (FVPL) by applying IAS 39; and

(iii) Liabilities that arise because the insurer issues, or fulfils obligations arising from, the contracts in (i) and (ii) above.

5 An entity's activities are treated as being predominantly connected with insurance if, and only if, the entity's so-called predominance ratio meets specified thresholds. The predominance ratio is calculated as the ratio of :

(a) the sum of the carrying amounts of the liabilities referred to in paragraph 4(b) above to

(b) the total carrying amount of all the entity's liabilities.

6 An entity's activities are deemed to be predominantly connected with insurance only if the predominance ratio:

(a) is greater than 90 per cent; or

(b) is less than or equal to 90 per cent but greater than 80 per cent and the entity does not engage in a significant activity that is unconnected with insurance.

7 In order to assess whether it qualifies for the temporary exemption from IFRS 9, an entity is required to compute the predominance ratio by using the carrying amounts of the liabilities reported on the entity's balance sheet, in accordance with IFRS Standards, at the annual reporting date immediately prior to 1 April 2016.

8 If there is a significant change in the entity's activities during the reporting period:

(a) an entity that previously qualified for the temporary exemption shall reassess whether its activities are still predominantly connected with insurance; and

(b) an entity that previously did not qualify for the temporary exemption is permitted to subsequently reassess whether its activities are predominantly connected with insurance at an annual reporting date before 31 December 2018.

9 First-time adopters of IFRS are permitted to apply the temporary exemption when fulfilling the criteria in paragraph 4 above.

10 When using the equity method to account for an entity's investments in associates and joint ventures, the entity is granted relief from using uniform accounting policies. That relief is available on an investment-by-investment basis and is valid (i) when the entity uses IFRS 9 in its financial statements and the associate or joint venture uses the temporary exemption from IFRS 9; or (ii) the entity uses the temporary exemption from IFRS 9 but the associate or joint venture uses IFRS 9.

11 An entity that applies that temporary exemption from IFRS 9 will be required to disclose information to enable users of financial statements to understand how the insurer qualified for the temporary exemption and to compare with entities applying IFRS 9.

12 In particular, an entity shall disclose fair value information about financial assets that would be measured at FVPL in accordance with IFRS 9. In doing so, the entity shall differentiate between:

(a) financial assets that have cash flows that are solely payment of principal and interest (excluding financial assets that are held for trading as per IFRS 9 or that are managed and whose performance is evaluated on a fair value basis); and

(b) financial assets that do not have such cash flows including financial assets that are held for trading as per IFRS 9 or that are managed and whose performance is evaluated on a fair value basis.

13 Entities are also required to disclose information about the credit risk exposure, including significant credit risk concentrations, inherent in the financial assets referred to in paragraph 12(a) above and that do not have low credit risk in accordance with IFRS 9.

14 The temporary exemption from IFRS 9 will be available for annual reporting periods beginning on or after 1 January 2018 and ends no later than for annual reporting periods beginning on or after 1 January 2021.

15 Entities may cease to apply the temporary exemption from IFRS 9 at any time. When doing so, they may at the beginning of any subsequent annual period irrevocably elect to apply IFRS 9.

Overlay approach

16 An entity that issues contracts within the scope of IFRS 4 and applies IFRS 9 is permitted, but not required, to reclassify from profit or loss to other comprehensive income, an overlay adjustment equal to the difference, for qualifying financial assets, between:

(a) the amount reported in profit or loss by applying IFRS 9; and

(b) the amount that would have been reported in profit or loss by applying IAS 39.

17 Financial assets qualify for the overlay approach when they are designated as not being held in respect of an activity that is unconnected with contracts that are within the scope of IFRS 4. In addition, these designated financial assets are measured at fair value through profit or loss (FVPL) in accordance with IFRS 9 but would not have been measured at FVPL in their entirety in accordance with IAS 39. Qualifying financial assets include surplus assets that an entity holds for the purposes of regulatory requirements or internal capital objectives.

18 An entity may apply the overlay approach to any or all eligible financial assets. First-time adopters of IFRS are permitted to apply the overlay approach to qualifying financial assets.

19 Presentation in profit or loss of gains or losses on financial assets to which the overlay approach is applied must reflect the application of IFRS 9, with a separate line item for the overlay adjustment. In addition, entities will be required to present, in other comprehensive income (OCI), the overlay adjustment separate from other components of OCI, consistently with IAS 1 *Presentation of Financial Statements*.

20 An entity that applies that overlay approach is required to disclose sufficient information to enable users of financial statements to understand how the amount of the overlay adjustment is calculated and the effect of the adjustment on the financial statements.

21 The overlay approach may only be first applied when an entity first applies IFRS 9 (other than the "own credit" requirements in isolation) and this approach does not have a fixed expiry date. Entities may cease to apply the overlay approach at any time. When doing so, the accumulated effect of the total overlay adjustment is reclassified to retained earnings without impacting profit or loss.

Appendix 2: EFRAG's technical assessment on Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts:* Amendments to IFRS 4

Notes to Constituents:

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on Applying *IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts: Amendments to IFRS 4* ("the Amendments"). In it, EFRAG assesses how the Amendments satisfy the technical criteria set out in the Regulation (EC) No 1606/2002 for the adoption of international accounting standards. It provides a detailed evaluation for the criteria of relevance, reliability, understandability and comparability, so that financial information is appropriate for economic decisions and the assessment of stewardship. It evaluates separately whether the Amendments lead to prudent accounting and finally considers whether the Amendments would not be contrary to the true and fair view principle.

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the criteria for European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRS or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

In its comment letter of 12 February 2016 on the Exposure Draft that preceded the Amendments, EFRAG commented that "a playing field within the insurance sector should be maintained as much level as possible, whilst acknowledging that a perfect level playing field will not and cannot be obtained, even with our proposals". Based on this reasoning EFRAG recommended to the IASB that the temporary exemption from IFRS 9 is made available below the reporting entity level. EFRAG also noted that, if this recommendation is taken up, additional requirements would be needed to address the accounting for internal transfers of financial assets and to ensure that material banking activities would not fall within the scope of the temporary exemption. The Amendments as issued do not allow the application of the temporary exemption below reporting entity level. However, for the reasons explained above this and other differences between our comment letter and the final Amendments do not necessarily preclude an assessment that the Amendments meet the criteria for endorsement.

Does the accounting that results from the application of the Amendments meet the technical criteria for endorsement in the European Union?

1 EFRAG has considered whether the Amendments meet the technical requirements of the European Parliament and of the Council on the application of international accounting Amendments, as set out in Regulation (EC) No 1606/2002 (The IAS Regulation), in other words that the Amendments:

(a) are not contrary to the principle of 'true and fair view' set out in Article 4 (3) of Council Directive 2013/34/EU (The Accounting Directive); and

(b) meet the criteria of, relevance, reliability, comparability and understandability required of the financial information needed for making economic decisions and assessing the stewardship of management.

2 EFRAG's assessment on whether the Amendments are not contrary to the true and fair view principle set out in Article 4(3) of Council Directive 2013/34/EU is based on the assessment of whether they meet all other technical criteria and whether they lead to prudent accounting. EFRAG's assessment also includes assessing whether the Amendments do not interact negatively with other IFRS and whether all necessary disclosures are required. Detailed assessments are included in this appendix in the following paragraphs:

(a) relevance: paragraphs 8 - 32;

(b) reliability: paragraphs 33 - 44;

(c) comparability: paragraphs 45 - 67;

(d) understandability: paragraphs 68 - 77;

(e) whether overall it leads to prudent accounting: paragraphs 78 - 85; and

(f) whether it would not be contrary to the true and fair view principle: paragraphs 86 - 91.

