IFRS 17 *Insurance Contracts*
User Outreach Report

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Objective

1 The objective of this session is to provide EFRAG TEG members with feedback received during EFRAG's User Outreach regarding current accounting of insurance contracts and regarding IFRS 17 *Insurance Contracts*.

Introduction

2 In order to prepare its input to the IFRS 17 draft endorsement advice, the EFRAG Secretariat conducted interviews with users between April and May 2018.

3 This User Outreach report summarises the feedback received during the user outreach activities of 31 users.

Question for EFRAG TEG

4 Does EFRAG TEG have any comments on the user outreach report?

User outreach activities

What we did

5 EFRAG consulted a number of European investor and analyst users of financial statements through telephone/webcast meetings and some in person. The outreach aimed at obtaining user views on:

(a) how they analyse and value insurance companies currently;

(b) how current financial reporting under IFRS 4 *Insurance Contracts* affects their analysis; and

(c) expected benefits, costs and issues regarding IFRS 17.

6 Three users presented their views on IFRS 17 at the EFRAG Board meetings of 20 March 2018 and 30 May 2018.

7 In addition, the EFRAG Secretariat consulted the EFRAG User Panel on 15 May 2018.

8 The feedback received at these meetings is included in this report.

9 The report has to be read in the following context:

(a) Although the interviews were based on a structured questionnaire, the specific questions asked during the interviews were tailored to the individual interviewees individual circumstances (e.g. sell-side analysts were not asked about their holding horizons). Questions posed also considered the users' ability to respond based on their apparent knowledge of IFRS 17. As a result, not all questions were asked of all users.

(b) Users were clear that their views could change as they better understand the effect of IFRS 17.

Interviews conducted

10 EFRAG sent out a public call for users to be interviewed and also emails were sent out to investors and analysts drawing their attention to the public call. This analysis summarises the interviews with 31 users.

11 The types of users interviewed were mostly buy side and sell side analysts who focus on equities. Other users interviewed were bond or credit market investors/analysts, credit analysts, a researcher and private/retail investors.

12 The users focus on a range of different insurance businesses, e.g. life, non-life, reinsurance, multi-line and also asset management.

Executive summary

13 The main feedback from users are summarised as follows.

Current accounting

14 Regarding the analysis and valuation of insurance companies currently, there are a wide range of sources of information and metrics being used by both specialist and generalist users. The generalist users undertake their valuations more frequently than the specialist users.

15 Specialist and generalist users indicated the current application of IFRS 4 *Insurance Contracts* limits comparability between insurance companies. As a result, users need to rely on alternative measures and/or to adapt the figures in the financial statements.

Information under IFRS 17

Comparability

16 Most specialist and generalist users are expecting an improvement in comparability between insurance entities for various reasons. Users appreciated that there would be only one framework applicable across countries and that they would benefit from the enhanced disclosures. A few users that expected an improvement in comparability also thought IFRS 17 did not go far enough in building a uniform reporting framework.

17 A minority of users were not convinced that IFRS 17 would improve comparability. Those that raised comparability concerns provided examples of the source of their concerns, especially lack of comparability such as the need to apply judgement, the standard being principle-based for some aspects and the availability of options.

Presentation and disclosure

18 Specialist users found the requirement to split the presentation between underwriting and investing activities, in the statement of comprehensive income, would provide useful information.

19 Also, both specialist and generalist users indicated the importance and usefulness of disclosures under IFRS 17.

Volatility

20 Most of the specialist and generalist users did not see volatility as a problem as long as it reflects real economic substance and the underlying causes were communicated clearly. One user stated that volatility is seen by users as an opportunity to learn more about the capabilities of the management in steering their company. Also, specialist users indicated that they can adjust their figures for volatility.

Transition

21 Many specialist and generalist users were uncomfortable with the range of transition approaches offered by IFRS 17 and that it would cause comparability concerns. It is feared that these will create confusion. Further, specialist users note the possibility of window dressing, e.g. double counting of profits, at transition.

Expected impact on cost of capital/investability of insurance sector

22 A majority of the specialist and generalist users expect the cost of capital to decrease or not to change while a minority expects an increase. Some specialist users considered that an initial rise in the cost of capital of the industry as a whole is expected due to the need for all market participants to adapt to the new approach. Subsequently, a decrease in the cost of capital was expected.

23 Also, it was noted that the decrease in cost of capital would not be for all insurance companies. With the benefit of more detailed information about the insurance business, the cost of capital for some insurance companies might rise. Some indicated that the investability of the insurance sector was expected to increase while others thought that even though IFRS 17 will improve accounting, IFRS 17 may not necessarily make it more accessible for generalists.

Expected costs of IFRS 17

24 Both specialist and generalist users expected their costs to be minor, and the costs to be made were rather seen as an investment. A few specialist users expected material or significant costs.

Benefits of IFRS 17

25 The users interviewed ranged from still developing their IFRS 17 knowledge to being knowledgeable; the specialist users being more knowledgeable than the generalist users.

26 Both generalist and specialist users saw benefits to IFRS 17. For example, the identification of onerous contracts, profit earned as services are provided, disclosure of the assumptions used and measurement being closer to Solvency II.

Costs versus Benefits of IFRS 17

27 A majority of specialist and generalist users anticipated greater expected benefits compared to expected costs.

Concerns with IFRS 17

28 Some specialist users raised concerns about the treatment of reinsurance. Other concerns raised by specialist users included concerns about the impact of IFRS 17 on the business models, the information they would (or would not) get from insurance companies and whether IFRS 17 would help in understanding cash generation. Also, the existence of an additional framework in addition to Solvency II was seen as a challenge.

Detailed analysis

29 The table below presents the number of respondents interviewed by location based on expected investing activities and respective type of user.

Table 1: Number of respondents by location based on expected investing activities and type of user

Respondent by location based on expected investing activities:		***Respondent by type of user[1]:***	
Specialist users:			
Global	7	Buy side analyst:	
France	6	• Equities	5
Germany	4	• Bond or credit market	1
UK	2	• Equity and bonds	1
Norway	1	• Portfolio manager	2
Denmark	1	Sell side analyst: Equities	10
Italy	2	Credit analysts/Rating agency	4
Netherlands	1	Researcher	1
	24		**24**
Generalist users:			
Global	2	Buy side analyst: Equities	2
Europe	1	Sell side analyst: Equities	3
Hungary	1	Private/Retail investors	1
Belgium	1	EFRAG User Panel	1
Italy	2		
	7		**7**

30 The names of the individual users and their respective organisations have been treated on a confidential basis.

Detailed feedback

Analysis and valuation of insurance companies currently

Information used currently

31 Twenty-one specialist and generalist users consider the financial statements to be one of the sources of information. While one specialist user stated that he does not often use most of the details in the financial statements.

32 Eight specialist users provided other additional sources of information that they use to value insurance companies. The sources of information mentioned were company specific releases, official statistics of the regulator, Solvency II reports, information from Insurance Europe, sell-side reports, macro-economic and market information (such as interest rates, etc.), direct contact with decision makers (CFOs, CEOs) /investor relation departments/brokers, data from data aggregators, own

[1] These were the categories specified by the participants in the interviews.

valuation, non-GAAP credit measures, contracts, business profile and consultant reports on the industry.

33 These specialists focus on predicting earnings, financial return, governance, stewardship, focus on cash, dividends, sustainable profitability and sustainability of business model.

34 Four generalist users indicated that they use all information that they are able to obtain to value insurance companies. Examples provided, besides the financial statements, were press releases, information directly from companies or investor departments, liaise with management, Solvency II reports, embedded value information, ratio analysis, governance, news from the press.

Metrics used currently

35 Different metrics are used by different *specialist* users:

(a) For sell-side specialist users, the metrics used are price/earnings ratio; book value, Solvency II including capital generation/ embedded value information; cash flow generation, e.g., to determine how dividends are funded; dividend yield; profit recognition pattern in some markets using present book value or, for life business, embedded value; operating profit (as defined) and they look at profit sources to exclude volatility in order to identify underlying earnings potential; sustainable earnings and economic value.