3 In its endorsement advice on IFRS 9, EFRAG assessed: "*that the mismatch in timing of the future insurance contracts Standard and IFRS 9 would create disruptions in the financial reporting by many entities undertaking insurance activities during the period until the forthcoming insurance contracts Standard is applied, which will make financial reporting less understandable for users while increasing costs for preparers*".

4 These disruptions arise because the business model of entities undertaking insurance activities is based on asset/liability management, with the objective of investing in assets in order to generate income and capital appreciation to cover insurance liabilities and provide profit for shareholders.

5 EFRAG's assessments below take into account this interrelationship between assets and liabilities as managed by insurers. In providing its assessments on whether the Amendments result in relevant, reliable, comparable and understandable information, EFRAG has relied on the fact that the Amendments do not introduce any recognition or measurement requirements. Instead, the Amendments either affect the timing of the full implementation of IFRS 9 (the temporary exemption), or affect the presentation of certain gains or losses arising from the application of IFRS 9 (the overlay approach), and contain disclosure requirements to explain the effect of these approaches.

6 EFRAG has focused its assessment on those aspects of the Amendments it considered most significant in relation to each of the criteria. EFRAG has accordingly focused on guidance that:

(a) is fundamental to the options in the Amendments;

(b) has been subject to substantial debate (evidenced by the comments EFRAG has received from constituents);

(c) may be problematic to apply; and

(d) relates to the issues raised by the European Commission in its request for endorsement advice dated 13 October 2016.

7 EFRAG has assessed the Amendments against each of the technical criteria for each of the following requirements (where relevant):

(a) having two options – the overlay approach and the temporary exemption from IFRS 9;

(b) temporary exemption from IFRS 9 (the temporary exemption); and

(c) overlay approach.

Relevance

8 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.

9 EFRAG considered whether the Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

Having two options – the overlay approach and the temporary exemption from IFRS 9

10 When alternative accounting options are made available, it is reasonable to expect that entities will select the option that is appropriate to their circumstances and that this selection will take into account the relevance of the resulting information for the users their financial statements. As a result, EFRAG expects that:

(a) entities that are eligible for both the overlay approach and the temporary exemption from IFRS 9 will consider which approach (applying IFRS 9 in the normal way or applying one of the options in the Amendments) provides the most relevant information for their users, while also taking into account cost-benefit considerations; and

(b) entities that are eligible for the overlay approach but not for the temporary exemption from IFRS 9 will consider whether the overlay approach provides more relevant information for their users than applying IFRS 9 in the normal way, again while also taking into account cost-benefit considerations.

11 It follows that the inclusion of two options in the Amendments does not inhibit the provision of relevant information in the specific circumstances in which the Amendments have been developed. Given the options in IFRS 4 for the measurement of the insurance liability, and the short period until the forthcoming insurance contracts Standard is effective, allowing some flexibility for continuity in financial reporting has the potential to provide relevant information.

The temporary exemption from IFRS 9

Scope and eligibility criteria

12 The temporary exemption is intended to target those insurance entities that are most significantly affected by the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard (i.e. those that are predominantly insurance entities). Entities that conduct both insurance activities and substantial other activities, including financial conglomerates, are not eligible to apply the temporary exemption because they fail the predominance test described in Appendix 1, paragraphs 5 - 6.

13 The qualifying criteria in the Amendments reflect the complexity of the insurance business model and recognise that the activities of insurers are not limited to issuing insurance contracts as defined in IFRS 4. As a result, the types of liability regarded as being connected with insurance for the purpose of the predominance test have been extended to address the range of contracts entered into by insurers. For example, the accounting for non-derivative investment contracts, if measured at FVPL, would be the same under IAS 39 and IFRS 9. Because these contracts are common in an insurer's business model, including them in the predominance test supports the relevance of the predominance test in assessing eligibility to apply the temporary exemption from IFRS 9.

14 There may be insurers that are regarded by the market as pure insurers but that fail the 90 per cent predominance test. EFRAG considers that the second test of less than or equal to 90 per cent but greater than 80 per cent and not having a significant activity unconnected with insurance, smooths the bright line that could arise from a single quantitative threshold.

Temporary exemption at reporting entity level

15 The Amendments require the eligibility for the temporary exemption from IFRS 9 to be determined at the reporting entity level. This is consistent with the principle in IFRS 10 *Consolidated Financial Statements* requiring the use of uniform accounting policies when preparing consolidated financial statements. EFRAG assesses that requiring the use of either IFRS 9 or IAS 39 at the reporting entity level will result in similar financial assets being accounted for in a consistent way within the reporting entity.

16 EFRAG therefore assesses that applying the temporary exemption from IFRS 9 at reporting level is conducive to the provision of relevant information. EFRAG is however aware that some financial conglomerates with very sizeable insurance activities will fail the predominance test and would therefore not be eligible for the temporary exemption. EFRAG assesses that this limitation does not of itself prevent the Amendments from providing relevant information for those entities that qualify to use it. EFRAG also notes that application of both IFRS 9 and IAS 39 within the same set of consolidated financial statements would give rise to complexities such as the need for detailed rules for transfers of financial instruments between the insurance part of a reporting entity and the rest of that entity.

Reassessment of eligibility for the temporary exemption from IFRS 9

17 An entity is required to reassess its application of the temporary exemption from IFRS 9 if and only if there is a change in the entity's business activities during the reporting period. This reassessment provides relevant information in that it will highlight that the entity is no longer conducting significant insurance activities and will start to prepare financial statements on the same basis as other non-insurance entities.

18 In addition, an entity that did not initially qualify for the temporary exemption is permitted to reassess whether its activities are predominantly connected to insurance at an annual reporting date before 31 December 2018 if, and only if, there was a change in the insurer's business activities during that reporting period. This reassessment also provides relevant information because users of financial statements would be made aware of the change in business activity and they may adapt their evaluations and analyses accordingly.

Disclosures

19 The Amendments require disclosure of fair value information for (i) financial assets that give rise to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding (excluding any financial assets that meet the definition of held for trading in IFRS 9, or that are managed and whose performance is evaluated on a fair value basis); and (ii) all other financial assets.

20 EFRAG assesses that disclosure of this fair value information is relevant to users of financial statements because the entities that rely on the temporary exemption from IFRS 9 would not apply the impairment requirements in that Standard. Therefore, the fair value of these financial assets will provide relevant information such as an indication of expected credit losses under IFRS 9.

21 The Amendments also require an entity to disclose information about credit risk exposure for financial assets that meet the SPPI test. EFRAG considers that this

disclosure requirement provides relevant information because of the different impairment requirements under IFRS 9 and IAS 39.

22 Finally, the Amendments require disclosure of the fair value and the gross carrying amount under IAS 39 for financial assets that do not have low credit risk. This does not require the collection of new information because fair value disclosures are already required by IFRS 7 *Financial Instruments: Disclosures*. EFRAG considers that fair values (compared to the carrying amounts when applying IAS 39) will be relevant for users of financial statements in assessing the credit risk exposure for those riskier assets and the potential effect of applying the expected credit loss requirements in IFRS 9 because the fair values may provide a potential indication of impairment of the financial assets.