(b) For buy-side specialist users, the metrics used are key performance indicators; key risk indicators; price/earnings ratio; combined ratio; use of population growth and book value growth for life business and looking at sustainable cash flows; metrics to assess dividend paying capacity; cash flow generation; top line (change in premiums); net in-flows in life insurance; expenses ratios; loss ratios; investment margin; annual premium equivalent; new business margin; investment return on assets; operating results; net income and shareholder equity; capital generation; business value that has been generated; earnings per share; embedded value information; return on equities and information on different lines of business. For life business, focus is on Solvency II/embedded value type measures.

(c) The specialist researcher mentioned that the combined ratio is used.

(d) A specialist credit analyst mentioned metrics such as relative profitability (including capital and profit metrics; leverage and coverage).

36 There were also different metrics used by different *generalist* users. The metrics stated were valuation multiples; price to book value; comparisons made to peer groups as well as over time; price/earnings ratio; information on volume and profitability; capital adequacy; capital generation; dividend yield; ratios comparing capitalisation in the market versus net worth of a company; fixed assets/sales; added value per personnel; working capital management and capex/sales.

Valuing an insurance company currently

37 There were different views on the frequency of updating the users' valuation models. However, the specialist users made their valuations less frequently than the generalist users.

38 For two specialist users, update/relooking of their models ranged from bi-monthly to bi-annually (although it may happen more often if necessary). For three generalist users, update/relooking of their models ranged from every week to a quarterly basis.

Number of years users forecast returns/profits or typical holding period

39 Regarding the specialist users:

(a) Five buy-side specialists provided a range of holding periods between 2 to 5 years. The forecast period for most of these specialist users ranged from 2 to 10 years. One of these users mentioned that for some companies, they look at 10 to 20 years while for others between 1 year and 20 years depending on mismatches arising between the financial statements and the user's valuations.

(b) Three sell-side specialist users look at earnings between three to ten years out.

40 Regarding the generalist users, one sell-side generalist user stated that he invests for the long-term, i.e. seven to eight years while another forecasts returns mainly for one year. A buy-side generalist user indicated that he has a holding horizon of three to six months and for strategic investments, one to two years.

Current financial reporting

Specialist

41 Fourteen specialist users indicated that current accounting under IFRS 4 does not allow for the comparison of financial information. These users also made the following comments:

(a) Six users noted that as a result of the comparability issue they make use of alternatives measures;

(b) Four users stated that they make adjustments to the information reported in order to make it comparable between companies;

(c) Two of the users indicated that they were not in favour of shadow accounting under IFRS 4;

(d) One user stated that there was too much financial noise and moving parts, e.g. liabilities on statutory basis vs market values vs Solvency II vs US GAAP vs embedded value; and

(e) Another user indicated that: (i) inconsistent accounting policies and profit recognition patterns makes comparative use of information overly complex and difficult to assess the dividend capacity; (ii) the wide use of discount rates for liability measurement leads to complications in assessing risk in models; (iii) permitted inconsistent consolidation policies are misleading (iv) capital allocations are based on policies relating to profit recognition and liability measurement that are differently applied and are not consistent across geographies; (v) it is difficult to make sense of some accounting policies used in light of the fundamental economics of industry.

42 In contrast to the above, one specialist user indicated that they use operating profit as defined and look at profit sources to exclude volatility in order to look at underlying earnings potential. This user was also in favour of using cash rather than accrual accounting.

Generalist

43 Four generalist users indicated that the current application of IFRS 4 makes it very difficult to compare insurance companies. One user specifically indicated that the mere aggregation of data prepared under various financial reporting frameworks for consolidation purposes makes the data provided meaningless. Therefore, they are unable to analyse and compare the results from one company to another. In the absence of comparable financial reporting, these users indicated that they rely on other measures to make a comparison.

44 In contrast, one generalist user indicated that the flexibility of IFRS 4 did not have a significant impact on the life insurance market and on financial statement

presentation. This user believed that the accounting principles used by insurance companies are uniform for the sector.