Temporary exemption from specific requirements in IAS 28 and first-time adopters

23 The Amendments include additional exemptions in specific situations which may affect the relevance of information provided. These additional exemptions include:

(a) a temporary exemption from requirements in IAS 28 *Investments in Associates and Joint Ventures* to use uniform accounting policies for the purpose of applying the equity method. This exemption could result in entities that apply IFRS 9 in their own financial statements using financial statements of an investee that are based on IAS 39 for the purpose of applying the equity method; and

(b) a temporary exemption from IFRS 9 for first-time adopters subject to the qualifying criteria being met, especially as many first-time adopters have previously applied requirements for financial instruments under national GAAPs that are not significantly different to IFRS Standards and they may have similar concerns about the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard.

24 EFRAG acknowledges that one of the reasons for these additional exemptions is the potential significant practical difficulties and/or additional costs that may arise for affected entities. EFRAG considers that the Amendments include adequate disclosures to compensate for the potential reduction in relevant information.

Effect of the application of the temporary exemption

25 In assessing whether the temporary exemption addresses the issues summarised in Appendix 1, EFRAG considers that classifications, designations and assessments made on application of IFRS 9 on its effective date might not be the same as those that would have been made had the forthcoming insurance contracts Standard been applied at the same time as IFRS 9. Entities whose activities are predominantly connected to insurance will be in a position to implement IFRS 9 with more complete information, and thereby achieve a higher quality implementation, if doing so in conjunction with the forthcoming insurance contracts Standard. This supports an assessment that temporary exemption from IFRS 9 is conducive to the provision relevant information for users of financial statements.

The overlay approach

Scope and eligibility criteria

26 The overlay approach permits the reclassification from profit or loss to other comprehensive income (OCI) of the additional accounting mismatches and temporary volatility in reported earnings that could arise from the application of IFRS 9 to specific financial assets before the forthcoming insurance contracts Standard is applied. The Amendments permit the entity to apply the overlay approach to any or all eligible assets.

27 The overlay approach provides entities with additional optionality by permitting flexibility as to which of the qualifying financial assets it is applied. This additional flexibility could detract from the relevance of the resulting information. EFRAG however considers this potential detriment to relevance should be assessed against the background of the very specific circumstances in which the Amendments have been issued. As discussed above, the overlay approach has been developed to address very specific short-term issues, and eligible entities can be expected to consider the relevance of the resulting information in selecting their approach.

28 Additionally, EFRAG notes that the designated financial assets will be accounted for under IFRS 9. This results in a balance sheet that is fully consistent with the application of IFRS 9 in the normal way. The application of the overlay approach results in some changes in fair value being recognised in OCI rather than profit or loss. However, the Amendments' presentation and disclosure requirements make the effect of the overlay approach transparent.

29 In these circumstances, EFRAG assesses that the scope and eligibility criteria for the overlay approach are conducive to the provision of relevant information for users. These criteria serve to limit the application of the overlay approach to financial assets where IFRS 9 introduces additional accounting mismatches and temporary volatility. That is, it would resolve the financial reporting-related concerns expressed about the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard for certain entities.

Presentation

30 The amount reclassified from profit or loss to OCI is presented as a separate line item in both profit or loss and OCI. The effect on individual line items in profit or loss of the reclassified amount is also disclosed.

31 EFRAG assesses that these presentation requirements for the overlay approach provide relevant information for users. These requirements achieve transparency and thereby facilitate comparisons with entities that apply IFRS 9 in the normal way and with qualifying insurance entities that apply the temporary exemption from IFRS 9. The presentation requirements also serve to remove or reduce additional accounting mismatches and temporary volatility in earnings.

Conclusion on relevance

32 EFRAG's overall assessment is that the changes brought by the Amendments are conducive to the provision of relevant information.

Reliability

33 EFRAG also considered the reliability of the information that will be provided by using the Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

34 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

The temporary exemption from IFRS 9

Scope and eligibility criteria

35 EFRAG considers that a quantitative test to assess whether an entity is predominantly connected with insurance provides a simple and objective assessment because information used in the test is readily verifiable from the entity's financial statements or internal financial information.

36 In EFRAG's view, the identification of liabilities that arise because the insurer issues or fulfils obligations arising from contracts within the scope of IFRS 4 and from non-derivative investment contracts requires a degree of judgement. This judgement may impact whether an entity would be eligible for the temporary exemption from IFRS 9. However, EFRAG assesses that this identification is unlikely to demand excessive judgement and notes that the Amendments provide guidance. Also, an entity needs to disclose how it concluded that it is eligible for the temporary exemption from IFRS 9, which would include this judgement, if material.

Reassessment of eligibility for the temporary exemption from IFRS 9

37 The Amendments provides a one-year lead time for entities to apply IFRS 9 if they are no longer eligible for the temporary exemption subsequent to reassessment of their eligibility. This will potentially lead to a rushed implementation of IFRS 9 which may affect the quality of the resulting financial information.

38 However, EFRAG considers that all entities that apply the temporary exemption from IFRS 9 will be aware that the temporary exemption has a fixed expiry date. EFRAG notes that an implementation of IFRS 9 by that date would require preparation in advance, thus entities would be expected to be preparing for the implementation. In addition, the level of experience of IFRS 9 implementation available in the market (including consultants and experienced personnel) is expected to increase significantly from the time the Standard was issued in 2014 to the time that an entity ceases to be eligible for the temporary exemption.

39 Based on the above reasons, EFRAG is of the view that a lead time of one year for implementing IFRS 9 after reassessing and failing eligibility for the temporary exemption would not prevent the provision of reliable information.

Disclosures

40 The Amendments requires an entity to disclose the fair value at the end of the reporting period and the fair value change during the reporting period separately for financial assets that are not SPPI (excluding any financial assets that meets the definition of held for trading in IFRS 9, or that is managed and whose performance is evaluated on a fair value basis) and for all other financial assets. This requires the entity to perform the SPPI test under IFRS 9.

41 Application of the SPPI test requires judgement to ensure that financial assets are appropriately classified. However, IFRS 9 includes substantial application guidance on the application of the SPPI test as well as several illustrative examples. Further,

EFRAG has no reason to believe that the assessment is more difficult for an entity applying the temporary exemption than for other entities. Therefore, EFRAG assesses that the criterion is expected to be applied reliably.

The overlay approach

Scope and eligibility criteria

42 Entities applying the overlay approach determine which financial assets relate to contracts within the scope of IFRS 4. In some cases, it could be easy to identify financial assets relating to particular contracts within the scope of IFRS 4, e.g. where those contracts reference specific financial assets, are contractually linked or where the entity allocates financial assets to particular portfolios of contracts that are within the scope of IFRS 4. However, there may be situations in which the relationship between financial assets and contracts within the scope of IFRS 4 is unclear or less robust such as in non-participating contracts.

43 However, EFRAG considers that minimising the number of criteria needed to identity the financial assets that are eligible for the overlay approach makes the approach easier to understand and apply consistently. This is particularly important given the temporary nature of this relief. Therefore, EFRAG assesses that the eligibility criteria for financial assets is conducive to the reliability of the resulting information, considering the balance of materiality and cost.

Conclusion on reliability

44 EFRAG's overall assessment is that the changes brought by the Amendments are conducive to the provision of reliable information.

Comparability

45 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

46 EFRAG has considered the Amendments results in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

Introducing two options – the overlay approach and the temporary exemption from IFRS 9

EFRAG's endorsement advice on IFRS 9 Financial Instruments

47 In considering the benefits and drawbacks of a temporary exemption from IFRS 9 for entities undertaking insurance activities, EFRAG noted the following in the section of its IFRS 9 endorsement advice assessing European public good:

> *The loss of comparability between entities undertaking insurance activities and other entities, banking entities in particular, relating to financial instruments amounts, cannot be denied; however, it is to be put in the perspective of the currently low level of comparability of the financial statements of entities undertaking insurance activities – among each other or with others – that results from the current situation under IFRS 4. The measurement of insurance liabilities currently differs between entities undertaking insurance activities because the current IFRS 4 has grandfathered previous national GAAP to the point that different GAAPs may be used in a same set of financial statements for the accounting of various insurance liabilities. Therefore, with or without a deferral option, the financial statements of insurance businesses will not reach any acceptable level of comparability before the new insurance contracts standard is introduced. As a result, the effects of the loss of comparability between companies and entities undertaking insurance activities on financial instruments amounts are not, in EFRAG's view, commensurate with the disruptive effects on financial statements as a whole that successive changes and accounting mismatches could have on users.*

Impact of two options

48 The Amendments introduce two options, i.e. the overlay approach and the temporary exemption from IFRS 9. Entities may also opt to apply IFRS 9 in the normal way. An entity can therefore choose from up to three possible approaches, depending on its circumstances. As a general rule, EFRAG considers that options serve to reduce comparability between entities' financial statements. However, the impact of these particular options should be assessed in the context of: (i) the lack of comparability of insurance entities' financial statements that currently exists; and (ii) the extent to which the use of these options can mitigate the disruptive effects of the misalignment between the effective dates of IFRS 9 and the forthcoming insurance contracts Standard.

49 EFRAG expects that entities will select an option that provides the most relevant information given the circumstances of that entity, taking into account cost and benefit considerations. EFRAG also notes that: (i) entities applying the overlay approach will also use IFRS 9; and (ii) the required disclosures result in the provision of information that will enable users to compare entities applying the temporary exemption and entities applying IFRS 9 (with or without the overlay approach). Finally, for financial conglomerates, EFRAG's assessment can be found in Appendix 3 below.

The temporary exemption from IFRS 9

50 EFRAG considers that the application of the temporary exemption from IFRS 9 only at reporting entity level could affect the ability of users to make meaningful comparisons of financial statements of pure (or predominant) insurance groups and the insurance divisions of financial conglomerates. EFRAG notes that the significance of this potential reduction in comparability needs to be weighed against the complexities that would arise from allowing the use of a temporary exemption (and hence different accounting policies for similar financial assets within the same business model) for different components of the same reporting entity. In addition, as noted in paragraph 47, this impact of this reduction should be considered in the current context of the lack of comparability among insurance entities' financial statements.

Predominance ratio

51 EFRAG considers that the predominance ratio being quantitative can be computed consistently because the calculation is simple and objective to apply. As a result, using such a ratio will increase comparability because entities will have a similar basis to assess whether they are eligible to apply the temporary exemption from IFRS 9.

Disclosures

52 The disclosures for the temporary exemption from IFRS 9 promote comparability between entities that apply the temporary exemption from IFRS 9 and entities that apply IFRS 9:

(a) an entity applying the temporary exemption from IFRS 9 is required to provide fair value information separately for (i) financial assets that give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding and (ii) all other financial assets. Financial assets that meet the definition of held for trading in IFRS 9, or that are managed and whose performance is evaluated on a fair value basis, are not included in the first category.

(b) entities applying the temporary exemption are required to provide information about credit risk exposure for financial assets that meet the IFRS 9 SPPI test. This disclosure enables users of financial statements to compare the credit exposure of financial assets between entities that apply the temporary exemption from IFRS 9 and those that do not.

(c) entities are required to disclose the fair value and the gross carrying amount of financial assets that do not have low credit risk at the end of the reporting period. This disclosure enables users of financial statements to compare the amounts of impairment and credit risk of financial assets between entities who apply the temporary exemption from IFRS 9 and those that do not.

53 There will be a reduction in comparability between the financial statements of entities applying IFRS 9 in the normal way, those applying the overlay approach and those applying the temporary exemption from IFRS 9. However, EFRAG considers that the disclosure requirements for the temporary exemption from IFRS 9 will enable the users of financial statements to make comparisons among these three categories of entity. The disclosures for the temporary exemption from IFRS 9 are similar to some of the disclosures required by entities applying IFRS 9.

Effective date and transition

54 Entities that are eligible for the temporary exemption from IFRS 9 and elect this option will continue to apply IAS 39. As a result, no changes will be needed for comparative information. Therefore, the financial statements would be accounted for in a consistent way through time.

Effect of the application of the temporary exemption

55 EFRAG assesses that users of financial statements may avoid the difficulties in predicting long-term economic performance of insurance entities and forecasting earnings based on profit or loss information if an entity whose predominant activities are insurance applies the temporary exemption from IFRS 9 instead of applying IFRS 9 before the forthcoming insurance contracts Standard. This results from the insurance entity continuing relevant trends until IFRS 9 is applied at the same time as the forthcoming insurance contracts Standard.

56 In addition, the valuation models for users of financial statements would not need to be changed twice in a short period of time, i.e. due to the effective date of IFRS 9 in 2018 and subsequently the implementation of the forthcoming insurance contracts Standard. Therefore, as a result of avoiding two significant consecutive changes, the users of the financial statements of these entities would continue to have trend information that is important for their analysis.

Applicability of the overlay approach and the temporary exemption from IFRS 9 to first-time adopters of IFRS

57 A first-time adopter of IFRS is permitted to apply either the temporary exemption from IFRS 9 or the overlay approach when it meets the qualifying criteria.

58 EFRAG considers that, for a first-time adopter of IFRS that applies the temporary exemption, its separate financial statements would be comparable to other entities that also apply the temporary exemption. In addition, it would also be comparable to its parent company if the parent company also applies the temporary exemption.

59 For the overlay approach, EFRAG notes that a first-time adopter applying the overlay approach would also apply IFRS 1 *First-time Adoption of International Financial Reporting Standards*. As for any first-time adopter, the restatement of comparative information makes the financial statements of the entity comparable over time and between entities.

60 Therefore, EFRAG assesses that extending the scope of the overlay approach and the temporary exemption for applying IFRS 9 to first-time adopters of IFRS would result in comparable information, in the light of entities' business models.

The overlay approach

Difference between de-designation of specific financial assets or ceasing to use the overlay approach

61 An entity that applies the overlay approach shall de-designate a previously recognised financial asset as relating to contracts within the scope of IFRS 4 only when there is a change in the relationship between that financial asset and the contracts within the scope of IFRS 4. If a financial asset is de-designated, the accumulated effect of the overlay adjustment is reclassified to profit or loss.

62 In contrast, an entity applying the overlay approach may stop applying the approach and the accumulated effect of the total overlay adjustment is reclassified to retained earnings without impacting profit or loss.

63 Consequently, the accumulated effect of the overlay adjustment could be allocated to profit or loss or to retained earnings. However, this difference responds to situations that are economically different.