Information under IFRS 17

Comparability

<u>Specialist</u>

45 Seventeen specialist stated that IFRS 17 is expected to result in better comparability compared to IFRS 4 because:

(a) it would increase predictability of the future;

(b) it will bring more stability to earnings and disclosures on the source of earnings will enhance this;

(c) it will meet the users' requirements in respect of measuring the liabilities but more guidance was preferred on discount rate;

(d) there will be consistent accounting, including consistent revenue recognition, along with disclosures about the assumptions and better comparisons can be made on performance among other company types; and

(e) it introduces comparability across countries and increases the understanding of the accounting by different companies.

46 One specialist user was not sure at this stage whether IFRS 17 would result in better comparability but stated that IFRS 17 is a step in the right direction.

47 Seven specialist users (of which four were supportive of IFRS 17 but three were either not very supportive or were not sure of the impact at this stage) had comparability concerns under IFRS 17 due to:

(a) the options under IFRS 17 therefore the impact would depend from company to company. However, disclosures would help to reduce the comparability issue;

(b) judgement used by entities on variables used for their valuation of the insurance liabilities, e.g. discount rates. It was indicated that uniform application of these variables would arguably increase comparability;

(c) the risk adjustment having no standard calibration, although disclosures could help to alleviate this concern;

(d) no rule on how to calculate the duration of assets and liabilities and not requiring information by business line; and

(e) scope and local differences.

<u>Generalist</u>

48 Five generalist users stated that IFRS 17 is expected to result in improved comparability because:

(a) there will be one framework applicable to all and not a mixture of national standards;

(b) of the recognition of off-balance sheet items, the new revenue recognition guidance and separate presentation of the insurance and investment result; and

(c) there will be more relevant and transparent information.

49 One generalist private investor was not clear what the figures would be in the financial statements under IFRS 17 in terms of premiums and losses by line of business.

Presentation and Disclosure

<u>Specialist</u>

50 Nine specialist users stated that separate presentation between investing and underwriting results would be useful. One user thought it was too early to tell.

51 Four specialist users had the following individual views:

(a) Separate presentation of groups of contracts in asset and liability positions could be useful but it is not game changing in terms of how they look at things.

(b) The net result after reinsurance should be disclosed.

(c) More segment disclosure is needed as well as disclosure on sources of earnings.

(d) CSM run-off in aggregate and per product line should be disclosed.

<u>Generalist</u>

52 One generalist user noted that it is useful to limit the netting of groups of contracts that are in an asset position and groups of contracts that are in a liability position as netting can obscure important information.

53 Another generalist user welcomed the separate presentation of the insurance and investment result.

Volatility

<u>Specialist</u>

54 Twenty users provided the following reasons as to why they do not regard volatility as a problem:

(a) Eight users stated that as long as transparent information and communication from preparers enables them to understand the volatility;

(b) Nine users noted that volatility should reflect economic reality which is useful.

(c) Three users acknowledged that adjustments could be made to eliminate the effect of volatility; and

(d) One user had an expectation that under IFRS 17 they will see much more stable numbers.

55 However, one specialist user indicated that a potential increase in volatility of reported profit may be a concern while another stated that the magnitude of the impact is hard to quantify at this stage.

<u>Generalist</u>

56 Four generalist users indicated that volatility is not an issue as long as it reflects the real economic substance. These users indicated that:

(a) volatility provides insight into how management is dealing with economic setbacks;

(b) hiding volatility by showing stable results does not permit an assessment of the management of risks;

(c) volatility might increase the cost of capital in some cases but that is what is needed to accurately reflect the nature of the insurance business;

(d) volatility should be reflected especially for assets and liabilities; and

(e) current results lack credibility as they do not portray economic volatility.

Transition approaches

Specialist

57 Specialist users had the following comments:

(a) Nine users noted that the different transition methods would cause comparability concerns. Ideally only one transition method should be applied. Some users noted that disclosures could help users in understanding and making adjustments to the figures, but not everyone was convinced that the disclosures required by IFRS 17 were sufficient. One user was not particularly concerned by any impact on comparability;

(b) Six users had concerns or were not sure of the impact of the different transition approaches, e.g., concerns that people will choose the option they want in terms of opening balances and a window dressing, not necessarily choosing what is most appropriate (transition to Solvency II was used as an example) and concerns relating to taxation impacts. Two of these users also suggested that there was the potential for double counting of profits;

(c) One user expected that insurers will agree on a common approach; and

(d) One user noted that the restatement of in-force business would overwhelm users' understanding for a generation.