64 EFRAG notes that designation and de-designation of financial assets as relating to specific liabilities is an established business practice whereby – for a particular time period – the performance of identified (financial) assets can be assigned to the policyholders of (most frequently) participating insurance liabilities. Although the

scope of the overlay approach is wider than relating to participating insurance liabilities, EFRAG assesses that the economic effects of this business practice are different from ceasing to apply the overlay approach in its entirety. In the former case, an insurer may replace the performance of one particular (financial) asset with the performance of another financial asset in order to ensure the promised return to the policyholder. In the latter case, the insurer no longer applies the overlay approach because it considers the reasons for doing so have disappeared or are balanced by other effects.

65 An entity that applies the overlay approach also applies IFRS 9. Hence, an entity that stops applying the overlay approach will as from the next annual period, apply IFRS 9 fully. Transitioning back to IAS 39 is not permitted. EFRAG assesses this as leading to comparable information over time for those particular entities.

Disclosures

66 The overlay approach isolates the impact of the difference between applying IFRS 9 and IAS 39 in a single line both in profit or loss and OCI. Therefore, EFRAG assesses that the disclosures will provide users with the information needed for a comparison of the impact on an entity using the overlay approach with the impact on entities that do not apply the overlay approach to all (or some of) their financial assets. Hence, applying the overlay approach can be compared to applying either the temporary exemption from IFRS 9 or IFRS 9 in the normal way.

Conclusion on comparability

67 EFRAG's overall assessment is that the changes brought by the Amendments may not provide comparable information but at the same time do not worsen the current lack of comparability between insurance entities. EFRAG considers that the lack of comparability is balanced by the relevance of the resulting information and the fact that the proposed options address the issues for most insurers arising from the misalignment of the effective dates of IFRS 9 and the forthcoming insurance contracts Standard. As the options are temporary in nature, and given the arguments listed above, EFRAG considers that the lack of comparability is acceptable.

Understandability

68 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting, and the willingness to study the information with reasonable diligence.

69 Although there are a number of aspects related to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

70 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendments is understandable, is whether that information will be unduly complex.

71 It is recalled that, in its endorsement advice relating to IFRS 9, EFRAG assessed that the information resulting from IFRS 9 was not unduly complex as the requirements in that Standard are generally built upon clear principles.

Temporary exemption from IFRS 9

72 For those entities applying the temporary exemption from IFRS 9, the disclosures will enable users of financial statements:

(a) to understand how the insurer qualified for the temporary exemption; and

(b) to compare insurers applying the temporary exemption with entities applying IFRS 9.

73 EFRAG assesses that the additional disclosures relating to how the insurer qualified for the temporary exemption are easy to understand because they are based on the carrying amounts of an insurer's liabilities or, in case of a reassessment, are based on a factual change in business activities.

The overlay approach

74 For those entities applying the overlay approach, the disclosures will enable users of financial statements to understand:

(a) how the total amount reclassified from profit or loss to OCI in the reporting period is calculated; and

(b) the effect of that reclassification on the financial statements.

75 EFRAG assesses that the additional disclosures relating to how the insurer has applied the overlay approach are easy to understand because they are based on the carrying amounts of the designated financial assets. EFRAG understands that designation of financial assets to particular insurance liabilities from time to time is an established business practice and assesses that the effects of this business practice are not new to specialised users of financial statements of insurers and consequently well understood by them.

Applying IFRS 9 Financial Instruments

76 Entities that do not choose to apply the temporary exemption from IFRS 9 or the overlay approach will apply IFRS 9 *Financial Instruments*. For those entities, EFRAG's earlier assessment, as noted in paragraph 71, remains valid.

Conclusion on understandability

77 EFRAG's overall assessment is that the changes brought by the Amendments are conducive to the provision of understandable information.

Prudence

78 For the purpose of this draft endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated and liabilities or expenses are not understated.

79 The Amendments introduce no new recognition and measurement requirements. Instead, the Amendments rely on the recognition and measurement requirements of IAS 39 and IFRS 9.

Temporary exemption from IFRS 9

Eligibility criteria

80 The temporary exemption from IFRS 9 is available to those entities whose activities are predominantly connected with insurance and which, based on their activities, would be faced with accounting mismatches that are due to the misalignment of the effective dates of IFRS 9 and the forthcoming insurance contracts Standard. By applying the temporary exemption from IFRS 9, eligible entities could avoid these accounting mismatches in their financial statements.

81 EFRAG has, in its IFRS 9 endorsement advice, assessed that IFRS 9 improves prudence in several areas. The most important area is the more forward-looking expected credit loss model for measuring loan loss provisions in IFRS 9, in comparison to the incurred loss model in IAS 39. In allowing predominant insurers to delay the application of this more prudent accounting, the temporary exemption is not conducive to prudence. However, in our endorsement advice in IFRS 9 we noted that insurance entities' holdings in debt-type assets is typically concentrated in assets of investment grade. This factor significantly mitigates any negative effects on prudence.

82 In addition, the negative effects on prudence should be balanced against avoidance of the accounting mismatches mentioned above. The scope of the temporary exemption from IFRS 9 is such that only entities that are significantly affected by accounting mismatches and resulting volatility will be able to use it. EFRAG assesses that this limitation in scope further serves to restrict the negative effects on prudence.

The overlay approach

Eligibility criteria

83 Examples of financial assets that would be measured at fair value through profit or loss under IFRS 9 but would not have been measured at fair value through profit or loss in their entirety when applying IAS 39 are debt-type financial assets that fail the SPPI test, equity instruments currently measured according to the available for sale category or equity instruments measured at cost in line with the cost exemption under IAS 39.

84 The overlay approach involves first applying IFRS 9 in the normal way, then reclassifying certain of the fair value changes from profit or loss into OCI through the mechanism of an overlay adjustment. The overlay adjustment could have a positive or a negative effect on profit or loss depending on the particular circumstances. However, this incremental information will have no effect when considered at the level of total comprehensive income. For this reason EFRAG assesses that the overlay approach is neutral to prudence. EFRAG also notes that the overlay approach results in the provision of additional information in comparison with applying IFRS 9 in the normal way.

Conclusion on prudence

85 EFRAG's overall assessment is that the options introduced by the Amendments either have no effect on prudence (overlay approach), or postpone certain improvements in prudence (temporary exemption from IFRS 9) but only in situations where this negative effect is appropriately balanced against other considerations such as relevance of the information.

True and Fair View Principle

86 A Standard or Amendment will not impede information from meeting the true and fair view principle when, on a stand-alone basis and in conjunction with other IFRS, it:

(a) does not lead to unavoidable distortions or significant omissions in the representation of that entity's assets, liabilities, financial position and profit or loss; and

(b) includes all disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss.

87 EFRAG assesses that the Amendments provide relevant, reliable, understandable information, do not reduce comparability and lead to sufficiently prudent accounting, taking into account the unusual and short-term circumstances that gave rise to them (i.e. the misalignment of the effective dates of two Standards both of which have a very significant impact on a particular sector).

88 EFRAG assesses that the Amendments do not create any negative interactions with other IFRS and are specifically designed to complement IFRS 4 and IFRS 9. Accordingly, EFRAG assesses that the Amendments do not lead to unavoidable distortions or significant omissions and therefore do not impede financial statements from providing a true and fair view.

89 EFRAG also concludes that the disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss are required.

90 As a result, EFRAG concludes that the application of the Amendments would not lead to information that would be contrary to the true and fair view principle

Conclusion

91 Accordingly, for the reasons set out above, EFRAG's assessment is that the Amendments meet the technical requirements for EU endorsement as set out in the IAS Regulation.

Appendix 3: Assessing whether the Amendments are conducive to the European public good

Introduction

1 EFRAG considered whether it would be conducive to the European public good to adopt *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts: Amendments to IFRS 4* ("the Amendments"). In addition to its assessment included in Appendix 2, EFRAG has carried out an impact analysis that considers a number of issues in order to identify any potential negative effects for Europe on the application of the Amendments. In doing this, EFRAG considered:

(a) whether the Amendments improve financial reporting. This requires a comparison of the Amendments with the existing requirements and how they fit into IFRS as a whole;

(b) the costs and benefits associated with the Amendments; and

(c) whether the scope of the temporary deferral of IFRS 9 could give rise to competition issues in the EU.

2 These assessments allow EFRAG to draw a conclusion as to whether the Amendments are likely to be conducive to the European public good. If the assessment concludes there is a net benefit, the Amendments will be conducive to the objectives of the IAS Regulation.

Whether the Amendments are likely to improve the quality of financial reporting

3 EFRAG notes that the Amendments have been developed to address a very specific, short-term situation, being the misalignment of the effective dates of IFRS 9 and the forthcoming insurance contracts Standard. In order to achieve the desired impact, the Amendments provide options that can be selected, depending on the circumstances of each entity, to minimise the adverse impact of that misalignment. A number of options for the measurement of financial assets is not inappropriate given the range options for measuring insurance liabilities that is available in accordance with IFRS 4. The range of options available in accordance with IFRS 4 will be much reduced under the forthcoming insurance contracts Standard.

4 EFRAG has therefore concluded that the Amendments are a necessary, even if unusual, solution to this very specific problem. EFRAG assesses that, without any remedy, the misalignment of effective dates would impact the quality of financial reporting by affected entities to varying degrees depending on their circumstances. Accordingly, the Amendments will serve to improve the quality of financial reporting relative to the situation without any remedies enabling insurers to reduce the impact of the misalignment.

Costs and benefits of the Amendments

5 EFRAG has considered whether, and if so to what extent, implementing the Amendments in the EU might result in incremental costs for preparers and/or users, and whether those costs are likely to be exceeded by the benefits to be derived from its adoption. This assessment has been based on the premise that IFRS 9 will be endorsed for use in Europe in accordance with its effective date of 1 January 2018.

Costs for preparers

6 In applying the Amendments, depending on their circumstances entities have the ability to choose to apply IFRS 9 in the normal way or to select between up to two alternative options.

Overlay approach

7 When applying the overlay approach, preparers also apply IFRS 9. Preparers will also incur incremental costs related to the application of the overlay approach. These incremental costs relate to the more complex record-keeping required in order to track information about eligible financial assets under both IAS 39 and IFRS 9 at financial asset level and the related supplementary internal controls.

8 Preparers will also incur incremental costs in preparing for the disclosures related to the overlay approach to ensure that users fully understand the impact of the overlay in the specific circumstances of the entity.

Temporary exemption from IFRS 9

9 When initially applying the temporary exemption from IFRS 9, preparers will incur costs to educate users and, more particularly, market participants about the reasons for applying the temporary exemption from IFRS 9. EFRAG assesses that preparers may have to organise special briefings for users and other affected parties in order to provide that education.

10 Preparers will also incur additional costs to provide users with information about their financial assets that would otherwise have resulted from applying IFRS 9. Preparers will thus incur costs in preparing the disclosures related to the temporary exemption from IFRS 9. EFRAG assesses that users may have additional information needs resulting in requests to preparers to provide that information. Such additional information needs may be based on the granularity of information that is provided by entities applying IFRS 9 and which is not provided to the same extent by entities applying the temporary exemption from IFRS 9.

11 Preparers will also incur costs in the preparation of disclosures for the temporary exemption since these disclosures include information to be provided to users of financial statements to enable them to make some comparisons with entities applying IFRS 9.

12 Preparers that apply the temporary exemption will implement IFRS 9 later than its normal effective date and will continue to apply IAS 39 in the meantime. At this later date, these preparers will have more complete information about the effects of the forthcoming insurance contracts Standard. If preparers were instead required to apply IFRS 9 on its normal effective date, they may need to revisit certain of their assessments and designations made on initial application of IFRS 9 when the forthcoming insurance contracts Standard comes into effect. Accordingly, use of the temporary exemption will to some degree serve to reduce overall IFRS 9 implementation costs by avoiding this additional work.

13 Preparers may further benefit from synergies in running a single project to implement both IFRS 9 and the forthcoming insurance contracts Standard at the same time,

rather than running two projects for each Standard in fairly quick succession, thereby reducing costs.

Conclusion – cost for preparers

14 Overall, EFRAG's assessment is that both options will result in additional costs for preparers. However, the temporary exemption will also lead to certain cost mitigations compared to implementing IFRS 9 on its normal effective date and implementing the forthcoming insurance contracts Standard at a later date. These cost mitigations might outweigh the additional costs. In any case, EFRAG expects that entities will consider the costs and benefits of each option that is available to them and select the option that is appropriate to their specific circumstances and in doing so take into account the relevance of the resulting information for users.

Costs for users

Overlay approach

15 EFRAG assesses that users will incur costs in understanding the amount of the overlay adjustment, its composition and its effects. EFRAG further assesses that in case of newly designating or de-designating financial assets to the overlay approach, users will incur costs in understanding the reasons for such changes in designation and the impacts on the overlay adjustment.

Temporary exemption from IFRS 9

16 EFRAG assesses that the IAS 39 requirements are well known by specialist users and thus there will be no additional cost relating to their continuous application. However, EFRAG assesses that specialist users may incur additional costs in understanding the basis for the application of the temporary exemption from IFRS 9.

17 EFRAG is aware that some users (mostly users who are not insurance sector specialists) have concerns about the costs to them of permitting the continued use of IAS 39. They argue that this will create difficulties in comparing insurance entities with non-insurance entities. However, EFRAG understands that the majority of entities that follow the insurance sector are specialist users. EFRAG further considers that the views of more specialist users should be given more weight in our assessment in this particular case.

Conclusion – cost for users

18 Overall, EFRAG's assessment is that both options will result in additional costs for users in understanding the (reasons for) the relevant approach chosen by the preparers in their specific situation. Further, some generalist users will incur additional costs in comparing insurance entities with non-insurance entities.

Benefits for preparers and users

Overlay approach

19 EFRAG assesses that the overlay approach will allow preparers to remove the volatility from profit or loss resulting from the misalignment of the implementation dates of IFRS 9 and the forthcoming insurance contracts Standard, for the selected eligible financial assets.

20 Users will benefit from relevant and transparent information provided under IFRS 9 and will receive complementary information in order to understand the implications of the overlay adjustment. They will further benefit in that volatility from additional accounting mismatches will not appear in profit or loss during this interim period before the application of full IFRS 9.

Temporary exemption from IFRS 9

21 EFRAG assesses that the temporary exemption will allow preparers to avoid recognising the volatility in profit or loss and accounting mismatches that would result from applying IFRS 9 before the forthcoming insurance contracts Standard. As noted above, preparers will also avoid the costs relating to a consecutive implementation of two related accounting standards.