Generalist

58 Generalist users had the following comments:

(a) Transition period will be long and will create confusion for analysts but investor days should take care of that;

(b) There is a need for additional disclosures in order to cope with the options on transition;

(c) There is no perfect solution to the problem. It will be an uncomfortable journey but they can live with the transition options;

(d) The transition measures are seen as a practical expedient. Ideally only one transition method would be permitted.

Expected impact on cost of capital / Investability of insurance sector

Specialist

59 Specialist users had the following comments:

60 Seven users provided a balanced view:

(a) Six users noted a transition period would be necessary for the market to absorb the new accounting and its effects (getting acquainted with the new metrics). The cost of capital is initially expected to rise but after some time it should overall be lower or stay at the same level. This would apply to the insurance industry as a whole, but individual companies may see different results;

(i) This is because all market participants (issuers, investors, auditing firms, supervisors) will need time to adapt to this new approach and find a new equilibrium in terms of information provision:

- Issuers will need to develop common disclosure templates;
- Investors will need to understand the variables and transitional arrangements chosen by each issuer, the impact of the first-time application, the volatility induced by the new accounting rule, the impact on pricing;

- auditing firms will need to set benchmarks to challenge assumptions set forth by issuers;
- supervisors will need to provide supplementary guidelines to issuers, if the new equilibrium on disclosure poses risk to financial stability (access to financial markets, avoidance of the insurance sector).

(b) One user thought that the cost of capital would be lower but not for everyone.

61 Eight users thought the cost of capital would be lower or would not change at all.

62 Three users thought the cost of capital would increase.

63 Three users did not have any expectations on the impact of the cost of capital of insurers or were not yet in a position to form a view.

Generalist

64 Generalist users had the following comments:

(a) Four users thought the cost of capital would decrease because of more disclosures and increased comparability. This may attract new investors that currently avoid the insurance sector because of the complexity. Also, the investability of the sector was expected to increase. One of these users noted that if volatility were to increase, this would also increase the cost of capital but that would be a reflection of the underlying business.

(b) One user noted that the cost of capital may increase because investors that currently invest in the insurance industry for the dividends as a proxy for bond returns may find out that they are actually buying shares with the risks that are attached to it.

Benefits and costs of IFRS 17

65 The users interviewed ranged from those still developing their knowledge on IFRS 17 to being reasonably knowledgeable:

(a) Six specialists were knowledgeable of IFRS 17 but the other specialists were developing their IFRS 17 knowledge.

(b) Most generalists ranged from starting to look at IFRS 17 to having general knowledge of IFRS 17. Two generalists were reasonably knowledgeable about IFRS 17.

Expected costs

<u>Specialist</u>

66 Ten specialist users expected their costs to be minor/not significant. Costs expected to be incurred by these users are the following:

(a) Time needed for the learning curve and to understand the numbers;

(b) Adjustments to the users' models as companies change accounting or the way they disclose things and other IT costs; and

(c) Bridging different regulations, Solvency II, embedded accounting.

67 Three specialist users expected that material/significant costs will be incurred by them due to training, remodelling and making reconciliations.

68 One specialist user was not sure of the cost impact.

Generalist

69 Two generalist users expected their costs to be reasonable and to create value. They mentioned that there will be costs for them to understand IFRS 17. While one generalist user was not sure.

Would users update their valuation models more often than today and are any adjustments expected to IFRS 17 numbers?

Specialist

70 Six specialist users did not expect a huge/fundamental change in their models nor did they have issues with updating their models. One specialist user stated that changes are expected in modelling with IFRS 17 (which could be costly) in order to try and understand the information. Another specialist user stated that it was too early to assess the extent to which the valuation models will be changed.

71 Four specialist users considered that adjustments would be made to the IFRS 17 numbers and/or non-GAAP measures would continue to be used.

Generalist

72 One generalist user indicated that even under IFRS 17, analysts would always make adjustments to numbers for various reasons, this user also indicated that non-GAAP measures would continue to be used.