22 Users will benefit from the temporary exemption because they can continue using their existing models until IFRS 9 and the forthcoming insurance contracts Standard are applied. EFRAG expects that the IASB will continue to make its best endeavours to issue the forthcoming insurance contracts Standard in sufficient time that the two standards can be applied at the same time by insurers electing to apply the temporary exemption from IFRS 9.

Conclusion – benefits for preparers and users

23 Overall, EFRAG assesses that the benefits for both users and preparers are likely to exceed the costs of applying the Amendments for the reasons stated above.

Potential competition issues within the EU

Temporary exemption from IFRS 9

24 EFRAG's endorsement advice on IFRS 9 was positive except for a reservation based on the impact on the insurance industry of applying IFRS 9 before the finalisation of the forthcoming insurance contracts Standard. As noted elsewhere in this letter, the Amendments provide two optional reliefs one or both of which will be available to all entities that undertake significant insurance activities. In that respect, some form of solution is available to the entire insurance industry.

25 However, one of the options in the Amendments - the temporary exemption from IFRS 9 – is available only to entities that are predominant insurers at the reporting entity level. EFRAG has assessed that most financial conglomerates (with both significant insurance and significant non-insurance activities) will fail the predominance test and not be able to apply the temporary exemption from IFRS 9 at consolidated level.

26 It should be noted that the IASB's decision to limit the optional temporary exemption from IFRS 9 to the reporting entity level is consistent with the long-established and fundamental principle that consolidated financial statements should be prepared using consistent accounting policies. EFRAG assesses that the Amendments provide for the use of consistent accounting policies for financial assets in the entity's financial statements. As a result, similar financial assets within the same business model would be accounted for in a consistent way within the same reporting entity.

27 In order to provide additional context for this assessment, EFRAG analysed the consolidated financial statements of 50 European-based groups that conduct significant insurance business. Based on disclosed insurance liabilities within this sample, EFRAG estimated that the optional temporary exemption from IFRS 9 will be available to approximately 75-80% of the industry in accordance with the Amendments. It will not be available to the remaining 20-25%, which is essentially the proportion conducted by the insurance divisions within larger financial conglomerates.

28 EFRAG has therefore considered whether this difference in the availability of the options in the Amendments could give rise to competition issues within the European insurance sector. Specifically, EFRAG has considered the extent to which financial conglomerates could be placed at a competitive disadvantage compared to predominant insurers that are eligible for the exemption. In this regard, EFRAG has been made aware of the following arguments that could be relevant from a competition perspective:

(a) Some argue that the inability to use the temporary exemption from IFRS°9 would give rise to a disincentive to invest in equities (relative to those entities that are able to use the temporary exemption) because:

(i) The risk appetite of some insurance companies, constrained by regulatory requirements, is based on several indicators, amongst which is IFRS profit or loss. For other insurance companies, the risk appetite is based mainly on regulatory requirements. The former category of insurance companies define maximum volatility levels for IFRS profit or loss and adjust their investment portfolios in light of this indicator;

(ii) IFRS 9 does not allow recycling to profit or loss of gains and losses for equity instruments held at fair value through OCI, in contrast to the treatment for the available for sale category in IAS 39. As a result, some argue that insurance companies applying IFRS 9 might choose to invest in financial assets that show less volatility such as bonds which overall also provide a lower return;

(b) Due to the non-recycling of gains and losses on equities held at fair value through OCI to profit or loss, some argue that financial conglomerates would have no practical choice but to report less relevant information about their performance; and

(c) The cost mitigations available to predominant insurers that are eligible for the temporary exemption (see paragraphs 12-13 above) would not be available to financial conglomerates.

Disincentive to invest in equities

29 In its endorsement advice on IFRS 9, EFRAG noted the following:

> *Some constituents have argued that the default requirement to measure all equity instruments, including unquoted ones for which a fair value is not reliably determinable, at fair value through profit or loss may negatively impact the investment appetite for equity instruments of long-term investors.*
>
> *For life entities undertaking insurance activities, measuring equity instruments at fair value through profit or loss may result in fluctuations in profit or loss that may not reflect the economics of their business, because the insurance liabilities which are backed by these assets are measured either at cost (based on existing IFRS 4 Insurance Contracts that allows the use of local GAAP) or at current value through other comprehensive income (based on a future insurance contracts standard). EFRAG notes that those entities undertaking insurance activities that already measure their insurance liabilities at current value through profit or loss (on the basis of the existing insurance contracts standard) do not have this issue.*
>
> *IFRS 9 provides an option to measure equity instruments that are not held for trading (or are not contingent consideration in a business combination under IFRS 3) at fair value through other comprehensive income which could reduce accounting mismatches, however some entities undertaking insurance activities are unlikely to avail themselves of this option. This is because any gains or losses in those equity instruments are never reclassified from other comprehensive income to profit or loss even when the equity investments are sold, while changes in the insurance liabilities due to changes in the current rate are recognised in or reclassified to profit or loss. Those entities undertaking insurance activities argue that the lack of reclassification makes it more difficult to portray the performance of their investment activities.*
>
> *It has been brought to the attention of EFRAG that other long-term investors, in certain European jurisdictions may face undesirable effects of measuring equity investments at fair value through profit or loss. These entities argue that they invest in equity investments with a long-term horizon and the fair value movements recognised in profit or loss on period-by-period basis does not reflect the economic reality of their business since any gains or losses on their equity investments will only be realised at expiry of their investment horizon. For these long-term investors, EFRAG believes that the option to recognise fair value changes in other comprehensive income is not a preferred solution. While it would remove the fluctuations resulting from unrealised gains or losses from profit or loss and recognise it in other comprehensive income, the prohibition on reclassification of accumulated gains or losses from other comprehensive income to profit or loss is regarded as distorting the performance of these entities given that these equity investments are held primarily for capital appreciation in the long run. EFRAG also believes that, as a consequence, this*

may lead to non-GAAP measures being developed by such entities to provide relevant information about their performance by removing the fluctuations caused by unrealised gains or losses from profit or loss. However, based on limited evidence, EFRAG assesses it is unlikely that these entities would change their investment strategy as a result of the implementation of IFRS 9.

30 In summary, therefore EFRAG assessed that IFRS 9 may not optimally reflect the business model of long-term investors in equities. However, EFRAG notes that this is a broader issue that extends well beyond the insurance sector. Moreover, in the context of the arguments made on disincentives to invest, EFRAG's endorsement advice on IFRS 9 also noted that "*EFRAG believes that broader economic considerations such as the need for entities undertaking insurance activities to obtain a yield on their asset portfolio sufficient to meet their obligations to policy holders are likely to outweigh any accounting concerns in deciding whether or not to invest in equity investments*".

31 In addition, EFRAG notes the following:

(a) the Amendments are of a temporary nature. The temporary exemption expires in 2021 or, if earlier, when the forthcoming insurance contracts Standard is applied. This contrasts with the long-term nature of the business model of insurance companies;

(b) the forthcoming insurance contracts Standard requires a measurement of insurance liabilities at current value, as do the Solvency II requirements. Some industry experts have informed EFRAG that Solvency II requirements are now a much more important driver of risk appetite than IFRS profit or loss; and

(c) the business practice of reallocation of financial assets may help in reducing any accounting mismatches. This is because very volatile financial assets can be re-allocated and replaced with less volatile financial assets within the same measurement category.

Less relevant information on performance

32 In order to determine the potential impact of the Amendments on the ability of insurers to report the results of their insurance activities, EFRAG reviewed the 2015 financial statements of 50 European-based groups that conduct significant insurance business. Of this sample, 14 were classified as insurance-led groups, 34 as financial conglomerates controlled by the ECB and 2 were financial conglomerates not-controlled by the ECB. Based on the 2015 financial statements, all but one of the 14 insurance led groups in the sample would clearly have the option to apply the temporary exemption from IFRS 9. One reinsurer would have to demonstrate it does not engage in a significant activity unconnected with insurance.

33 In the case of the 36 financial conglomerates in the sample, more than half did not identify their insurance business as a separate segment under IFRS 8 *Operating Segments*. Some considered their insurance business to be a sub-segment while others mentioned explicitly in their financial statements that the insurance business was part of one or more of their banking segments or as part of the "Other" segment. To the extent that information is available:

(a) the insurance liabilities of one of these financial conglomerates was greater than 90 percent of the entity's total liabilities, which would enable them to apply the temporary deferral; and

(b) for some other financial conglomerates, the insurance liabilities were less than 20 per cent of the entity's total liabilities, raising the question of the significance of insurance activities to these entities.

34 The main elements of information that were provided in the financial statements of entities failing the predominance test related to the technical reserves supporting the insurance activities and investment contracts, the income and expenses related to insurance activities and the risk management of the insurance activities. However, this information was not provided by all of them, neither was it done in a consistent way.

35 In its endorsement advice on IFRS 9, EFRAG considered that the temporary exemption should not be available to banking or "other" businesses within a financial conglomerate. Given the diversity in current reporting practices relating to insurance activities, EFRAG additionally assesses that, for those financial conglomerates that do not report separately on their insurance divisions in their financial statements (e.g. as a separate segment), the impact of applying or not applying the temporary exemption from IFRS 9 would not be visible at the level of the insurance business. Instead, any such effect would be integrated in the overall banking or "other" operating reporting segments.

36 Some may argue that information on the performance of the insurance business is provided to some specialised users such as analysts following the company. EFRAG notes that the relevant nature of information within the context of the IAS Regulation is to be assessed based on what is provided within the financial statements to ***all*** users of financial statements, not only to some privileged users. Hence, EFRAG does not agree with the argument provided.

37 EFRAG acknowledges that the recognition of losses on equity instruments in OCI without any recognition in profit or loss, even when the instrument can be deemed impaired, may not appropriately reflect an entity's performance in the view of those investors who expect to have all impairment losses included in profit or loss. However, this is an issue for all entities applying IFRS 9 and is not specific to the insurance sector.

38 EFRAG acknowledges that financial conglomerates may face additional accounting mismatches and volatility that pure (or predominant) insurers would be able to mitigate by using the temporary exemption from IFRS 9. The overlay approach is however available to conglomerates and would serve to mitigate the additional mismatches and volatility in profit or loss. However, the overlay approach involves higher costs and does not address volatility in equity.

Cost mitigations available to predominant insurers

39 EFRAG notes that all insurance entities will in due course be required to implement both IFRS 9 and (presumably) the forthcoming insurance contracts Standard, and will incur costs in doing so. Any differences in the cost burden between insurers that are eligible for the temporary exemption and those that are not therefore relate only to the timing of the implementation activities rather than the need to undertake them. However, as noted in paragraphs 12-13 predominant insurers that are eligible to use the temporary exemption from IFRS 9 will be able to make use of certain cost mitigations that are will not be available to financial conglomerates.

40 Financial conglomerates will be able to use the overlay approach which will mitigate the effects on profit or loss of the misalignment of effective dates. However, implementing the overlay approach will lead to additional costs over and above those incurred in implementing IFRS 9 in the normal way. Predominant insurers that can use the temporary exemption from IFRS 9 will be able to avoid the financial reporting effects without incurring these costs.

41 Set against these factors, EFRAG notes that financial conglomerates will need to implement IFRS 9 on its normal effective date in their non-insurance divisions irrespective of whether the temporary exemption could be used at the level of their

insurance business(es). Financial conglomerates will therefore need to establish an IFRS 9 implementation project in line with the normal effective date for the purpose of their consolidated financial statements, which is not the case for predominant insurers that are eligible to use the temporary exemption from IFRS 9. This is expected to result in synergies that will serve to mitigate the costs of implementing IFRS 9 within the insurance business(es). For example, EFRAG has been informed that the most significant cost incurred in IFRS 9 implementation arises from the need to upgrade or develop systems and models to apply the expected credit loss requirements, and that many entities are managing this on a centralised basis.

42 EFRAG has not been able to quantify these various cost issues or reach a conclusion as to whether they result in a competition issue of sufficient magnitude to warrant further action.

Other considerations

43 EFRAG notes that applying the temporary exemption below the reporting entity level would lead to the application of different accounting policies in the reporting entity financial statements, reducing the relevance of the information provided. This could be mitigated by the provision of proper presentation and disclosure requirements to enable users to understand the financial position and performance of the entity.

44 EFRAG further notes that applying the temporary exemption below reporting entity level would create the potential for earnings management or avoidance of the expected credit losses impairment requirements in IFRS 9 due to internal transfers of assets between the insurance business and the banking business of a financial conglomerate. This could be mitigated by additional requirements on how to account for internal transfers of assets.

45 EFRAG considers that without such mitigating requirements, the clear and complete effect of differences in accounting policies or earnings management would not necessarily appear within the financial statements, in particular in situations where the insurance business is part of the banking or "other" operating segment.

46 EFRAG notes that the Amendments as issued do not contain such requirements. In addition, EFRAG recalls that the predominance ratio has been widened in the Amendments, compared to the initial proposals of the IASB, permitting most predominant European insurers to benefit from the temporary exemption.

47 A concern has also been raised with EFRAG that application below the reporting entity level could give rise to competition issues between banking-led financial conglomerates and pure banks. This could arise because the use of different accounting policies for financial assets within same conglomerate would give rise to structuring opportunities that are not available to entities that apply the same policies throughout their group.

Overlay approach

48 EFRAG is not aware of any issues where the use of the overlay approach would affect competition between entities.

Conclusion on competition issues

49 EFRAG's analysis is that the scope of the temporary deferral from IFRS 9 results in certain cost mitigations being available to predominant insurers but not to the insurance divisions of financial conglomerates, and that the alternative solution (overlay approach) that is available to conglomerates addresses some but not all of the concerns over potential additional accounting volatility during the short period in question. EFRAG has not been able to quantify these matters and is not in a position

to conclude on whether they amount to a material competition issue from an economic perspective or merit any additional action at EU-level.

Conclusion on European public good

50 EFRAG considers that the Amendments will generally bring improved financial reporting when compared to a mandatory application of IFRS 9 at the same time as all other entities, with an acceptable cost-benefit trade-off. As such, their adoption is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management's stewardship.

51 EFRAG has not identified that the Amendments could have any adverse effect on the European economy, including financial stability and economic growth.

52 Furthermore, EFRAG has considered whether there are any other factors that would mean adoption is not conducive to the public good and has not identified any such factors.

53 Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing the Amendments, EFRAG assesses that adopting the Amendments is conducive to the European public good.