Benefits of IFRS 17

Specialist

73 Users made the following comments:

(a) As stated in paragraph 50 above, nine users noted that profit earned based on services provided and the split between underwriting and investing result was useful information to them. One user thought it was too early to tell. Of the ones that thought it was useful, the profit recognition pattern was considered more intuitive and makes more sense [than under current practices]. One of these users added that it was a good indication of how companies cope with the low interest rate environment.

(b) Some users stressed the importance of the disclosures, e.g., disclosing the assumptions used in measuring insurance liabilities.

(c) One user noted that discount rates should reflect what is happening in the real world, and that Solvency II was not helpful in this regard.

(d) One user saw a potential for significant improvements in corporate governance which will lead to benefit for regulators through better understanding of pricing policies, onerous contracts and risks.

Generalist

74 Users made the following comments:

(a) IFRS 17 will “fair value” insurance liabilities, which will reduce the “mismatch” between marked-to-market assets and liabilities. In this respect, IFRS 17 will move closer to the Solvency II approach, which is positive for the assessment from credit investors;

(b) There is an expectation that IFRS 17 may reduce the need to rely on non-GAAP measures;

(c) The identification of onerous contracts is not only useful information, it is also important in bringing discipline to the management of insurance companies to see the errors made in the past; and

(d) The split between underwriting and investing results is seen as very useful. In one user's view, some insurers compensate poor underwriting with successful investing activities, thus overstating the success of their core business.

Costs versus benefits of IFRS 17

75 The following users provided their views regarding expected costs versus expected benefits of IFRS 17:

Table 2: Costs versus benefits of IFRS 17

	Number of users
Expected benefits greater than expected costs	18
Expected benefits *not* greater than expected costs	1
Expected benefits equal to expected costs	1
Uncertain/cautious for the moment	4
No indication	7
Total	**31**

Concerns with IFRS 17

76 Twelve specialist users provided various concerns as follows:

(a) IFRS 17 would be a very different approach and view of the insurance world. It would be another big change after Solvency II and the time and effort spent understanding the effect of Solvency II;

(b) IFRS 17 would affect/change the business models of insurers (e.g. duration of liabilities which would alter the balance with assets, from an asset and liability perspective);

(c) any possibility of accounting arbitrage that may arise;

(d) the additional complexity under IFRS 17, e.g. difficulty to understand the CSM impact;

(e) lack of comparability between IFRS 17 and Solvency II as Solvency II does not require profit or loss and also due to the difference in discount rates;

(f) the annual cohort requirement is not comparable with Solvency II and losses taken upfront may have a negative impact as it does not reflect the underlying earnings;

(g) the use of estimates, as their valuation models refer to dividends that depend on cash generation;

(h) uncertain whether IFRS 17 would help in the understanding of cash flow generation;

(i) accounting will still be a 'black box' and extensive disclosures are needed; and

(j) the granularity of information and disclosures that will be obtained from companies. For example, how companies will separate product lines, what will happen with discount rates and any tax implications where tax is based on IFRS 17.

77 In addition, six specialist users raised various concerns/points to note regarding reinsurance accounting under IFRS 17:

(a) Concerns were raised regarding the mismatch in accounting of a primary insurer who obtains reinsurance, how that will work and whether users would be able to understand. For example, difficulties in understanding the asymmetry on reinsurance, relating to recognition of onerous contracts immediately for the underlying contract but including the reinsurance contract held on the balance sheet;

(b) The mismatch between reinsurance and insurance was not considered helpful and the net of the two would be preferred. Reinsurance and insurance are not considered separate businesses, and the net effect is considered;

(c) The future of reinsurance business could be under threat with the introduction of Solvency II and pricing for reinsurance could be changed in the future; and

(d) One user stated that he had witnessed an increase in accounting arbitrage contracts for reinsurance. He considered the new requirements to be helpful.

78 The concerns on IFRS 17 from three generalist users were:

(a) IFRS 17 is not easy to understand;

(b) There were concerns regarding the consistency of the assumptions used by insurers, especially the discount rate used; and

(c) IFRS 17 should be changed to require line of business reporting similar to that in Solvency II.